INDEX

CITATIONS

Cases:

Cases—Continued. Page

Cases—Continued. Page

Miscellaneous:

Miscellaneous—Continued.

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 34

FEDERAL POWER COMMISSION, CITY OF AKRON AND PENNSYLVANIA PUBLIC UTILITY COMMISSION, PETITIONERS

v.

HOPE NATURAL GAS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR PETITIONERS

OPINIONS BELOW

The opinion of the Circuit Court of Appeals is officially reported in 134 F. (2d) 287, and may be found at R. IV, 169–207.[1] The opinion of the Federal Power Commission is reported in 44 P. U. R. (N. S.) 1, and may be found at R. I, 1–89.

[1] In the record citations, roman numerals refer to the volume and arabic numerals to the page.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 16, 1943 (R. IV, 207). The petition for a writ of certiorari was filed on April 6, 1943, and was granted on May 17, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. § 347), and Section 19 (b) of the Natural Gas Act (15 U. S C. § 717r).

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act (52 Stat. 821; 15 U. S. C. § 717) are set forth in Appendix A, pp. 124–135.

QUESTIONS PRESENTED

The Federal Power Commission, acting pursuant to the Natural Gas Act, after complaints by the Cities of Cleveland and Akron and the Pennsylvania Public Utility Commission, and after extensive hearings, found that the interstate rates of Hope Natural Gas Company were unreasonable and unlawful and issued an order reducing the Company's future rates by $3,609,-857 annually. The Federal Power Commission adopted a "prudent investment" rate base. The circuit court of appeals invoked the "present fair value" theory to set aside the Commission's findings and order. The questions presented are:

1. Whether, for rate-making purposes under the Natural Gas Act, the Commission is author-

ized to use a rate base determined exclusively upon the basis of prudent investment measured by "actual legitimate cost" less depreciation,[2] or whether it must use a rate base which reflects estimates of the extent and effect of post-investment fluctuations in labor and material prices.

2. Whether the Commission must include in "actual legitimate cost" amounts previously and correctly charged to operating expenses, in accordance with industry practice of the time, and determined by the Commission to have been recouped through revenues received from rate payers.

3. Whether the Commission may determine actual existing (accrued) depletion and depreciation and the annual allowance in operating expenses for these factors, upon the basis of "actual legitimate cost," or whether the Commission must base such determinations upon estimates of the "present fair value" of the property.

4. Whether the court below erred in holding that in determining the actual existing (accrued) depletion and depreciation, the Commission failed to take into account "the present condition of the property."

[2] "Actual legitimate cost" (which Section 6 (a) of the Natural Gas Act authorizes the Commission to ascertain for natural-gas companies) less existing depreciation has been interpreted by the Commission to be "prudent investment." *Re Canadian River Gas Company*, 43 P. U. R. (N. S.) 205; *Detroit* v. *Panhandle Eastern Pipe Line Co.*, 45 P. U. R. (N. S.) 203; see *Re Chicago District Electric Generating Corp.*, 39 P. U. R. (N. S.) 263.

5. Whether the "economic-service-life" principle, as applied by the Commission in this case, is a reasonable method of determining the actual existing depletion and depreciation and the annual allowance therefor.

6. Whether the court below erred in holding that $165,963 for an experimental deep-test well, which was completed dry and charged to operating expenses in 1941, should have been included in 1940 operating expenses.

7. Whether the rates fixed by the Commission are just and reasonable in the statutory sense and nonconfiscatory in the constitutional sense.

8. Whether the Commission has jurisdiction to determine the *lawful* rates for interstate sales of natural gas at wholesale after the effective date of the Natural Gas Act of 1938 and prior to the issuance of a Commission rate-fixing order.

9. Whether the court below erred in holding that the Commission's "findings as to past rates * * * should be set aside."

STATEMENT

THE COMPANY

Hope Natural Gas Company ("Hope"), a wholly owned subsidiary of the Standard Oil Company (New Jersey), is conceded to be a "natural-gas company" within the meaning of the Natural Gas Act (R. III, 19). Hope purchases and produces natural gas in West Virginia, transports it in pipe lines to the West Virginia-Ohio

and West Virginia-Pennsylvania state lines, and there sells it in interstate commerce to its affiliates, East Ohio Gas Company and River Gas Company, for resale to ultimate consumers in Ohio; to its affiliate, Peoples Natural Gas Company, for resale to ultimate consumers in Pennsylvania; and to the nonaffiliated Manufacturers Light and Heat Company and Fayette County Gas Company for resale in Pennsylvania (R. I, 17). About 80% of Hope's total sales are in interstate commerce and 95% of such sales are to its aforementioned affiliates (R. I, 18). About 20% of Hope's total volume of gas is sold in intrastate commerce to local consumers in West Virginia. Hope has been purchasing, producing, transporting, and selling natural gas for more than forty years. Hope's interstate sales in 1940 amounted to about 53,000,000 MCF, and its interstate gross revenues in that year amounted to $19,296,755. (R. I, 51.)

Hope's only outstanding securities since its inception have been in the form of common stock, now having an aggregate par value of approximately $28,000,000. During the four decades of its operations, Hope has paid more than $108,000,000 in dividends, including $11,000,000 in stock dividends. The average annual yield on the average annual amount of Hope's capital stock issued for cash or other assets has exceeded 20%. (R. III, 15.) Hope's balance sheet at the end of 1938 showed a net investment, per books, in the entire

gas plant of approximately $15,500,000;[3] an investment in Government bonds of $11,000,000 and cash and investments of $5,500,000 (R. III, 21-24).

THE STATUTE

The Natural Gas Act, effective June 21, 1938 (the "Act"), requires that all rates or charges by natural-gas companies in connection with the transportation or sale of natural gas subject to the Act be just and reasonable, and declares any rate or charge that is not just and reasonable to be unlawful (Sec. 4 (a)). It provides that the Federal Power Commission, upon complaint of any State, municipality, State commission, or gas distributing company, or upon its own motion, whenever it finds that any rate is unjust or unreasonable, shall determine the rate to be thereafter observed and in force, and shall fix the same by order; and, further, that the Power Commission "may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates" (Sec. 5 (a)). Any State, municipality or State commission may file a complaint with the Power Commission, complaining of anything done or omitted to be done by any natural-gas

[3] Prior to 1938 Hope had transferred $7,500,000 from the depletion and depreciation reserves to earned surplus (R. I, 19, Ex. 61; R. III, 176–179). An adjustment to account for that transfer would reduce the $15,500,000 net investment per books shown as of 1938 to about $8,000,000.

company in contravention of the provisions of the Act (Sec. 13).

Under Section 14 (a) the Power Commission may investigate any matter "to determine whether any person has violated or is about to violate any provision of this Act" and may "make available to State commissions and municipalities, information concerning any such matter". Section 16 authorizes the Power Commission to perform any and all acts it may find necessary or appropriate to carry out the provisions of the Act. And Section 17 (c) requires the Power Commission to make available to the several State commissions "such information and reports as may be of assistance in State regulation of natural-gas companies".

PROCEEDINGS BEFORE THE COMMISSION

In July 1938, the Cities of Cleveland and Akron filed complaints with the Power Commission charging that the rates collected by Hope from East Ohio Gas Company ("East Ohio") were excessive and unreasonable (R. II, 1, 7). In October 1938, the Power Commission, on its own motion, instituted an investigation to determine the reasonableness of all of Hope's interstate rates (R. II, 28). In March 1939, the Pennsylvania Public Utility Commission filed a complaint with the Power Commission, charging that the rates collected by Hope from Peoples Natural Gas Com-

pany, Manufacturers Light and Heat Company, and Fayette County Gas Company were unreasonable (R. II, 18). The City of Cleveland's complaint, as amended and modified, prayed specially for a determination by the Power Commission that Hope's collected rates from East Ohio were unreasonable and therefore unlawful, and for a determination of just and reasonable Hope-East Ohio rates from June 30, 1939, to the date of the Power Commission's decision, requesting such determinations "in the aid of State regulation" and particularly to afford the Public Utilities Commission of Ohio a proper basis for disposition of a fund collected by East Ohio under bond from Cleveland consumers during the period since June 30, 1939 (R. II, 14).[4]

[4] The fund represents the difference between East Ohio's previous rates and the lower rates established by ordinance of the City of Cleveland, which East Ohio is collecting pending its appeal from the ordinance to the Public Utilities Commission of Ohio, under §§ 614–644 *et seq.* of the Ohio General Code. See *Public Utilities Comm. of Ohio* v. *United Fuel Gas Co.*, 317 U. S. 456, 463.

Representing that the Ohio Commission's determination of the reasonableness of the retail rate established by the City of Cleveland for sales by East Ohio to Cleveland consumers, for the years in which the fund was accumulated, "was ultimately dependent upon the lawfulness" of Hope's wholesale charge to East Ohio (R. II, 45), the City in its amended complaint of January 6, 1939, had requested the Power Commission to determine the lawful wholesale rates from and after June 21, 1938, to the effective date of its order fixing Hope's rates. In a brief subsequently filed before the Power Commission, the City limited the request to cover rates

In October 1939, the Power Commission consolidated for hearing the three complaint cases and its own investigation of Hope's interstate wholesale rates (R. II, 34). Hearings were held in 1940[5] and 1941, and after briefs were filed, the case was argued orally before the Power Commission sitting *en banc* on October 27, 1941 (R. II, 48). The Commission decided the case on May 26, 1942, when it entered an "Order Reducing Rates" charged by Hope and, in addition, separate "Findings as to Lawfulness of Past Rates" collected by Hope from East Ohio (R. I, 1, 8).

THE COMMISSION'S DETERMINATIONS

The Commission's "Order Reducing Rates" required Hope to reduce its interstate rates for the future to reflect a reduction of not less than $3,609,857 in operating revenues on an annual basis (R. I, 6). More particularly, the order re-

---

charged from and after June 30, 1939, for the reason that a settlement had made the question moot with respect to the earlier period originally covered.

[5] On December 20, 1940, the Power Commission denied without prejudice a motion of the Cities of Cleveland and Akron for an immediate order reducing the Hope-East Ohio rates upon Hope's own testimony, for the reason that "there is insufficient evidence of record, at this time, to support the prayer for relief requested by the movants," and subject to the reservation that "this order is not to be construed as a determination of any of the issues in the pending principal proceedings" (R. II, 43).

quired minimum reductions of 7 cents per MCF from the 36.5¢ and 35.5¢ rates previously charged East Ohio and Peoples Natural Gas Company, respectively, and 3 cents per MCF from the 31.5¢ rate previously charged Fayette County Gas Company and Manufacturers Light and Heat Company (R. I, 73–74). The Commission's "Findings as to Lawfulness of Past Rates", made in deciding the complaint of the City of Cleveland, determined that the rates collected by Hope from East Ohio were unjust, unreasonable, excessive, and therefore unlawful, by $830,892 in 1939, $3,219,551 during 1940, and $2,815,789 on an annual basis since 1940; and further determined just and reasonable rates for gas sold to East Ohio for resale for ultimate public consumption to be $11,528,608 for 1939, $11,507,185 for 1940, and $11,910,947 on an annual basis for 1941 and the first half of 1942 (R. I, 12–13).

The Commission founded its "Order Reducing Rates" upon a rate base of $33,712,526, upon which it granted Hope a 6½% rate of return, or $2,191,314 annually (R. I, 4). This rate base was determined to be the actual legitimate cost of Hope's interstate property less existing depletion and depreciation, plus allowances for unoperated acreage, working capital, and future net capital additions (R. I, 50).

The Commission's rate base was arrived at substantially as follows: The Commission found

that Hope had kept complete documentary evidence, through books, records, and vouchers, of its expenditures throughout its existence, so that no estimates were required to ascertain the actual legitimate cost of its property (R. I, 23, 174). Pursuant to a check of the inventory of Hope's property in service, and pursuant to an examination, analysis, and audit of Hope's records, the Commission determined the cost to be $51,957,416 as of December 31, 1940, for the property devoted to interstate sales (R. I, 3, 50). From this amount, the Commission deducted accrued depletion and depreciation, which it found to be $22,328,016 (R. I, 4, 45, 50).[6] It arrived at this figure by applying the "economic-service-life" method to actual legitimate cost (R. I, 41). In making these determinations the Commission was guided by a study conducted by a qualified staff engineer, who made a field inspection of Hope's physical properties to aid in the determination of service lives (R. I, 42; R. III, 158). To the cost, less accrued depletion and appreciation, the Commission then

[6] The actual existing depletion and depreciation found by the Commission came to about $24,000,000 *less* than the depletion and depreciation of some $46,000,000 which the Company had accrued on its books (R. I, 81). One of the Commissioners dissented on the ground that the Commission should have deducted from actual legitimate cost, accrued depreciation and depletion of not less than $38,000,000, the reserve remaining on the Company's books after it had transferred $7,500,000 from that reserve to surplus (R. I, 81). See n. 3, p. 6, *supra*.

added $1,392,021 for future net capital additions, $566,105 for useful unoperated acreage, and $2,-125,000 for working capital, yielding the total rate base of $33,712,526 (R. I, 50).

Using 1940 as a test year to forecast future revenues, and forecasting expenses at the 1940 figure plus $421,160, the Commission allowed Hope operating expenses and taxes amounting to $13,495,584 (R. I, 5, 65). Of this total $1,460,-037 represented the annual allowance for depreciation and depletion (R. I, 53, 65). This allowance was determined by the Commission in the same way as the actual existing depreciation and depletion, by the application of the "economic-service-life" method to the actual legitimate cost of Hope's properties (R. I, 51–52).

The Commission's "Findings as to Lawfulness of Past Rates" were arrived at on the same principles and in substantially the same manner as the "Order Reducing Rates," except that they were based on actual operating experience for the years in question, instead of a test year (R. I, 11).

In issuing its order and findings the Commission rejected Hope's argument that post-investment changes in price levels had to be reflected in the rate base and in computing both accrued depreciation and depletion and the annual allowance in operating expenses for these items (R. I, 20–23, 36, 41, 52). It condemned as hypothetical and without probative value the "reproduction cost new" and "trended original cost" estimates

(amounting to approximately $97,000,000 and $105,000,000, respectively) submitted in evidence by Hope in support of its claimed rate base of some $66,000,000 (R. I, 20–23). The Commission also rejected Hope's contention that, in any event, the rate base should have reflected an additional sum of about $17,000,000, largely representing expenditures for well-drilling prior to 1923 which Hope had charged to operating expenses (R. I, 24–34). Likewise unsuccessful was Hope's argument for adopting the "percent condition" theory of measuring accrued depreciation (R. I, 38).

Pursuant to Section 19 of the Act, Hope filed an application for rehearing (R. II, 51), and upon denial petitioned the United States Circuit Court of Appeals for the Fourth Circuit for a review of the Commission's "Order Reducing Rates" and the Commission's "Findings as to Lawfulness of Past Rates" (R. IV, 3).[7]

DECISION OF THE CIRCUIT COURT OF APPEALS

On review, the court below, with one judge dissenting, set aside the Commission's "Order Reducing Rates" on the basic grounds that: (1) the Commission's use of a prudent investment rate base failed to reflect "present fair value," in view

[7] Hope did not seek a stay of the Commission's order from the Circuit Court of Appeals and such order has not been stayed; instead Hope agreed with its customer companies to charge the ordered rates pending litigation, upon the customers' agreement to make Hope whole if the Commission's order should be finally invalidated.

of the post-investment "decided change" in price levels shown by the record and by judicially noticeable facts (R. IV, 172, 183–184); (2) the Commission erroneously excluded from the rate base the well-drilling costs previously incurred and charged to operating expenses prior to 1923 (R. IV, 172, 184–189); (3) the Commission improperly determined accrued depreciation on the basis of "theoretical formulas," without considering the present physical condition of Hope's property (R. IV, 172, 189–190); (4) the Commission should have based its annual allowance in operating expenses for depreciation and depletion upon the "present fair value" of the physical property, instead of upon actual legitimate cost (R. IV, 194–198); (5) the Commission should have included in 1940 operating expenses $165,963 for an experimental deep-test well, which was completed dry and charged to operating expenses in 1941 (R. IV, 198); (6) the Commission should have made an annual allowance for depreciation and depletion on capital added to the rate base after 1940 (R. IV, 196).

The court below also set aside the Commission's "Findings as to Lawfulness of Past Rates," holding that: (1) the Commission had no jurisdiction to make findings as to lawfulness of past rates "to be given effect in rate proceedings before state commissions," and that rates filed with the Commission under Section 4 (c) of the Act became the

only "lawful" ones which Hope could charge or accept until changed by the Commission; (2) the Commission could investigate "the conditions and rates of the past" as an incident of its power to fix future rates, but that so viewed the findings in question were invalid for the same reasons as its "Order Reducing Rates," and were also objectionable in that they were based on actual experience for the years in question, rather than reasonable estimates of expense based on experience during a prior period (R. IV, 200, 202).[8]

SUMMARY OF ARGUMENT

I

In judicial review under the Natural Gas Act the statutory and constitutional standards coalesce. As there is no question here of the adequacy of the Commission's procedure or the existence of evidence to support its basic findings, the question is whether its order, as applied to the facts before it and viewed in its entirety, produces an arbitrary result. *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 586. Thus tested, the order is clearly valid. The prescribed rates are plainly not arbitrary in the light of the financial history of the Company,

[8] On March 8, 1943, the court below granted a motion for the stay of its mandate pending further order, upon the condition that a petition for writ of certiorari be filed with the Supreme Court of the United States within thirty days (R. IV, 209). The petition was filed on April 6, 1943.

which discloses, through the payment of dividends and the accumulation of earned surplus, that it has earned the total investment in the Company nearly seven times over. If the Company's proffered rate base were accepted, its average rate of return during the preceding several years would have been only 3.27 per cent; so modest a rate, without protest, suggests an inflation of the rate base claimed. *Dayton Power & Light Co.* v. *Public Utilities Commission,* 292 U. S. 290, 311, 312; *Lindheimer* v. *Illinois Bell Telephone Co.,* 292 U. S. 151. Moreover, many doubtful items were resolved in favor of the Company, which aggregate over $26,000,000 in terms of the rate base, and more than $600,000 in terms of annual operating expenses; and the rate of return, 6½ per cent, is a generous one. The actual experience of the Company under the prescribed rates provides reassurance that in fact they were liberal.

We turn, nevertheless, to a consideration of the component determinations made by the Commission which were reviewed and set aside by the court below.

II

The Commission properly used prudent investment to determine the rate base. It found the base to be $33,712,526, calculated to be the actual legitimate cost of gas plant in service less accrued depletion and depreciation plus net capital

additions through 1943, unoperated acreage and working capital.

The statute clearly contemplates that the Commission should give primary if not exclusive emphasis to prudent investment, if constitutionally possible. There is, we submit, no constitutional barrier. The so called rule of *Smyth* v. *Ames,* requiring a fair return on the "present fair value" of the property, is unsound and unworkable. It is based on the eminent domain principle of just compensation for a taking of property, a principle which is inapposite to regulation. Criticism of the doctrine by informed sources has been persistent and weighty. On the basis of long experience, virtually all informed opinion is agreed that effective rate regulation on a fair-value basis is a practical impossibility and that the standard of prudent investment is sound in principle and eminently workable, is just to consumers and to investors, and will attract sufficient capital to secure adequate service.

The view of the court below, that price trends must be taken into account, would introduce in another way the same irrelevancies and uncertainties which have led to the breakdown of the present-fair-value rule. There should be no compulsion upon the Commission to employ formulas of that sort. If price trends are relevant as bearing upon stability of investment, this factor can be taken into account in determining the permitted rate of return.

III

In determining actual legitimate cost or investment, the Commission correctly refused to include in the rate base $17,000,000 representing largely intangible costs of well drilling properly charged to operating expenses before 1923. The Commission found that it was the accepted practice at the time for the industry to charge well-drilling expenditures to expense, that Hope deliberately and correctly accounted for such items as operating expenses, and that well-drilling expenditures had been contemporaneously recovered through revenues from the rate payers. In accordance with the overwhelming weight of authority, the Commission, although it was willing to and did correct genuine accounting errors, refused to include in the investment base the amounts previously and properly charged to operating expenses. To have included such amounts would have taken multiple exactions from the rate payers by compelling them to pay a return and an annual allowance for depreciation on the money they had already paid to the utility. The utility has no existing capital investment in the well-drilling costs for which the rate payers have reimbursed the Company, and is not entitled to a return on capital invested by its rate payers.

IV

The Commission properly used the economic-service-life principle in determining accrued de-

preciation. This principle embodies a consideration of the present physical condition of the property as well as a consideration of the functional causes of depreciation. By returning the full original investment, the method used is fair to the utility, investors, and consumers. The Commission's practice is one which has been analyzed and approved by this Court. *Lindheimer* v. *Illinois Bell Telephone Co.,* 292 U. S. 151, 167, 168. The method has likewise been approved by the Interstate Commerce Commission, the Bureau of Internal Revenue, and most utility commissions. Moreover, the amount deducted by the Commission for accrued depletion and depreciation was about $24,000,000 less than the amount which the Company had accrued on its books for depletion and depreciation.

V

The Commission properly used prudent investment as a base in determining the annual allowance for depreciation and depletion. The rates of depreciation and depletion were based on the economic-service-life principle and were thus correlated with the accrued depreciation and depletion. The rates were applied to the actual cost of the property. Under the decision of this Court in the *Natural Gas Pipeline* case, *supra,* a wasting asset business of limited life, such as the enterprise here involved, is in no event constitutionally entitled to no more than a return of its

actual legitimate cost of plant at the end of the economic life of the property. Any additional return would require the rate-payers to contribute to the capital of the company. See *Lindheimer* v. *Illinois Bell Telephone Co., supra,* at 169. The method applied by the Commission is that universally recommended and followed by business enterprises, economists, accountants, and state and regulatory agencies.

VI

Hope was not harmed by the exclusion from the operating expenses for 1940 of an experimental deep-test well completed in 1941, since the future allowance for that purpose was more than large enough to absorb any possible errors in accounting for the test year.

VII

In aid of state regulation the Commission exercised its broad investigatory and fact-finding powers to determine the extent to which Hope's interstate wholesale rates were unjust and unreasonable and therefore unlawful for the years 1939, 1940, 1941 and the first half of 1942. It is doubtful that these findings are here reviewable. See *United States* v. *Los Angeles & S. L. R. Co.,* 273 U. S. 299, 309, 310. There was, however, authority to make the findings despite the lack of reparation power. Cf. *Atlantic Coast Line* v. *Florida,* 295 U. S. 301. Resort to such authority

promotes the Congressional purpose of an efficient and harmonious dual system of rate regulation. *Public Utilities Comm. of Ohio* v. *United Fuel Gas Co.,* 317 U. S. 456, 467. The findings, like the order prescribing future rates, are supported by evidence.

ARGUMENT

I

VIEWED IN ITS ENTIRETY, THE COMMISSION'S ORDER PRESCRIBING RATES COMPLIES WITH THE STATUTORY REQUIREMENTS AND IS NOT CONFISCATORY

A. SCOPE OF JUDICIAL REVIEW

The Natural Gas Act and the decisions of this Court prescribe the division of functions between the Commission and the courts reviewing its rate orders. Section 19 (b) of the Act, conferring jurisdiction upon the circuit courts of appeals to review orders of the Commission, accords finality to the Commission's findings "as to the facts, if supported by substantial evidence." This fits within the general pattern of recent Congressional policy, revealed in other statutes, to entrust specialized agencies with the functions of appraising conflicting evidence, measuring the weight and credibility of testimony, and finding the facts. *Opp Cotton Mills, Inc.* v. *Administrator,* 312 U. S. 126, 154; *N. L. R. B.* v. *Link-Belt Co.,* 311 U. S. 584, 597; *Rochester Tel. Corp.* v. *United States,* 307 U. S. 125, 146; *Federal Trade Commission* v.

Algoma Co., 291 U. S. 67, 73. In this aspect, the judicial inquiry on review of the Commission's order is limited to whether a fair hearing was afforded the Company and whether there is substantial evidence to support the Commission's findings of fact. *St. Joseph Stock Yards Co.* v. *United States,* 298 U. S. 38, 51; *Interstate Commerce Commission* v. *Louisville & Nashville R. R.,* 227 U. S. 88, 91; *Virginia Ry. Co.* v. *United States,* 272 U. S. 658, 663; *Tagg Bros. & Moorhead* v. *United States,* 280 U. S. 420, 444; *Florida* v. *United States,* 292 U. S. 1, 12.

No question was raised below as to the finality of the Commission's factual findings, or as to the meeting of all procedural requirements. The court below did not hold that any of the Commission's findings, whether basic or ultimate, were not supported by substantial evidence; the record in fact contains substantial evidence to support each basic and ultimate finding made by the Commission.[8a] The court below likewise did not hold that Hope was denied a fair hearing; and here again the record clearly establishes the contrary. The Commission's order of October 3, 1939, fixing the date of the hearing, set forth all the issues involved and, pursuant to the Commission's rules

[8a] For example, original cost: R. I, 225–341; R. III, 25–81. Depreciation: R. I, 373–390; R. III, 25–81, 175–201. Rate of return: R. III, 224–365, 397–489. Working capital: R. III, 211–224. Income, allocation of costs of service: R. III. 224–365.

of practice, prescribed the procedure for Hope "to open and close these proceedings with the presentation of its evidence"[9] (R. II, 34–36). At the hearing, Hope was afforded and availed itself of full opportunity to present its evidence, to cross-examine witnesses, to test, explain or rebut evidentiary facts, to present briefs and oral argument, and otherwise to be heard on all the issues involved.[10]

Apart from the questions of procedural requirements and factual sufficiency, there remain solely the issues of whether the rates prescribed by the Commission are "just and reasonable" under the Act, and whether they violate any constitutional precepts of fairness. Rate-making orders must face in the courts the scrutiny to which administrative and regulatory orders of Government agencies in other fields are subjected (cf. *Gray* v. *Pow-*

[9] Sec. 50.63 of the Commission's Provisional Rules of Practice and Regulations under the Natural Gas Act.

[10] There were forty-three days of hearing, at which a comprehensive record of more than 14,000 pages of exhibits and testimony was produced and during which Hope presented its case-in-chief, cross-examined Commission witnesses, and presented rebuttal and surrebuttal testimony. Main and reply briefs were filed by Hope and by the other parties to the proceedings; these briefs included requested findings in great detail, both basic and ultimate, relating to all subjects involved in the proceedings. Oral argument was presented by Hope's counsel to all five members of the Commission on October 27, 1941. After the Commission issued its opinion and order fixing rates, Hope filed an extensive petition for rehearing and stay of the order.

ell, 314 U. S. 402; *South Chicago Coal & Dock Co.* v. *Bassett,* 309 U. S. 251), but there is no reason to require that they run any more formidable gauntlet.[11] In this aspect—the statutory and constitutional standards being substantially the same—the true test is whether "the limits of due process" have clearly been overstepped, and whether "the Commission's order, as applied to the facts before it and viewed in its entirety," produces an arbitrary result. *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 586. But in condemning the rates prescribed by the Commission, the court below did not view the Commission's order "in its entirety" in order to determine whether it produced unreasonable or confiscatory results. The court rather concerned itself with particular determinations of the Commission, contrary to the repeated pronouncements of this Court that the result of the rate fixed, not the method employed, is determinative (*West Ohio Gas Co.* v. *Public Utilities Commission,* 294 U. S. 63, 70; *Railroad Commission* v. *Pacific Gas & Electric Co.,* 302 U. S. 388, 394), and that the courts may not interfere unless the complaining party clearly establishes that the pre-

[11] See Black, Douglas, and Murphy, J. J., concurring in *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 608; Frankfurter, J., concurring in *Driscoll* v. *Edison Light & Power Co.,* 307 U. S. 104, 122; Brandeis, J., concurring in *St. Joseph Stock Yards Co.* v. *United States,* 298 U. S. 38, 78–82.

scribed rates are confiscatory. *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 305; *Lindheimer* v. *Illinois Bell Telephone Co.,* 292 U. S. 151, 169; *Dayton Power & Light Co.* v. *Public Utilities Commission,* 292 U. S. 290, 298; *St. Joseph Stock Yards Co.* v. *United States,* 298 U. S. 38, 53.

B. VIEWED IN THEIR ENTIRETY, THE COMMISSION'S PRESCRIBED RATES ARE PLAINLY NOT ARBITRARY

As shown hereinafter (pp. 33–49, 70–109), the Commission's rate order adequately meets even the supererogatory criteria adopted below. It is even clearer, however, that the Commission's results, when viewed in their entirely, meet every test of reasonableness and fall far short of confiscation.

1. *Hope's financial history*

The total rate reductions ordered by the Commission amounted to a decrease of about $3,600,000 in annual operating revenues (R. I, 6). The impact of this reduction upon Hope must be appraised against the background of the Company's financial history. From the time of its incorporation in 1898 through 1940, Hope's total issue of capital stock for cash or property has been about $17,000,000 (R. III, 7). On this investment, Hope has paid dividends of over $108,000,000 and has accumulated an earned surplus of over $8,000,000—thus earning its total investment in the Company

nearly seven times over.[12] During its entire business life, down to 1940, Hope has earned an average of more than 20% per year on the average annual amount of its capital stock issued for cash and other assets (R. III, 7, 15, 17).[13] After recouping all expenses, its overall net operating income or profit has exceeded $86,000,000 (R. III, 17, Sched. 4).

2. *Actual experience under prescribed rates*

A sound test to measure a complaint that rates are confiscatory is the actual financial experience of the public utility thereunder. *Lindheimer* v. *Illinois Bell Telephone Co.,* 292 U. S. 151, 163; cf. *Louisville* v. *Cumberland Tel. & Tel. Co.,* 225 U. S. 430, 433, 436; *Knoxville* v. *Knoxville Water Co.,* 212 U. S. 1, 16, 18; *Lincoln Gas Co.* v. *Lincoln,* 250 U. S. 256, 262, 268; *Brush Electric Co.* v. *Galveston,* 262 U. S. 443, 446. Even against the backdrop of its very profitable history, the actual experience of the Company under

[12] The precise figures are (R. III, 7, 15, 17):

Capital stock issued for cash	$15,600,000
Capital stock issued for property	1,369,300
Total	16,969,300
Dividends paid in cash	97,273,640
Dividends paid in capital stock	11,000,000
Total	108,273,640
Earned surplus accumulated	8,159,170

[13] On an average *invested* capital of $23,198,278, Hope has earned an average of $2,772,210 annually (R. III, 15), or about 12% per year.

the lower rates prescribed by the Commission, since July 15, 1942, when they became effective, answers any claim of confiscation.[14]

The Commission allowed Hope a 6½% rate of return on investment. During 1939, 1940 and 1941, the Company paid dividends of 10% on its common stock (R. III, 14); and in the year 1942, during about half of which the lower rates were in effect, it still found it possible to pay dividends of 7½%. During the three years 1940–1942, Hope's earned surplus increased by $8,500,000, to a total of almost $14,000,000, an increase sufficient to pay a 50% dividend on all outstanding capital stock (Appendix B, Table 4). The liquidity and affluence of the Company may be gathered from the fact that at the end of 1942, its financial position per books showed nearly as great an investment represented by cash and Government bonds as by net utility plant in service. (Appendix B, Table 4.)

In fixing the rates for the future, the Commission employed the Company's 1940 level of gas sales and revenues (R. I, 51, 70). But during the four years 1939–1942, Hope's interstate gas sales

[14] The results of the Company's operations for 1941 and 1942 are not in the record but have been made available by the Company to the Commission in sworn statement form. They appear in Appendix B, pp. 136–140, *infra*. At the oral argument we shall move for leave to have this material included in the record.

and revenues showed a considerable increase (Appendix B, Tables 1 and 2):

Year	Interstate gas sales, MCF	Interstate gas revenues
1939	41, 350, 559	$14, 866, 894
1940	53, 604, 243	19, 296, 755
1941	63, 685, 009	22, 835, 340
1942	69, 960, 811	25, 229, 783

The additional 16,000,000 MCF of gas sold in 1942 as compared with 1940 would, at the old rates, have correspondingly increased Hope's gas revenues more than $6,000,000 (Appendix B, Tables 1 and 2). Had the Commission used the 1942 level, which was not accompanied by a corresponding increase in operating expenses, the Commission would have been justified in making an additional substantial reduction in Hope's rates. For the prescribed rates, based upon 1940 operations and limited to a 6½% rate of return, would have resulted in a reduction of $4,757,452 in Hope's 1942 revenues, had they been in effect for the entire year; whereas if the rates had been based upon 1942 operations and likewise limited to a 6½% rate of return, the reduction in 1942 revenues would have been $5,849,242. Therefore, even under the prescribed rate reduction, Hope is earning $1,091,790 annually in excess of a 6½% rate of return, if the 1942 level is taken as the criterion (Appendix B, Tables 1, 1–A and 5). This excess of $1,000,000 is equiv-

alent to a 6½% return on a $16,800,000 investment, which is equivalent to adding this amount of investment to the rate base for the year 1942.

3. *The rate base sought by Hope does not square with its financial history*

How wide of the mark falls Hope's complaint of confiscation may be gathered by equating its average rate of earnings against the rate base to which it claims to be entitled. The Commission allowed a rate base of $33,712,526 (R. I, 50). Hope sought a base of some $66,000,000 (R. I, 20–23), founded upon estimates of "reproduction cost new" amounting to about $97,000,000, and estimates of "trended original cost" amounting to about $105,000,000, alleged to be evidence of present "fair value." These estimates were obviously too conjectural and illusory (R. IV, 180) to support a finding of confiscation as a result of their rejection in favor of the recorded and accurate cost figures. *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 319; *Railroad Commission* v. *Pacific Gas & Electric Co.,* 302 U. S. 388, 397. But apart from their unreliability, if Hope's estimates are accepted, Hope's average rate of return for the four-year period from 1937-1940 would amount to only 3.27% (R. I, 481). "So modest a rate suggests an inflation of the base on which the rate has been computed" for "men do not transact business without protest at confiscatory rates." *Dayton Power & Light Co.* v.

Public Utilities Commission, 292 U. S. 290, 311–312. Not only has Hope never seen fit to apply for leave to increase its rates pursuant to Section 5 (a) of the Act, but its gas plant has been well maintained and operated and during this period it has received an annual average return of about 9% on the average investment (R. III, 13–17; 21–24). Such a financial history completely disposes of any contention that during the years 1937–1940 Hope was not receiving an adequate return. Cf. *Lindheimer* v. *Illinois Bell Telephone Co.*, 292 U. S. 151.

4. *Doubtful items of substantial amount were resolved by the Commission in Hope's favor*

The reduction in rates ordered by the Commission, amounting to about $3,600,000 annually, was reached after the allowance of substantial items in the rate base and in operating costs which the Commission might well have excluded. The resolution of these doubts in Hope's favor by the Commission, resulting in an increase in the rate base of perhaps $26,000,000 and an increase in allowed operating costs of some $600,000, renders well-nigh impossible any clear or convincing showing that the prescribed rates are confiscatory. Cf. *Lindheimer* v. *Illinois Telephone Co.,* 292 U. S. 151, 175. These are some of the more important instances in which doubts were resolved in favor of Hope and liberal allowances made to it as a consequence:

1. Items totalling almost $26,000,000 were included in the rate base although strong arguments were presented for their exclusion, to wit:

(a) The Commission included in the rate base $1,295,953 representing plant costs in 1918–1923, which were first capitalized by Hope and then arbitrarily charged off to operating expenses (R. I, 35). Since the Company had already recouped that amount from the revenues paid by rate payers during the years for which those items were included in operating expenses, the Commission would have been justified on purely equitable considerations in excluding that total from the rate base.

(b) The Commission (one member dissenting) deducted from actual original cost only $22,328,016 for accrued depletion and depreciation. This was about $24,000,000 less than the amount which Hope had already accrued on its books for depletion and depreciation (R. I, 50, 80–89; R. III, 175–176). Hope could hardly have been heard to complain if the Commission had accepted the Company's own figures, as Commissioner Scott urged; yet the lesser sum was deducted, giving a correspondingly larger rate base.

(c) The Commission included in the rate base Hope's entire gas acreage costing $566,105, notwithstanding that some of it is not being presently used in the Company's business and therefore might well be rejected as a base for a return to the Company (R. I, 47–48).

(d) As the court below noted, the Commission included in the rate base $277,820 more for working capital than Hope's corrected claim totalled for that item (R. IV, 193–194).

2. Doubtful items totalling more than $600,000 were added to annual operating expenses and thus reflected in the prescribed rates, to wit:

(a) The Commission allowed, on a cost basis, $1,460,037 in annual operating expenses for annual depletion and depreciation. This allowance is greater by some $120,000 than that which Hope's claimed annual rates for depreciation would have produced (R. I, 52–53; R. III, 207–209).

(b) At the Company's request, $138,018 for administrative and general expenses was allowed in operating expenses for 1940, although such amount was formerly capitalized by election of the management (R. I, 49–50).

(c) The Commission added $421,160 to the 1940 figures for operating expenses, which already exceeded 1939 operating expenses by $2,300,000 (R. I, 62). This included an allowance for increased West Virginia property taxes, even though the Company had represented to the Commission that, as a result of the ordered rate reduction, it expects to save $338,000 annually in West Virginia property taxes (Hope's Reply Brief before the Federal Power Commission, p. 52).

3. The Commission allowed Hope a return of 6½% upon its rate base (R. I, 4). This is to be contrasted with the 5½% return allowed by the

Commission to electric utilities (*Chicago District Electric Gen. Co.,* 2 F. P. C. Rep. 412 (1941)), and the even lower rate of 5% allowed by the Illinois State Commission—a rate which in itself raises no substantial Federal question. *Peoples Gas Light & Coke Co.* v. *Slattery,* 373 Ill. 31, 25 N. E. (2d) 482, appeal dismissed, 309 U. S. 634. See also *Knoxville* v. *Knoxville Water Co.,* 212 U. S. 1, 17.

In the acoustics of such liberality, the cries of confiscation ring hollow indeed.

The court below rejected the Commission's order prescribing rates because of what it regarded as a failure to observe certain required formulae in computing the rate base and the annual operating expenses. Even if the court was qualified to consider separately each item going into rate base and operating expenses, and the methods and theories of computation utilized by the Commission, we believe the objections to the Commission's order were unfounded.

These objections, which will be treated under Points II through VI of this brief, are directed to the use of a prudent investment rate base (Point II), the exclusion therefrom of certain well-drilling expenses (Point III), the determination of the accrued depreciation and depletion (Point IV), the annual allowance for such items (Point V), and the exclusion from 1940 operating expenses of expenditures for an experimental well (Point VI).

II

THE COMMISSION MAY PROPERLY USE A "PRUDENT INVESTMENT" RATE BASE

Chief among the court's objections to the Commission's order was the use of Hope's "prudent investment" in its interstate plant to compute the rate base. Since Hope had kept complete documentary evidence of its expenditures throughout its entire existence, the Commission found that this was the best evidence of the actual legitimate cost of Hope's plant, so that no estimates were needed (R. I, 23, 174). Upon the basis of Hope's own records, and after a check of the inventory of Hope's property in service, the Commission determined the cost of Hope's facilities devoted to interstate commerce, as of December 31, 1940, to be $51,957,416 (R. I, 3, 50). After deducting therefrom accrued depletion and depreciation, and adding thereto certain items for working capital, future capital additions and useful acreage, the Commission obtained a total rate base of $33,712,526 (R. I, 45, 50). Hope, on the other hand, claimed a rate base of some $66,000,000, and to support it offered evidence of "present fair value," consisting of estimates of "reproduction-cost-new" of Hope's plant, amounting to about $97,000,000, and estimates of "trended-original-cost" of the plant amounting to about $105,000,000. These estimates the Commission admitted in evidence and analyzed. However, it discarded them

as not being predicated upon facts and as too hypothetical, conjectural, and illusory to be accorded probative value in the proceedings (R. I, 20–22). The Commission also rejected Hope's argument that post-investment changes in price levels had to be reflected in the rate base (R. I, 20–23, 36, 41, 52). It accordingly adopted as the rate base the actual legitimate cost (depreciated) of the Company's facilities used in interstate commerce (R. I, 20–21, 36–50).[15]

The court below agreed with the Commission that Hope's estimates of "reproduction-cost-new" and "trended-original-cost" were too conjectural and illusory to be given any weight in determining the rate base (R. IV, 180). It nevertheless ruled that the prescribed rates were both confiscatory in the constitutional sense and unjust and unreasonable in the statutory sense,[16] for failure to reflect, as required by the rule of *Smyth* v. *Ames,* 169 U. S. 466, the increase in the present fair value of Hope's property since it had been installed, caused by the decided rise in the price level which the court discerned in Hope's estimates and of which it took judicial notice (R. IV, 180).

---

[15] By stipulation, Hope's distribution property and property used to transport coke-oven gas were excluded from the proceeding (R. I, 18).

[16] The lower court recognized, in accordance with *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, 586, that the statutory standard of "just and reasonable" (Section 5 (a)) coincided with the constitutional test of confiscation (R. IV, 175).

In so holding, the court below disregarded the clear intent of Congress that the Commission should, subject to constitutional limitations, use prudent investment in determining the rate base. It likewise disregarded the recent decision of this Court in *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, indicating that a rate base so determined is not *ipso facto* unconstitutional. Moreover, the court below imposed upon the Commission, without warrant in law, an obligation to find a "present fair value" of Hope's interstate properties on the basis of price trends.

A. THE NATURAL GAS ACT CONTEMPLATES USE OF PRUDENT INVESTMENT IN DETERMINING RATE BASE, SUBJECT TO CONSTITUTIONAL LIMITATIONS

The Natural Gas Act requires that interstate gas rates shall be "just and reasonable" (Sec. 4 (a)), and empowers the Commission to prescribe "just and reasonable" rates for the future and to order a decrease where existing rates "are not the lowest reasonable rates." (Sec. 5 (a)). The only formulae laid down by Congress to guide the Commission in exercising its rate-making powers, are those contained in Section 6:

> SEC. 6. (a) The Commission may investigate and ascertain the *actual legitimate cost* of the property of every natural-gas company, the depreciation therein, *and, when found necessary for rate-making purposes,* other facts which bear on the determination

> of such cost or depreciation and *the fair value of such property.*
>
> (b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the *original cost* thereof, and shall keep the Commission informed regarding the *cost* of all additions, betterments, extensions, and new construction. [Italics supplied.]

The emphasis upon actual and original cost, and the absence of any mention of "present fair value," lead to an inference that Congress intended the Commission to put primary if not exclusive reliance upon prudent investment. This inference becomes a definite indication of Congressional intention when considered with the House and Senate Committee reports on the bill which became the Natural Gas Act. These reports, in making a sectional analysis of the bill, refer only to original cost and not to "fair value" (H. Rep. No. 709, 75th Cong., 1st Sess., p. 5; S. Rep. No. 1162, 75th Cong., 1st Sess., p. 4).

That Congress desired the Commission to base rate making on prudent investment to the extent the Constitution permitted, is further to be gathered from a statute in *pari materia* with the Act here involved, and entrusted to the administration of the same agency: the Federal Power Act, enacted as Title II of the Public Utility Act of 1935. As originally introduced in the Sen-

551452—43——4

ate, Section 208 of S. 2796 (which became the Federal Power Act), whose language is identical with that of Section 6 of the Natural Gas Act, specifically placed rate regulation on the prudent investment basis. S. 2796, 74th Cong., 1st Sess. The Senate Committee on Interstate Commerce in favorably reporting the bill, approved such a rate-making basis (S. Rep. No. 621, 74th Cong., 1st Sess., at p. 52):

> Rate regulation must eventually be based on prudent investment. Recent decisions of the Supreme Court * * * afford grounds for the hope that this rule which the Committee considers essential to effective rate regulation will be sustained if the Congress should now definitely adopt it as a legislative policy.

An amendment offered by Senator Bailey, requiring the use of "fair value" as the rate base was not accepted (79 Cong. Rec. 8858), and on June 11, 1935, the Senate passed S. 2796, providing in Section 208 (c) that in determining just and reasonable rates, the Commission shall fix a rate base "not in excess of the actual legitimate cost of the property." 79 Cong. Rec. 9065; see also S. Rep. No. 621, 74th Cong., 1st Sess., p. 20.

However, on June 3, 1935, this Court had reaffirmed the doctrine of *Smyth* v. *Ames* in *West* v. *Chesapeake & Potomac Tel. Co.*, 295 U. S. 662. The House Committee apparently read the *West* decision as casting doubt on the constitutionality of

adopting prudent investment as the exclusive rate base, for in considering S. 2796, it deleted Section 208 (c) and inserted Section 208 (a), authorizing the Commission to ascertain actual legitimate cost, with the further authorization to ascertain "fair value," "when necessary for rate-making purposes." H. Rep. No. 1318, 74th Cong., 1st Sess., p. 30.

This legislative material leads to the conclusion that while Congress did not bind the Commission to the use of any single formula in determining the rate base (*Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575), it did intend the Commission to use prudent investment, and to consider "fair value" only if constitutionally necessary. Independent legal opinion, exemplified in the 1940 report of the Special Committee of the Public Utility Law Section of the American Bar Association, concurs in this view.[15]

---

[15] The Committee, analyzing Section 208 of the Power Act and the companion Section 6 of the Gas Act, stated (1940 Report, pp. 14–15):

"It will be noted that the primary duty of the Commission under these two provisions is to ascertain the cost of the property and the depreciation therein and that 'other facts which bear on the determination of such cost or depreciation, and fair value of such property' are to be determined only 'when found necessary for rate-making purposes.' There is here the possible inference that the Congress, when it drafted this provision, was hopeful that the courts would decide that nothing other than the 'actual legitimate cost' of the property would be 'found necessary for rate-making purposes.' However that may be, it is patent that an accounting or cost rate base was dominant in the Congressional mind, and that these

B. THERE IS NO CONSTITUTIONAL PROHIBITION AGAINST THE DETERMINATION OF A RATE BASE SOLELY ON PRUDENT INVESTMENT

This Court, in *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, had before it the propriety of a base selected by the Commission under the Natural Gas Act for the determination of an annual amortization allowance chargeable to operating expenses. This Court ruled that the owner of a "wasting-asset business of limited life" such as the company there involved, has no constitutional right to a return of more than its original investment, even though the reproduction cost of the company's property during the period in question is greater than the original cost. The reason assigned for the validity of disregarding the appreciation in the value of the plant was that "this theoretical accretion to value represents no profit to the owner, since the property dedicated to the business, save for its salvage value, is destined for the scrap-heap when the business ends" (315 U. S. at 593). While this issue did not involve the determination of a rate base on which the owner is entitled to a return, the applicable principles would seem to be the same as where a base for annual amortization allowance is in question. For if the owner of a "wasting-asset business of limited life"

---

very recent statutes in that respect are the very antithesis of some of the older state statutes which prescribe the reproduction cost new less depreciation formula."

does not have a constitutional right to recover more than his original investment, he can scarcely be entitled to an annual fair return upon more than such investment. The "theoretical accretion" to the original investment, which under the decision of this Court need not be returned to the owner in the form of annual amortization allowances, by parity of reasoning need not be recognized as a basis for an annual return in the form of earnings. Any line of distinction between these propositions would produce the anomaly of a requirement that an owner receive an annual return *upon* the accretion without being entitled to a return *of* the accretion itself—the fabrication of a constitutional right to receive piecemeal during the life of a business that which the owner is not entitled to receive in one lump sum at the expiration of its life. The determination of an amortization base is no more integral in the rate-making process than the determination of a rate base (cf. *Lindheimer* v. *Illinois Bell Telephone Co.*, 292 U. S. 151, 164). If the Commission is authorized to use actual legitimate cost for the former purpose as this Court held in the *Pipeline* case, it must be equally authorized to use it for the latter purpose.

Even if the decision of this Court in the *Pipeline* case be deemed limited to "wasting asset businesses of limited life," its applicability to the instant case would be clear. As will be shown more fully hereinafter (pp. 102–103), companies such as Hope, engaged in the extraction and sale of

natural gas, are in a real sense "wasting asset businesses of limited life"; for according to accepted scientific principles, the wells and pools from which the gas is being withdrawn will inevitably be exhausted within a predictable future.

While this Court in the *Pipeline* case did not explicitly denounce the so-called rule of *Smyth* v. *Ames,* which requires that reproduction cost be considered in determining a rate base, we suggest that the decision in effect leaves the Commission free to reject conjectural estimates of reproduction cost and to adopt prudent investment as the rate base.[16]

C. THE COURT BELOW ERRED IN REQUIRING THAT PRICE TRENDS BE UTILIZED IN DETERMINING THE RATE BASE

In support of its claim to a $66,000,000 rate base, Hope sought to prove the "present fair value" of its interstate facilities by offering esti-

[16] This was gathered from the opinion of the majority not only by the three Justices concurring in a separate opinion (315 U. S. 575, 606), but also by the Public Utility Law Section of the American Bar Association (1942 Report, pp. 121–122) and the Committee on Progress in the Regulation of Public Utilities of the National Association of Railroad and Utilities Commissioners (Proceedings of 54th Annual Convention (1942) pp. 223–227). See also *Implications of the Case of F. P. C.* v. *Natural Gas Pipeline Co.*, Public Utilities Fortnightly, October 22, 1942, pp. 604–618.

The dissenting judge below also construed the *Pipeline* case to hold that there was no constitutional objection to the Commission's exclusive use of the prudent investment method; and he concluded that the Commission's order was within the scope of its statutory authority, reasonable, and supported by substantial evidence (R. IV, 203–205).

mates of "reproduction cost new" and "trended original cost" (R. I, 143–208). The Commission received Hope's estimates of "present fair value." However, when analysis revealed such estimates to be erroneous and conjectural, the Commission rejected them in favor of the actual legitimate cost, as reliably shown by Hope's complete books and records (R. I, 20–23). The court below agreed with the Commission as to the unreliability of such estimates, but held that decided price-rises since the original investment, which the court found in the record and judicially noticed, should have been taken into account in the rate base (R. IV, 172, 183–184). In this we submit the court erred, both in its assumption of fact and in its conclusion that price-trends were any more reliable than reproduction-cost estimates.

1. There is no evidence that present value is greater than original cost

In setting aside the Commission's rate order because it disregarded post-investment price rises, the court apparently assumed that the original cost of Hope's properties was substantially lower than their present value. There is little to support such an assumption. Although Hope has been in existence over forty years, it has been adding to its property gradually during all that time. The opinion below appears to assume that Hope acquired most of its property during periods of low prices. The facts belie this assumption. Ac-

cording to Hope's Exhibit 20 (R. I, 207, col. 2), only $25,000,000 of a claimed original cost of $70,-000,000 was installed prior to 1917, and the rest ($45,000,000) was installed thereafter, when prices were rising. Included in these figures are the intangible costs of well-drilling originally charged to operating expenses, most of which were incurred prior to 1917; the exclusion of these costs would reduce substantially the $25,000,000 figure (Exhibit 20, p. 66). Moreover, the property installed during the low-price period has been largely depreciated. Therefore, although the price level has unquestionably risen since Hope first began operations, its substantial capital expenditures during the period of higher prices, coupled with the depreciation of its low-cost equipment, may well give a "present-value" figure not far removed from original cost.

2. Results obtained by use of price trend factors are illusory and unreliable

Even on the assumption that the present value of Hope's properties exceeds its original cost, the "price-trends" which the court below held to be a mandatory factor in the rate base are no more reliable than the estimates of fair value which the Commission rejected with the court's approval. The Commission is not aware of any method of "price trending"—whether general or specific—which does not share the inherent qualities of conjecture and illusion found in the cus-

tomary methods of determining "reproduction cost" and "trended original cost," as the court below conceded and as shown in the Supplement to this Brief (pp. 4–26, 42–48).

(a) *Specific* price trend factors may be applied in two ways. The first method is to obtain the quantity of labor or materials of a given class which went into a plant at the time of construction, and then to translate that quantity into present prices by comparing present prices with the original prices. For instance, if hourly cost of labor had by 1940 increased 300% over the cost in 1900, the estimated total cost of labor expended in 1900 in plant which is in service in 1940, would be multiplied by the translator factor of 300.

Where the translator is applied directly to the various elements which go to make up a plant, such as labor, materials and services, unreliable results are inevitable. For example, to use the illustration involving labor, Hope in this case multiplied the estimated labor costs incurred many years ago by a translator factor which recognized present prices of labor, without giving any recognition whatever to the increase in efficiency which has taken place and the consequent greater productivity of the same amount of labor, particularly through the use of modern tools and machines and through the reduction in the work day (R. III, 101–108). Thus, if labor costs of $100,000 went into the plant in 1900, and if the hourly rate of labor is now three times as great,

the original labor costs multiplied by 300%, or $300,000, would be the estimated value of the labor item in 1940, under the trended original cost. This assumes that the old methods of laying pipeline would prevail in 1940 and that the trench for "Big Inch" would today be dug by pick and shovel—assumptions wholly at variance with the facts. Similarly, in the case of gas mains, the old quantity at the old cost is multiplied merely by the translator factor which recognizes present prices, without giving any effect whatsoever to the improvements made in long distance transmission (R. III, 110–119). It is clear, therefore, that no better results would be obtained by the use of index numbers or price trends than have been obtained by reproduction cost studies. As a matter of fact, in many instances the results would be identical.

The other method of applying specific price trend factors involves a comparison of unit costs at the time of construction with "current reproduction" unit costs. To illustrate, if in 1900 a section of pipe cost $5,000 installed, and the estimated cost of reproduction was $7,500 in 1940, a translator of 150 would be applied to the investment figure. It is obvious that use of the unit cost method results automatically in the reproduction cost figure; hence, the translation of original cost into present values by this method suffers from all the infirmities of reproduction cost estimates.

(b) *General* price trends are used to determine the changes in the purchasing power of a dollar, rather than to translate the actual costs of specific facilities into present costs.[17] The use of general price trends to determine a rate base proceeds on the assumption that a dollar invested in Hope in 1900 should retain the same purchasing power in 1940; that is, its value should be maintained at such a level as to buy as much shelter, food, clothing, entertainment, etc., in 1940 as it could purchase in 1900. This method uses general index numbers rather than specific index numbers as the translator, but it possesses all the infirmities notoriously inherent in the reproduction cost method for which it has on occasion been substituted. Cf. *West* v. *Chesapeake & Potomac Tel. Co.,* 295 U. S. 662, 669–670. Moreover, while it is probably true that the index-number method can give just as accurate results as those obtained by use of reproduction cost and in less time, it is subject to additional objections. There are no satisfactory indices with which to value the dollar. No one knows the exact manner in which an investor in 1900 would have desired to spend a dollar, or the manner in which the same or another investor might desire to spend a dollar in 1940. The indices for this purpose are rather crude, and their use has a more logical relation to monetary control than to the valuing of specific

[17] See *West* v. *Chesapeake & Potomac Telephone Co.*, 295 U. S. 662.

public utilities. Moreover, the problem is not so much that of maintaining the purchasing value of the dollar as it is of maintaining the investment at its original amount. Large classes of investors, such as bondholders and preferred stockholders, make their investments under contracts by which they are to receive the principal amount of their investment (or par) and no more, irrespective of fluctuations in the price level. Common stockholders, on the other hand, may be adequately protected by adjusting the rate of return. Finally, the value of the dollar and the value of specific utilities may point in opposite directions, as occurred in the case of street railways in the 1920's. Cf. Brandeis, J., dissenting in *St. Louis & O'Fallon R. Co.* v. *United States,* 279 U. S. 461, 494–496.

These weaknesses in the use of price trends are magnified by the compulsory force to which the court below held them entitled. But apart from the unreliability of price trends, there is no warrant in law for the imposition of an obligation upon the Commission to utilize them. The Constitution "does not bind rate-making bodies to the service of any single formula or combination of formulas." *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 586. Yet the view of the majority below would restrict that freedom of choice by imposing the condition that the formula chosen in any case must yield a result

generally equivalent to that which would be obtained from the use of price trends. The *Pipeline* decision forecloses any contention that a rate order founded upon a prudent investment rate base is arbitrary simply because a larger rate base would result from the adoption of a formula reflecting prevailing price levels. Thus, the decision there sustained the use of an amortization base reflecting actual legitimate cost regardless of the fact that another basis of determination, taking into account post-investment fluctuations in price levels, would have yielded a larger sum. The question is not whether the use of price trends is permissible (cf. Stone, J., dissenting in *West* v. *Chesapeake & Potomac Tel. Co.,* 295 U. S. 662, 690) but whether it is mandatory; and this Court in the *Pipeline* case has in our view answered this in the negative.

For these reasons, we submit that the use of price trends was improperly held below to be a necessary factor in rate making.

D. THE RULE OF SMYTH V. AMES SHOULD BE RENOUNCED

We believe that the circumstances discussed above, and the similiarity between Hope's business and that involved in the *Pipeline* case, would warrant reversal of the decision below without further reconsideration of the doctrine of *Smyth* v. *Ames.* But since it is not certain that the vitality of that doctrine is at an end (see, e. g.,

Hale, *Does the Ghost of Smyth* v. *Ames Still Walk?,* 55 Harv. L. Rev. 1116), we respectfully urge this Court, in the interest of clarifying the Commission's functions as well as those of all other rate-making bodies, to place the troublesome phantom in its grave, and thus terminate the unsound and uneconomic dogma which it has evoked.

In offering argument against the "fair value" concept and in favor of the "prudent investment" concept of rate making, we ask the Court's indulgence, realizing that it is well informed on the subject and has on numerous occasions given judicial attention to the matter. Various members of the Court have, upon several occasions, severely criticized the "mischievous formula for fixing utility rates in *Smyth* v. *Ames*". *Driscoll* v. *Edison Light & Power Co.,* 307 U. S. 104, 122 (Frankfurter, J., concurring); *McCart* v. *Indianapolis Water Co.,* 302 U. S. 419, 423 (Black, J., dissenting); *Southwestern Bell Telephone Co.* v. *Public Service Commission,* 262 276, 292 (Brandeis, Holmes, J. J., dissenting); *St. Louis & O'Fallon R. Co.* v. *United States,* 279 U. S. 461, 551–552 (Brandeis, Holmes, Stone, J. J., dissenting); *West* v. *Chesapeake & Potomac Tel. Co.* 295 U. S. 662, 680 (Stone, Brandeis, Cardozo, J. J., dissenting). However, we believe that such argument is appropriate because

the conflict between the two concepts presents the major issue in this case.[18]

We have printed in a Supplement to this brief various pertinent materials, including excerpts from the brief filed by the United States as *amicus curiae* in *Driscoll* v. *Edison Light & Power Co.,* No. 509, October Term, 1938, and from the supplement to the Commission's brief in *Federal Power Commission* v. *Natural Gas Pipeline Co.,* Nos. 265 and 268, October Term, 1941. These materials show "the havoc raised by insistence on reproduction cost" as "a matter of historical record," how the rule of *Smyth* v. *Ames* "has seriously impaired the power of rate-regulation," how the "fair value" rule "has proved to be unworkable by reason of the time required to make the valuations, the heavy expense involved, and the unreliability of the results obtained"; and

[18] Hope contended below that the general question whether the Commission may use the prudent investment method of rate making is not presented, since neither the Commission nor its staff had so designated the principal item used in determining the rate base. This is little more than a quibble. Since the wisdom of Hope's plant costs and investments has not been questioned, the actual legitimate cost or gross plant investment as determined by the Commission is synonymous with "prudent investment." *Southwestern Bell Telephone Co.* v. *Public Service Commission,* 262 U. S. 276, 289 (Brandeis, J., dissenting); *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 306. The separate opinion of Commissioner Scott clearly demonstrates that the Commission considered actual legitimate cost to be synonymous with prudent investment (R. I, 81).

how "even the investor, on whose behalf the constitutional safeguards have been developed, has received no protection against the rebounds from the inflated stock-market prices that are stimulated by the 'fair value' doctrine." (*Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, 605–606.) These materials also show that the prudent investment approach produces a sound and workable rate base; that it curtails the length and expense of rate litigation and regulation; and that it protects the interests of both the consumers and the investors.

Here we shall show, in addition, that the "fair value" rule is based on principles of eminent domain which are irrelevant in rate making; that in rate regulation, as in price fixing, the reasonableness of the regulation should be the guiding principle; and that the allowance of a fair return on the capital prudently invested in the enterprise is reasonable.

While the material contained in pages 53–70 *infra,* is in large measure derived from the discussion in the Government's brief in the *Pipeline* case, we include it here, in somewhat condensed form, since the issue seems to us to be more centrally raised in this case, and its inclusion, in lieu of mere reference thereto, will serve the convenience of the Court and of the several parties in Nos. 34 and 35.

1. The fair value rule is based on eminent domain concepts

The rule that a rate is confiscatory unless it enables the utility to earn a fair return on the present fair value of its property is based on the doctrine in the law of eminent domain that "just compensation" must be paid for property "taken" for public use. *West* v. *Chesapeake & Potomac Tel. Co.,* 295 U. S. 662, 671; cf. *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 602, 603.

This is confirmed by the historical development of the fair value rule. While at first protection against abuses in rate regulation was held to lie at the polls, not in the courts (*Munn* v. *Illinois,* 94 U. S. 113, 134), this view was later abandoned and the question of the reasonableness of rates was recognized to be justiciable, unreasonably low rates being held to constitute a deprivation of property without due process of law or a taking of property without just compensation. *Railroad Commission Cases,* 116 U. S. 307, 325, 331; *Georgia Railroad & Banking Co.* v. *Smith,* 128 U. S. 174, 179; *Chicago &c. Ry.* v. *Minnesota,* 134 U. S. 418, 458; *Budd* v. *New York,* 143 U. S. 517, 547. The "fair value" rule emerged shortly thereafter in *Reagan* v. *Farmers' Loan & Trust Co.,* 154 U. S. 362, which invalidated a rate order under which the company could not pay even one-half of its bond interest. The Court there observed *obiter* that the Constitution prohibits a taking of

"the use [of property] for the public benefit at less than its market value," just as it forbids acquisition of title to the property by eminent domain at less than "the value of the property as it stood in the markets of the world" (154 U. S. at 410).[19]

The analogy of a "taking" was not expressly referred to again until the lower court in *Smyth* v. *Ames* held that the earning of "a fair interest on the actual value of the property" of the railroad company is a measure of the reasonableness of rate reductions, just as in condemnation of title to the railroad "the present value of the property, and not the cost" is the proper measure of compensation. *Ames* v. *Union Pacific Ry.,* 64 Fed. 165, 177 (C. C. Neb.).

This text extracted from the law of eminent domain became the basis of the "fair value" rule of *Smyth* v. *Ames,* 169 U. S. 466, for determining the constitutionality of rates. See Henderson, *Railway Valuation and the Courts,* 33 Harv. L. Rev. 902, 906–912; Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 960–964. The rule is invoked to prevent rate regulation on any basis other than "present fair value"

---

[19] In *Covington & Lexington Turnpike Road Co.* v. *Sandford*, 164 U. S. 578, 596, the Court observed that rates fixed so low as to destroy the value of property for all purposes would be invalid as a deprivation of property without due process of law.

(*cf. West* v. *Chesapeake & Potomac Tel. Co.*, 295 U. S. 662), notwithstanding that when *Smyth* v. *Ames* was decided, original cost probably exceeded the "present fair value" of the utility's property, so that the original effect of the rule was to permit rates to be based on a value less than original cost.

2. The eminent domain concept of present fair value is inapplicable to rate regulation

In practice the "present fair value" test makes it impossible to measure the reasonableness of rates by any coherent standard, and renders rate regulation logically impossible.

The practical impossibility of developing a workable rule under the "present fair value" concept arises fundamentally from the fact that eminent domain principles have no proper application in the field of rate regulation. See Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 963.[20] Even before *Smyth* v. *Ames* was decided, it had already been established in a utility condemnation case that "the value of property, generally speaking, is determined by its productiveness—the profits which its use brings to the owner" (*Monongahela Navigation*

[20] It was precisely this principle of "just compensation" that led Mr. Justice Field in 1877 to dissent in *Munn* v. *Illinois*, 94 U. S. 113, and to deny any power in the States to regulate rates. 94 U. S. at 143.

Co. v. *United States,* 148 U. S. 312, 328–329; see *C. C. C. & St. L. Ry.* v. *Backus,* 154 U. S. 439), and that compensation must be paid not only for the physical property but also for the franchise. Earning power under the old rates thus became the test of value in condemnation cases. Hale, *The "Fair Value" Merry-Go-Round,* 33 Ill. L. Rev. 517, 519–520; Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 964.[21] In a rate case, however, the earning power necessarily depends on the rates to be allowed, which is the very question at issue.

Any physical property has only a scrap value unless it is capable of earning a return sufficient to justify a larger evaluation; consequently, the rate level, whose determination must await computation of "fair value" under *Smyth* v. *Ames,* is itself the prime factor in that value. Cf. *Ecker* v. *Western Pacific R. Corp,* 318 U. S. 448, 483; *Group of Investors* v. *Milwaukee R. Co.,* 318 U. S. 523, 540; *Consolidated Rock Co.* v. *DuBois,* 312 U. S. 510, 525. The value of a going concern in fact depends on earnings under whatever rates may be anticipated. The present fair value rule creates but offers no solution to the dilemma

[21] Of course, where the property of a nonutility without franchise is condemned, it is only the physical property and not the earning power or prospective profits that are taken and paid for. *Mitchell* v. *United States,* 267 U. S. 341; *Joslin Co.* v. *Providence,* 262 U. S. 668; *Bothwell* v. *United States,* 254 U. S. 231.

that value depends upon the rates fixed and the rates upon value. See Brandeis, J., concurring in *Southwestern Bell Telephone Co.* v. *Public Service Commission,* 262 U. S. 276, 292; *Federal Power Commission* v. *Natural Gas Pipeline Co., supra,* at 603 (Black, Douglas, Murphy, J. J., concurring); *Los Angeles Gas Co.* v. *Railroad Commission,* 289 U. S. 287, 305; *West* v. *Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 689 (Stone, J., dissenting); Hale, *The "Fair Value" Merry-Go-Round,* 33 Ill. L. Rev. 517–520; 2 Bonbright, *Valuation of Property,* pp. 1094 et seq.; Henderson, *Railway Valuation and the Courts,* 33 Harv. L. Rev. 1031.

The utter illogicality of invoking eminent domain principles of "just compensation" in rate regulation is best shown by the fact that strict application of those principles would render all rate regulation invalid or impossible. When property is taken under the power of eminent domain, the owner is "entitled to the full money equivalent of the property taken, and thereby to be put in as good position pecuniarily as it would have occupied if its property had not been taken." *United States* v. *New River Collieries Co.,* 262 U. S. 341, 343. Since the value of a public utility depends on earning power, under condemnation principles its present value would have to be measured by its earnings at the existing rates, and would be calculated by capitalizing those earnings at the prevailing rate of return upon investments involv-

ing similar risks. On the rate base thus determined, a fair return would have to be allowed which would, of course, be the rate of return on investments involving similar risks. The result would be no change in rates at all. This absurdity results from the truism that every rate reduction which reduces the net earnings of a utility *ipso facto* reduces the value of that utility; if the value prior to the rate reduction must be preserved for constitutional reasons, it necessarily follows that every rate order which reduces that value is invalid.[22] See Barnes, *The Economics of Public Utility Regulation* (1942), pp. 401–402.

While not in terms abandoning the "taking" theory with its corollary requirements of "just compensation" (see *West* v. *Chesapeake & Potomac Tel. Co.,* 295 U. S. 662, 671), this Court has resolved the dilemma, albeit at the expense of logic, by holding that some rate regulation is

[22] The dilemma is not evaded by the contention that the actual market value will be less than the capitalized earnings by reason of the fact that the market will take into account the prospect of future rate regulation. A business has greater value if its owner can anticipate earnings in excess of just and reasonable profits, and the prospect of future regulation does not entirely diminish that anticipation. Hale, *The "Fair Value" Merry-Go-Round*, 33 Ill. L. Rev. 517, 530. If, therefore, under eminent domain principles, market value, which is earning power in the case of a public utility, sets the measure of "just compensation" and if rates must be fixed to pay the utility "just compensation" in the eminent domain sense, rates can never be reduced below the market expectations prior to the rate proceedings, and adequate rate regulation is still impossible.

permissible. In part the Court has permitted the exclusion of value supposedly due to "monopoly" position (*Clark's Ferry Co.* v. *Public Service Commission,* 291 U. S. 227, 238; see Whitten, *Fair Value for Rate Purposes,* 27 Harv. L. Rev. 419, 421–423; Richberg, *A Permanent Basis for Rate Regulation,* 31 Yale L. J. 263, 267), even though an exclusive franchise is an element of value in a condemnation case. *Monongahela Navigation Co.* v. *United States,* 148 U. S. 312, 328–329. In effect "value" became "a word of many meanings" (cf. *Group of Investors* v. *Milwaukee R. Co.,* 318 U. S. 523, 540), so that such factors as good will and earning power, while material to "exchange value" in condemnation cases, were excluded in determining the "special value" for rate purposes. See Brandeis, J., concurring in *Southwestern Bell Telephone Co.* v. *Public Service Commission,* 262 U. S. 276, 310–311.

The very existence of the power to regulate rates, therefore, shows that the concepts of "just compensation" and "fair value", drawn from the law of eminent domain, have no place in rate cases. Bonbright, *op cit. supra,* pp. 1092–1096; Bauer and Gold, *Public Utility Valuation,* p. 147; Beutel, *Valuation as a Requirement of Due Process,* 43 Harv. L. Rev. 1249, 1267; Hale, *The "Fair Value" Merry-Go-Round,* 33 Ill. L. Rev. 517, 519, 530; Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959.

3. Rate regulation should be deemed violative of due process only if arbitrary or unreasonable

These dilemmas and inconsistencies are avoided if rate regulation is regarded not as a taking of property for public use, but simply as an exercise of regulatory power. There is adequate room for such a distinction. Eminent domain is the power to command a sale; it involves an appropriation of title or of the use of property which is essential to the Government's need and which promotes the public welfare. Lewis, *Eminent Domain* (3d ed. 1909) § 6. The taking is justified not because the property is a public nuisance or other obstacle to valid legislative ends, but because it is needed for some valid public purpose or project. Nichols, *Eminent Domain* (2d ed. 1917), p. 278; Orgel, *Valuation under Eminent Domain* (1936), p. 2; see Gardner, *The Massachusetts Billboard Decision,* 49 Harv. L. Rev. 869, 889–892.

The regulation of rates, on the other hand, promotes the public welfare, not by a "taking," but by regulating and restricting the owner's use and enjoyment of his own property. Lewis, *Eminent Domain* (3d ed. 1909), §§ 246, 249. Congress may of course subject the use of privately owned property to reasonable limitations in order to serve valid legislative ends, even though the regulation diminishes the value of the property. Under "the police power in its proper sense, * * * property rights may be cut down, and to that extent

taken, without pay." *Block* v. *Hirsh,* 256 U. S. 134, 155.

Examples of valid legislative regulations which diminish the value of property without compensation are numerous. A state may prohibit the manufacture of an article or the conducting of a business within certain territorial limits;[23] it may prohibit the emission of smoke from buildings even though this requires the discontinuance of the use of private property and the incurring of considerable expense (*Northwestern Laundry* v. *Des Moines,* 239 U. S. 486); it may limit the use of property and even destroy it outright, in order to save or benefit another class of property "which, in the judgment of the legislature, is of greater value to the public";[24] and it may control prices in appropriate circumstances. *Nebbia* v. *New York,* 291 U. S. 502. Such reasonable restrictions on the use of property in the interest of the public are not "takings" for which just compensation must be paid. *Monongahela Bridge Co.* v. *United States,* 216 U. S. 177, 193; *Union Bridge Co.* v. *United States,* 204 U. S. 364, 388–403; *West Chicago Street Railroad Co.* v. *Chicago,* 201 U. S. 506,

---

[23] *Powell* v. *Pennsylvania,* 127 U. S. 678 (oleomargarine); *Mugler* v. *Kansas,* 123 U. S. 623, 661 (intoxicating liquors); *Reinman* v. *Little Rock,* 237 U. S. 171 (livery stable); *Hadacheck* v. *Los Angeles,* 239 U. S. 394 (bricks).

[24] *Miller* v. *Schoene,* 276 U. S. 272, 279–280; *Lawton* v. *Steele,* 152 U. S. 133; *cf. Standard Oil Co.* v. *Marysville,* 279 U. S. 582; *Euclid* v. *Ambler Co.,* 272 U. S. 365; *Pennsylvania Coal Co.* v. *Mahon,* 260 U. S. 393.

524; see Gardner, *The Massachusetts Billboard Decision,* 49 Harv. L. Rev. 869, 889–892.

The constitutional criteria applied to price-fixing regulations are of peculiar applicability to rate regulation. "Rate-making is one species of price-fixing. Price-fixing, like other forms of social legislation, may well diminish the value of the property which is regulated. But that is no obstacle to its validity." *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 603 (Black, Douglas, Murphy, J. J., concurring).[25]

The power of the Government to fix prices or rates was formerly explained by saying that the regulated company had "dedicated" its property to the public use, but this has been characterized

---

[25] The "taking" concept has not even a superficial relevance to utility regulation except where the state requires a utility to extend its service (*New York & Queens Gas Co.* v. *McCall,* 245 U. S. 345; *New York ex rel. Woodhaven Gas Light Co.* v. *Public Service Commission,* 269 U. S. 244) or forbids abandonment if the utility continues to do business anywhere within the state. *United Gas Co.* v. *Railroad Commission,* 278 U. S. 300, 308–309. No question of forbidding abandonment or compelling an extension is involved here. Any duty on the part of Hope to continue or extend its service is in effect based upon the community's dependence, for which the utility itself is responsible. *Cf.* Cardozo, J., dissenting in *Interstate Commerce Commission* v. *Oregon-Washington R. Co.,* 288 U. S. 14, 17. The instances are numerous and familiar in which a duty has been founded on dependence or reliance and in which the concepts of eminent domain are manifestly irrelevant. See, e. g., *Moch Co.* v. *Rennsselaer Water Co.,* 247 N. Y. 160, 167; *Slater* v. *Illinois Central R. Co.,* 209 Fed. 480 (C. C. M. D. Tenn.); *Siegel* v. *Spear & Co.,* 234 N. Y. 479; *Creeley* v. *Creeley,* 258 Mass. 460, 463.

as "merely another way of saying that if one embarks in a business which public interest demands shall be regulated, he must know regulation will ensue." *Nebbia* v. *New York,* 291 U. S. 502, 534. In reality there is no true "dedication," for the property remains private property. *Minnesota Rate Cases,* 230 U. S. 352, 431–432; *Interstate Commerce Commission* v. *Oregon-Washington R. Co.,* 288 U. S. 14, 40–41.

Utility regulation, and rate fixing in particular, is thus not a "taking" of property for public use but an exercise of the police power in the form of a restriction upon the use or enjoyment of private property. The validity of such regulation does not depend upon impairment of the value of property; impairment of value is frequently the consequence of regulation. The true test of constitutionality under the due process clause in a rate case, as in all regulatory cases, is simply whether the regulation is reasonable. This is the standard in the analogous field of price fixing. This Court, after observing that there was nothing "peculiarly sacrosanct about the price one may charge," has held that "price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty." *Nebbia* v. *New York,* 291 U. S. 502, at 539.

4. It is not unreasonable to limit the earnings of a utility to a fair return upon the capital prudently invested

Measured by the principles governing the validity of regulatory acts of government, and particularly by those relating to price-fixing, the prudent-investment rate base chosen by the Commission easily passes muster.

As this Court held in considering the Natural Gas Act, the Constitution does not bind the Commission "to the service of any single formula or combination of formulas," but leaves it free, within the ambit of its statutory authority, "to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 586.

This decision leaves the regulatory body at liberty to select formulae suggested by sound business practice and producing no arbitrary result. We submit that an acceptable and reasonable formula is the prudent investment standard adopted by the Commission. This point requires little elaboration here. Mr. Justice Brandeis has demonstrated the reasonableness of the investment basis by reference to a wealth of relevant data.

See *Southwestern Bell Telephone Co.* v. *Public Service Commission,* 262 U. S. 276, 289. Additional data are supplied in the Supplement to this brief (at pp. 66–89 thereof), in which we show that the prudent investment basis of rate regulation is sound and workable, that it is overwhelmingly supported by the great body of professional opinion, and that many experienced regulatory bodies have adopted and advocated its utilization. The principal advantages of the prudent investment base will merely be briefly recapitulated at this point.

(a) Prudent investment, in contrast to present value, can be determined expeditiously, accurately, and to a degree of exactness that leaves substantially little ground for conflict between the public and private interests. Once a prudent investment rate base has been determined, the redetermination of a rate base thereafter would amount to the relatively simple task of ascertaining net plant additions, an inquiry greatly facilitated by the use of the companies' books of account and its continuing property records. The importance to the public and to investors of the simplification of the administrative problems of regulation that would follow from the adoption of prudent investment as a rate base can hardly be exaggerated.

(b) An investment base is fair and just to the utilities. Practical experience in California, Massachusetts and elsewhere shows that this method has attracted the necessary capital and

has secured adequate service. A basis of rate regulation which maintains the Company's financial integrity and permits it to raise the required capital cannot be deemed arbitrary. See Brandeis, J., concurring in *Southwestern Bell Telephone Co.* v. *Public Service Commission,* 262 U. S. 276, 291; Hale, *Conflicting Judicial Criteria of Utility Rates,* 38 Col. L. Rev. 959, 969–970.

(c) The investment base is fair to investors in the utility. The investor's contribution to public service is his capital, and he is treated equitably when he is allowed a compensatory return thereon. Public utilities usually finance a large part of their plant through issuance of bonds and preferred stocks, whose returns are contractual and fixed. Stability of investment and safety of principal are important factors to these investors.

A rate base predicated upon investment is the most stable type and is thus fair to such investors. Even as to common stock, stability of investment is obtained under prudent investment. It is merely necessary to adjust the rate of return to current costs of capital; indeed, such adjustment might well convert common stocks into gilt-edge investments, by protecting them from depreciation in value during time of depression.[26]

---

[26] Under the rule of *Smyth* v. *Ames*, on the other hand, utility investors tend to receive both the benefit of appreciation in property values and protection against depreciation. This is so because in periods of deflation, regulatory agencies cannot undertake to fix values in strict conformity to *Smyth* v. *Ames* without throwing many utilities into receivership,

(d) State and federal regulation of utilities' accounts are giving increased reliability to investment figures. Appendix C to this brief (pp. 141–143 *infra*) lists the state commissions which control the issuance of securities and have prescribed accounting by utilities on an original cost or investment basis. See also *American Tel. & Tel. Co.* v. *United States,* 299 U. S. 232; *Alabama Power Co.* v. *Federal Power Commission,* 128 F. (2d) 280 (App. D. C.), certiorari denied, 317 U. S. 652; *Louisville Gas & Electric Co.* v. *Federal Power Commission,* 129 F. (2d) 126 (C. C. A. 6), certiorari denied, 318 U. S. 761.

The investment basis is the standard accounting practice used by business institutions in reporting their financial transactions to stockholders, banks and other interested parties. Because it combines

---

and this would, of course, deprive consumers of necessary utility service. Bonbright, *Merits of Original Cost and Reproduction Cost*, 41 Harv. L. Rev. 593, 621–622; see Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 423–424. "The rule by which the utilities are seeking to measure the return is, in essence, reproduction cost of the utility or prudent investment, whichever is the higher." Brandeis, J., in *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276, 311. Since, under the practical operation of the *Smyth* v. *Ames* rule, the utilities are not compelled to suffer from a decline in values, it is not unreasonable to deny them the increase. And if some account must be taken of the factor of increasing prices as bearing upon the stability of investment, this may readily be accomplished by altering the rate of return. See Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 434–435; Richberg, *A Permanent Basis for Rate Regulation*, 31 Yale L. J. 263, 273.

exactness, ease of application, and equitableness, it is the standard best adapted to modern business conditions and practices in this country.

(e) The prudent investment base is fair to consumers, by assuring them a sound and stable utility whose services will be rendered at the lowest rate consistent with the attraction of necessary capital and with a reasonable return to investors.

(f) The use of the prudent investment basis of rate regulation is the long-established practice of the Federal Power Commission,[27] and in 1940 it reported to Congress that its rate-making policy was to insist upon such a rate base (20th Annual Report of the Federal Power Commission, p. 62). Proof of the reasonableness of the method and its compliance with constitutional requirements is to be found in the fact that the Commission has obtained consent reductions in natural gas rates on this basis, exceeding $9,600,000 annually.[28] Consent reductions would hardly have been forthcoming if rates based on prudent

---

[27] *Re Albany Lighting Co.*, 25 P. U. R. (N. S.) 36, 39; *Re Interstate Power Co.*, 32 P. U. R. (N. S.) 1, 10; *Los Angeles* v. *Nevada-California Electric Corp.*, 32 P. U. R. (N. S.) 193, 206; *Re Chicago District Electric Generating Corp.*, 39 P. U. R. (N. S.) 263; *Re Canadian River Gas Co.*, 43 P. U. R. (N. S.) 205, 224; *Detroit* v. *Panhandle Eastern Pipe Line Co.*, 45 P. U. R. (N. S.) 203; *Re Interstate Natural Gas Company*, 48 P. U. R. (N. S.) 267, 274.

[28] The $3,750,000 interim rate reduction approved in *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, was followed by a final consent rate reduction of an additional $2,750,000 and was based on prudent invest-

investment had produced a return which the companies considered to be unreasonable and confiscatory.[29]

The rule of prudent investment thus combines exactness, ease of application, and appropriateness for determining a return fair to the utility, investors and the public. It is the standard for rate making best adapted to modern business conditions and practices in this country. Since it is clearly reasonable and produces no arbitrary result, rate regulation on the basis of prudent investment is entirely consistent with due process, in addition to being well adapted to serve the Congressional objective of producing "just and reasonable" rates. Cf. *Nebbia* v. *New York,* 291

---

ment. F. P. C. Order Accepting Reduced Rates for Filing and Terminating Proceedings, September 19, 1942. Additional reductions on the prudent investment basis were obtained in the following cases: *Re Lone Star Gas Co.*, F. P. C. Docket Nos. G–208, G–209, May 4, 1942, Order Reducing Rates by $2,053,564 annually; *Re El Paso Natural Gas Co.*, F. P. C. Docket Nos. G–424, G–257, October 29, 1942, Order Reducing Rates by $526,000 annually; *Re Northern Natural Gas Co.*, Feb. 4, 1943, Order Making Effective Reductions in Rates by $2,087,000 annually; *Re Louisiana P. S. Comm.* v. *United Gas Pipe Line Co.*, F. P. C. Docket Nos. G–133, G–148, G–157, G–193, April 16, 1943, Order Making Effective Reductions in Rates by $2,195,287 annually.

[29] Under the Federal Power Act (Secs. 20 and 14), the rate base prescribed for licensed hydroelectric projects is the "net investment," which is the equivalent of prudent investment (41 Stat. 1077, 16 U. S. C. § 791). In twenty years, 128 major hydroelectric projects have been constructed at a cost of $740,000,000 (20th Annual Report, F. P. C., p. 15).

551452—43——6

U. S. 502, 537–539. There being no constitutional objection to prudent investment on the ground of reasonableness and no statutory restriction upon its use, the Commission should be permitted to adopt that formula. See *American Tel. & Tel. Co.* v. *United States,* 299 U. S 232, 244; *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 606 (Black, Douglas, Murphy, J. J., concurring). And to eliminate any doubts as to the propriety of such a rate-making method, we suggest that the so-called rule of *Smyth* v. *Ames,* as enunciated in the *Southwestern Bell* case, should be renounced.

III

THE COMMISSION PROPERLY EXCLUDED FROM ACTUAL LEGITIMATE COST THE INTANGIBLE COSTS OF WELL DRILLING AND OTHER ITEMS PROPERLY CHARGED TO OPERATING EXPENSE PRIOR TO 1923 AND FULLY RECOUPED FROM RATEPAYERS

The Commission found that Hope's actual legitimate cost amounted to $51,957,416 (before depreciation) for the property devoted to interstate sales as of December 31, 1940. The Commission declined to include in that figure an additional sum of about $17,000,000,[30] consisting largely of expenditures by Hope and the com-

[30] This $17,000,000 figure is before depreciation. After depreciation it amounts to about $4,000,000 as the court below noted (R. IV, 184).

panies from which it acquired properties, for labor and drilling equipment used in drilling wells before 1923. These expenditures, until 1923, were charged to operating expenses in accordance with the general practice in the industry.[31] The court below held the Commission's action improper, and ruled that these items must now be capitalized and reflected in the rate base, principally on the ground that they had been "erroneously charged to expense" instead of to capital (R. IV, 186–189). We believe that the ruling below embodies two fundamental errors: (1) the items in question were not in fact "erroneously" charged to expense; and (2) the decisions of this Court, principally *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, 590–591, support the Commission's determination against capitalizing items previously and properly treated as operating expenses and recovered from revenues received from ratepayers.

A. NATURE OF CONTESTED ITEMS

The actual legitimate cost of Hope's interstate properties, as determined by the Commission, was obtained by going to the books and records of the Company, which covered its entire history, and were complete and well kept. All necessary rec-

[31] In 1923, the West Virginia Public Service Commission, pursuant to its jurisdiction over intrastate rates, required Hope to charge future expenditures for well-drilling to capital (R. I, 28).

ords had been preserved; there was therefore no occasion to resort to estimates. (R. I, 174; R. III, 25–30.) In determining Hope's actual legitimate cost the Commission accepted all of the Company's book figures, making adjustments for items which were clearly wrong and about which there is no dispute.[32] The Commission thus adopted the accounting decisions of the Company's competent management made over a long period of years.

The "original cost" of Hope's interstate properties, as of December 31, 1938, as shown on the Company's books in the plant investment account, was $52,730,666. However, Hope estimated its "original cost" at $69,735,638. (R. I, 25, 197; Exh. 20, Statement B.) This figure, which is $17,004,972 more than the amount shown on its own books, included: (a) Items which have been identified as expenditures charged to operat-

[39] Two main adjustments were made to correct accounting errors. One reduced the cost, as shown by the books, by $2,057,618 on account of retirements of property which had not been recorded in the books. The Company made this inventory adjustment to correct its books and the Commission accepted it. The other adjustment, which was recommended by the Commission's staff, would restore the amount of $1,295,953 which had been arbitrarily written out of the plant accounts by the Company. (R. I, 35, 256–258.) The Commission observed that there was "considerable question" as to whether this item should be restored (R. I, 35), but because the arbitrary write-offs were contrary to sound principles of accounting, finance, and business administration, and likewise contrary to the practices of the gas industry, the $1,295,953 was added to the book cost and included in the investment rate base.

ing expenses prior to December 31, 1938. Chief among these, and the largest item of difference between the Commission and Hope as to cost of plant, were expenditures for well-drilling amounting to $12,643,641. This was composed of $11,279,554 for wells drilled prior to 1923 by the Company itself, and $1,364,087 for wells drilled prior to 1923 by companies whose properties were acquired by Hope (R. I, 195; Exh. 20). Such expenditures were for labor, use of drilling-rigs, hauling, and similar costs—all known to the industry as "intangible well costs." They do not cover the cost of well equipment items, such as casing and tubing, which were included by the Commission in the "original cost." (b) Items for amounts that were never expended, such as interest during construction ($632,000), for which no charges were ever incurred. (R. I, 24, 180.) (c) Items which the Commission has already included in the rate base.[33]

Hope reached its estimate of "original cost" by ignoring its past accounting practice, instead making an inventory of all its properties, and then pricing the inventory according to prices obtained from vouchers and other documents and from engineer's estimates (R. II, 178–185, 201, 204–210).

The Commission refused to include these well-drilling and related costs in the rate base on the ground that those expenditures had been cor-

[33] The failure of the court below to notice this breakdown (R. IV, 184) was apparently an inadvertence.

rectly charged to operating expenses by the Company in accordance with the general practice of the industry; that they have already been recouped from Hope's customers; and that to include them in the rate base would result in duplicate charges (R. I, 26–29.[34] This accorded with the Commission's settled practice of accepting, in the process of determining cost or investment, books kept in the regular course of business, subject to the correction of errors found therein.

The majority below held that the entire $17,000,000 must now be capitalized and (less accrued depreciation) reflected in the rate base, because the items, "erroneously charged to expense" instead of to capital by the Company, "represent investment by the company in property which it uses in rendering the service for which rates are prescribed" (R. IV, 184–185, 189).

We submit that the court erred because (1) the items in question were properly charged to expense, and (2) since Hope has been reimbursed for them out of operating expenses, they do not represent investment on which Hope is entitled to a return. Since the intangible costs of well-drilling constitute more than $12,500,000 of the $17,000,000 involved, and present Hope's

[34] Although the Commission's present System of Accounts provides for the capitalization of such costs, it explicitly prohibits the reaccounting for items properly charged to expense in the past (R. I, 234–238; Ex. 58, R. III, 48).

contentions in their most favorable light, the following discussion and analysis will be in terms of these costs.

B. PRIOR TO 1923, HOPE INTENTIONALLY AND PROPERLY CHARGED WELL-DRILLING COSTS TO OPERATING EXPENSES

As the Commission found in accordance with the evidence, it was Hope's "consistent practice * * * up to 1923 to charge the cost of drilling wells to operating expense" (R. I, 27, 251–254; R. II, 173–177, 181). This reflected the almost universal practice not only of natural gas companies but of all extractive industries (R. I, 276–277), as Hope's chief accounting officer, who had been with the Company for many years, and the Commission's witnesses testified (R. II, 173–174; R. I, 253–256). Thus, in 1919, the Natural Gas Association of America opposed a provision in the first Uniform System of Accounts for Natural Gas Companies requiring the classification of well-drilling expenditures as plant costs, basing its opposition on the ground that such expenditures were incurred to maintain the business rather than to add to it (R. I, 255). And in 1921, Hope itself contended before the Public Service Commission of West Virginia that well-drilling costs should be treated as expense, and succeeded in obtaining permission so to charge them, thereby raising its rates to local consumers. *Re Hope Natural Gas Company,* P. U. R. 1921 E, 418, 433, 440. In that ruling the West Virginia

Commission observed that the failure of natural gas companies to capitalize well-construction expenses was commonly explained as follows: Since drilling expenses are incurred in an attempt to maintain sufficient gas production to meet demands, and since "notwithstanding such drilling, its available supply of gas is constantly and rapidly decreasing each year, * * * at least a part of the cost of maintaining this failing supply should be borne by consumers for the period within which such additional investment is made." *Re Hope Natural Gas Co.*, P. U. R., 1921 E, 418, 440.

However, in 1922, scarcely more than a year after its decision, the State commission issued a Uniform System of Accounts for all natural gas companies subject to its jurisdiction, including Hope, requiring them to charge expenditures for well-drilling to capital on and after January 1, 1923 (R. II, 174; R. I, 28). Hope accordingly changed its accounting procedure for these expenditures, not to correct any error, but rather to comply with the uniform system of accounts, to promote uniformity in the future. This change in accounting also recognized the progress then being made in gas and oil exploration and in drilling methods, which was bringing about the discovery of huge resources formerly unknown and unavailable and thus was removing the fear of rapid decrease in supply—the *raison d'être* of the former accounting procedure.

The propriety of Hope's accounting procedure up to 1923, as to well-drilling items, has been recognized by the Bureau of Internal Revenue. Questions as to the proper treatment of these expenditures have arisen under Section 212 (b) of the Revenue Act of 1918 (40 Stat. 1057, 1064–1065), which provided generally that the taxpayer's method of keeping books was to be accepted by the Commissioner of Internal Revenue, unless he found that method to be wrong. Under this provision, the Commissioner has allowed the taxpayer the option of capitalizing such items or charging them as ordinary and necessary operating expenses, provided that consistency is maintained. Income Tax Regulations, Reg. 103, Secs. 19.23 (m)–15 (b) (3); 19.23 (m)–16 (a) (1) This tax rule is still in effect, and most natural gas companies, including Hope, continue to charge such expenditures as operating expenses for income tax purposes (R. I, 255; R. II, 176).[35]

Since the intangible costs of well-drilling incurred prior to 1923 had already been properly charged by Hope to operating expenses, the Com-

[35] Even today, some oil companies still follow the practice of charging the intangible costs of well-drilling to operating expense for general accounting purposes (R. I, 254–256). This is in accordance with the general policy of conservatism, adhered to in extractive businesses, which frequently charges to expense items which in other industries would be charged to capital (R. I, 256). Cf. *Marsh Fork Coal Co.* v. *Lucas*, 42 F. (2d) 83 (C. C. A. 4); *Commissioner of Internal Revenue* v. *Brier Hill Collieries*, 50 F. (2d) 777 (C. C. A. 6).

mission properly refused to permit Hope now to renounce its own voluntary accounting practice, and to present the same items as capital expenditures in order to derive the benefit of an increased rate base.

C. THE WELL-DRILLING COSTS WERE FULLY RECOVERED THROUGH RATES AND SHOULD NOT NOW FORM A BASE FOR FURTHER ANNUAL RETURN

As we have shown, the practice of charging well-drilling costs directly to expense was common to the whole gas industry, and represented a managerial decision as to allocation of expenditures. Such a decision, like other managerial determinations as to allocation of costs, affects the operating figures of the utility and is bound to be reflected in the rates. Certainly Hope in fixing rates was influenced by the common managerial desire to recover all its costs, and these, prior to 1923, included well-drilling expenses, Indeed, the inclusion of these expenses was one of the means which Hope utilized to obtain a higher rate to consumers in West Virginia in 1921.[36] There can be little

[36] Even during the unregulated period, Hope as a public utility was required by the common law not to charge more than a just and reasonable rate. *Munn* v. *Illinois*, 94 U. S. 113, 126–127, 133; *Chicago, B. & Q. R. R. Co.* v. *Iowa*, 94 U. S. 155, 162. And the local commission could scrutinize the charges from Hope to the intrastate utilities in order "to prevent imposition upon the community served by the latter" (cf. *Houston* v. *Southwestern Tel. Co.*, 259 U. S. 318, 323), or in order to ascertain whether there is bad faith. Cf. *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276, 288.

doubt, therefore, that during the period when Hope was charging the costs of well-drilling to operating expenses, that is from the Company's inception in 1898 up to 1923, Hope fully recouped the costs of well drilling. During this 25-year period, Hope was earning an annual average return of 15% on its average invested capital[37] (R. I, 34; R. III, 13–14), which is of course the return after meeting all annual operating expenses including well-drilling costs.

The decision of this Court in *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U. S. 575, is in fact dispositive of this question, as was pointed out by the dissenting judge below (R. IV, 205–207). In the *Pipeline* case, involving an interim rate order under the Natural Gas Act, the Commission, solely for the purpose of that order, had "reluctantly" accepted as the rate base the Company's estimate of the value of all physical property—including excess capacity—calculated at reproduction cost new. The Company, however, sought to include in the rate base, *inter alia,* the costs of maintaining the excess capacity during the unregulated period, costs which had already been charged to operating expense. This the Commission rejected, and its determination was approved by this Court. The rationale expressed in the opinion (315 U. S. at 590–591) is closely

[37] The term "invested capital" is used to include capital stock and earned surplus. Hope's entire capital structure consists of common stock.

apposite here: Since the Company had treated these items as operating expenses to be compensated from earnings, and since the history of the Company before regulation showed an average annual return of 8% on the undepreciated investment, it could not be said "that the Commission has deprived the companies of their property by refusing to permit them to earn for the future a fair return and amortization on * * * *costs which the companies fail to show have not already been recouped from earnings* before computing the substantial 'net profits' earned during the first seven [unregulated] years." [Italics supplied.] This Court found it significant that the Company had "charged the out-of-pocket cost of maintenance of plant * * * as operating expenses deductible from net earnings before arriving at net profits", and pointed out the want of a showing "that the items which have never been treated as capital investment, have not been recouped during the unregulated period." See, also, *Natural Gas Co.* v. *Public Service Commission,* 95 W. Va. 557, 571, 121 S. E. 716, 723; *Peoples Gas Light & Coke Co.* v. *Slattery,* 373 Ill. 31, 25 N. E. (2d) 482, 493, appeal dismissed, 309 U. S. 634.[38]

---

[38] In addition to the cases quoted, *supra*, the following also prohibit reaccounting and support the principles employed by the Commission.

Los Angeles Gas & Electric Corp. v. *R. R. Comm'n*, 58 F. (2d) 256, 261, 267 (S. D. Cal.), affirmed, 289 U.S. 287; *North-*

As was true of the Company in the *Pipeline* case, Hope charged the items in question to operat-

---

western Electric Co. v. *Federal Power Commission*, 125 F. (2d) 882, 887 (C. C. A. 9); *cf. Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90, 95, 97–99; *Chicago & N. W. R. Co.* v. *Commissioner of Internal Revenue*, 114 F. (2d) 882, 886, certiorari denied, 312 U. S. 692.

A large number of rate-making bodies take the same view. *Elgin, Joliet & Eastern Ry. Co.*, 84 I. C. C. 587, 592; *Re Northwestern Electric Co.*, 36 P. U. R. (N. S.) 202, 208; *Re Canadian River Gas Co.*, 43 P. U. R. (N. S.) 205, 214; *San Francisco* v. *Pacific Gas & E. Co.*, P. U. R. 1918A, 506, 521; *Re Los Angeles Gas & E. Corp.*, P. U. R. 1931A, 132, 143; P. U. R. 1933E, 317, 323; *Re Leadville Water Co.*, P. U. R. 1921D, 172, 183; *Re Potomac Electric Power Co.*, P. U. R. 1917D, 563, 606; *Re Hawaiian Electric Co. Ltd.*, 33 P. U. R. (N. S.) 161, 165; *Re Kootenai Power Co.*, P. U. R. 1924E, 831, 833; *Illinois Commerce Comm'n* v. *Pub. Serv. Co. of No. Illinois*, 4 P. U. R. (N. S.) 1, 21; *Illinois Commerce Comm'n* v. *Commonwealth Edison Co.*, 15 P. U. R. (N. S.) 404, 405; *Re Peoples Gas Light & Coke Co.*, 19 P. U. R. (N. S.) 177, 196; *Re Indianapolis Water Co.*, P. U. R. 1919A, 448, 479; *Re Central Maine Power Co.*, P. U. R. 1918C, 792, 796; *Re Eaton Rapids*, P. U. R. 1922D, 94, 104; *Re West St. Louis Water & L. Co.*, P. U. R. 1922E, 805, 819; *Aluminum Goods Mfg. Co.* v. *Laclede Gas Light Co.*, P. U. R. 1927B, 1, 14; *Pub. Serv. Comm'n* v. *Montana P. Co.*, P. U. R. 1924B, 364, 372; *Hermann* v. *Newton Gas Co.*, P. U. R. 1916D, 825, 843; *Moritz* v. *Edison Electric Illum. Co.*, P. U. R. 1917A, 364, 390; *Maries* v. *Flatbush Gas Co.*, P. U. R. 1920E, 930, 1004; *Re New York State Rys.*, P. U. R. 1922B, 75, 79; *Re Westchester Lighting Co.*, 15 P. U. R. (N. S.) 299, 310; *Re Brooklyn Borough Gas Co.*, 21 P. U. R. (N. S.) 353, 371; *Public Util. Comm'n* v. *Duquesne Light Co.*, 20 P. U. R. (N. S.) 1, 10; *Pub. Util. Comm'n* v. *Peoples Natural Gas Co.*, 43 P. U. R. (N. S.) 82, 109; *Re Clarksburg Light & H. Co.*, P. U. R. 1917A, 577, 598, P. U. R. 1928B, 290, 296; *Re West Virginia Central Gas Co.*, P. U. R. 1918C, 453, 464, P. U. R. 1924E, 24, 34; *Re Mondovi Telephone Co.*, P. U. R. 1933B, 319, 321, P. U. R. 1933D, 142, 144; *Re Reedsburg Telephone Co.*, 7

ing expenses, received a substantial return on its investment, and has not shown that the items were not fully recovered. Since Hope is unable to show "with the clarity and definiteness befitting the cause" (*Lindheimer* v. *Illinois Bell Telephone Co.*, 292 U. S. 151, 164, 169; *Los Angeles Gas Co.* v. *R. R. Comm'n*, 289 U. S. 287, 304, 305; *St. Joseph Stock Yards Co.* v. *United States*, 298 U. S. 38, 53) that these expenditures "have not already been recouped from earnings," the Commission's refusal to permit Hope to earn for the future a fair return and depreciation on these expenditures cannot be said to deprive it of its property. *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, 590, 591; *Des Moines Gas Co.* v. *Des Moines*, 238 U. S. 153, 166.

The ground upon which the court below held that these costs belong in the rate base, was that (R. IV, 185) "the wells are existing property used by the utility in its service to the public. The items entered into their cost just as truly as if they had been charged to capital account" (quoting Mr. Justice Brandeis' definition of original cost as "the amount actually paid to establish the utility." *Southwestern Bell Telephone Co.* v. *Public Service*

P. U. R. (N. S.) 389, 395. See also *Statement Relating to the Original Cost and Reclassification of Utility Plant Pursuant to the Provisions of Uniform Systems of Accounts for Electric, Gas and Water Utilities*, by the Committee on Statistics and Accounts of the National Association of Railroad and Utilities Commissioners, September 20, 1940.

Commission, 262 U. S. 276, 295). This reasoning, however, confuses cost with return, and overlooks the basic principle that Hope is entitled to a return only on that part of costs which have not been and are not currently being returned to it through operating expenses. The intangible costs of well drillings may be part of Hope's costs in establishing the utility, but Hope is entitled to a return on those costs only so long as its investment therein has not been fully recouped. There is no principle which would entitle it to a continuing return on an item of property whose cost has been fully recovered from the rates received, and which thus does not represent an investment, even though the property involved remains in use.

The effect of Hope's practice of charging the intangible well-drilling costs to operating expense was to require the customers to pay not only for the current service being rendered to them but also to contribute the amount of these costs to the capital of the company. Cf. *Re West Virginia Central Gas Co.,* P. U. R. 1924 E, 24, 34–35. Since the customers have in effect financed these well-drilling expenditures, their capitalization in the rate base would violate the long-established rule that a utility should not be permitted a return on property constructed and financed with customer contribution. (*Louisiana R. R. Comm.* v. *Cumberland Tel. & Tel. Co.,* 212 U. S. 414, 424, *et seq.; cf. Lindheimer* v. *Illinois Bell Telephone Co.,* 292

U. S. 151, 169, 174; *Detroit Edison Co.* v. *Commissioner of Internal Revenue,* 319 U. S. 98). And since it is "the actual cost of the property—the investment the owners have made" (*Los Angeles Gas Co.* v. *R. R. Comm'n,* 289 U. S. 287, 306) with which we are here concerned, it was proper for the Commission to forbid the capitalization of these items.

Contrary to the view of the court below, there is nothing in *Board of Public Utility Commissioners* v. *New York Telephone Co.,* 271 U. S. 23, which prohibits the Commission from excluding intangible well-drilling costs from the rate base. In that case, the Public Utility Commission found that the Telephone Company had been taking excessive annual depreciation allowances, and the Commission attempted to absorb such excess by imposing rates which would reduce the prospective depreciation allowances of the Company below the *actual* rate of depreciation. This Court thought this to be error, holding that "the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations. Profits of the past cannot be used to sustain confiscatory rates for the future" (271 U. S. at 32).

That case is plainly inapplicable here. The Commission has not attempted here to impose prospective confiscatory rates in order to absorb past excessive profits; it has merely refused to allow Hope to capitalize expenditures already

recouped and thereby prospectively to earn excessive profits through an annual return and depreciation allowance on such expenditures. The *New York Telephone* case involved an order by the regulatory body directing "the company to make up current losses out of reserves accumulated from the past"; it raised no question "in regard to including property in the rate base which had theretofore been paid for out of operating expenses." *Wheeling* v. *Natural Gas Co.*, 115 W. Va. 149, 160, 175 S. E. 339. The distinction is between a rate producing less than a fair return in order *to equalize past* excessive profits, which was presented in the *Telephone* case, and a rate producing a fair return on investment from which fully recouped items have been excluded in order *to prevent future* excessive profits, which we believe is presented here.

The *Telephone* case is not apropos for an additional reason. Since its effect is to enable the Company to accumulate more than sufficient to replace the property at the end of its service life and thereby earn more than a fair return, the rule of that case would not apply to "wasting asset businesses of limited life," such as the natural gas industry, for there "the Constitution does not require that the owner * * * shall receive at the end more than he has put into it." *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. at 593.

D. PRACTICAL CONSIDERATIONS SUPPORT THE COMMISSION'S EXCLUSION OF THESE ITEMS FROM THE RATE BASE

As a practical matter, it is fundamental to effective rate regulation that a proper decision once made as to accounting policy be binding as to all past transactions thereunder. In utilities as in other enterprises, lines of demarcation, although clear in theory, are frequently "difficult * * * to observe in practice with scientific precision" (*Lindheimer* v. *Illinois Bell Telephone Co.,* 292 U. S. 151, 173), and, therefore, much discretion must be exercised even with accepted principles and practices as guides.

For example, there are items in the Commission's present System of Accounts whose treatment is borderline. The costs of exploration and development, as an illustration, are treated as current expenses. Such costs, involving expenditures for delay rentals, nonproductive well-drilling, and related matters, are necessary to maintain production. The Chief of the Commission's Bureau of Accounts, Finances and Rates testified that there was considerable support in accounting theory for capitalizing such expenditures, but because the practice of the industry was to treat them as expenses, he recommended that the Commission approve that method. (R. I, 259–260.) The Commission consequently allowed $600,000 as annual expenses for exploration and development (R. I, 53–54, 65), and Hope has raised no objection thereto. But if it is successful in its claim

for the retroactive capitalization of well-drilling expenditures, there is no reason why similar claims could not be successfully prosecuted in a future rate case to capitalize exploration and development costs which are now allowed as expenses. And over a period of years the latter costs would greatly exceed the well-drilling costs. Again, under the Commission's System of Accounts, Hope may elect to charge administrative and general costs to expenses, or to capitalize them. Hope informed the Commission that it chose the former alternative; hence the Commission allowed the Company $138,018 in 1940 operating expenses (R. I, 49–50). It would be manifestly wrong to permit Hope to capitalize the same costs in some future rate case.

To permit renunciation by a company of its own accounting practice would invite juggling of items many years after their occurrence, in any manner likely to benefit the utility. For example, in asserting a right to capitalize the well-drilling expenses here involved, Hope rejects its own past accounting practice of many years' standing, impeaches its books kept competently for a long period of years, nullifies the decisions of its management, and impugns financial statements and reports properly and correctly made by the Company in the past to the tax authorities, to regulatory commissions, and to the public generally (R. I, 31; R. II, 173–176). It substitutes the figures of a specially engaged witness, who

admittedly knows nothing about the practices and policies of Hope or the industry (R. II, 178–370). Mr. Antonelli, who was the Company's "expert" on this subject, admitted that he was not an accountant, that he was unfamiliar with the operations of the Company, and that he was not concerned with the accounting practices of the Company nor with its management's decisions or policy in the past regarding the classification of expenditures between operating expenses and plant (R. II, 315).[39] It is this calibre of expertise which, if the Commission's action is overturned, would be invoked to resuscitate ancient items charged to operating expenses, and to tender them as items of capital for which the rate payer must pay an annual charge.

E. REMAINING ITEMS EXCLUDED FROM THE RATE BASE

The remaining items, totalling some $4,500,000, which the Commission excluded from original cost, were made up of overhead charges and minor items of property. The former arise largely from the exercise of *nunc pro tunc* judgment in the allocation of expenditures between plant-investment and expenses. There is even less reason for permitting readjustment here than in the case of items which are at least arguably related to capital investment.

[39] Even he was obliged to admit on cross-examination that the retroactive capitalization of such items was improper (R. II, 326–327).

The minor property items consist largely of the estimated cost of minor structures, such as sheds and toolhouses, for which separate accounting entries were not made. This accorded with proper accounting standards, for these items were not separately identified in the plant investment account and were merely subsidiary to main structures which were so identified (R. III, 32). The items in question have been charged either to investment or expense. If to investment, they are already in the rate base, although not so identified. If to expense, they were properly treated as expendable and should not be included in the rate base for the reasons discussed above in connection with well-drilling expenses.

As for the item of $632,000, consisting of interest during construction which was never incurred, little need be said. Even in reproduction cost estimates, this Court has approved the disallowance of hypothetical costs which were never incurred by the utility. *Los Angeles Gas Co.* v. *R. R. Comm'n,* 289 U. S. 287, 310; *Wabash Valley Electric Co.* v. *Young,* 287 U. S. 488, 500.

IV

THE COMMISSION PROPERLY USED THE ECONOMIC-SERVICE-LIFE PRINCIPLE IN DETERMINING ACCRUED DEPRECIATION AND DEPLETION

In determining the proper rate base, the Commission first computed the original cost of Hope's