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IN THE

Supreme Court of the United States

October Term, 1943.

No. 34.

FEDERAL POWER COMMISSION, CITY OF AKRON and PENNSYLVANIA PUBLIC UTILITY COMMISSION,

v.

HOPE NATURAL GAS COMPANY.

Writ of Certiorari to Review a Judgment of the United States Circuit Court of Appeals for the Fourth Circuit.

BRIEF FOR THE PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK AMICUS CURIAE.

The Public Service Commission of the State of New York having an interest in this litigation, adverse to Hope Natural Gas Company, presents the following brief as *amicus curiae.*

This brief will be confined to the single question as to whether the labor and equipment cost of Hope Natural Gas Company, incurred prior to 1923 in drilling wells, and charged during those years to operating expenses, should

now be added to the capital account in determining the original cost of the property of that company devoted to the public service.

Statement of Facts.

This is a writ of certiorari granted by this Court on May 17, 1943, to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit, entered on February 16, 1943, which set aside an order of the Federal Power Commission reducing the rates of Hope Natural Gas Company, and which set aside the Federal Power Commission's "Findings as to Lawfulness of Past Rates."

Interest of the Public Service Commission of the State of New York.

The Public Service Commission of the State of New York is a state regulatory commission and is charged with the duty of regulating the rates and charges of natural gas companies distributing gas within the State of New York (§72 P. S. L.). In addition, it is empowered to require natural gas companies to keep continuing property records showing the original cost of their property used in the public service.

Section 114 of the Public Service Law of the State of New York in part provides:

> "Temporary rates.—To facilitate prompt action by the commission in proceedings involving the reasonableness of the rates of any public utility and to avoid delay in any such rate proceeding, the commission is hereby authorized to require any public utility company to establish, provide and maintain continuing property records, including a list or inventory of all of the physical property actually used in the public service, and to require any public utility company to keep its books, accounts and records in such manner

> as to show currently the original cost of said physical property and the reserves accumulated to provide for the retirement or replacement of said physical property."

The holding of the United States Circuit Court of Appeals for the Fourth Circuit in this proceeding that there should be included in the original cost of the property of the Hope Company amounts expended for labor and equipment in drilling gas wells where it appeared that such amounts had been charged by the company to operating expenses, will directly affect the New York State Public Service Commission in proceedings involving the proper rates and charges of natural gas companies, and in proceedings involving the establishment of continuing property records by such companies.

It has appeared in numerous prior proceedings, and in certain proceedings now pending, conducted by the New York State Public Service Commission, that natural gas companies under its jurisdiction, have charged to operating expenses large sums representing labor cost in drilling gas wells. The establishment of a legal rule that these amounts must be included in the original cost of the property of these companies would directly affect this Commission in the exercise of its statutory duties.

ARGUMENT.

The labor and equipment cost of Hope Natural Gas Company incurred prior to 1923 in drilling wells and charged during those years to operating expenses should not now be added to the company's capital account in determining the original cost of the property of that company used in the public service.

It is the position of the New York State Public Service Commission that the Federal Power Commission in its

opinion of May 26, 1942, properly determined this matter and that the Circuit Court of Appeals in setting aside the order of the Federal Power Commission, and in holding that these expenses must be considered in determining the original cost of the company's property, committed error. It is our position that the Court failed to distinguish between amounts that are properly included in fixing the original cost of the company's property and amounts that would be included in an estimate of what it would cost to reproduce such property under the present prices and under the presently prescribed accounting procedure. In this connection the Court said: "And, even if the prudent investment theory be adopted for determining the rate base, we see no valid reason for excluding these items from the investment." (P. 300).

We further urge that the Court failed to appreciate that the accounting practices under which the cost of drilling wells was charged to operating expenses were, at the time when the expenditures were made, entirely proper and in accordance with the then established accounting procedure. As to this the Court said: "There is little excuse for not considering as capital investment items *erroneously charged to expense.*" (P. 303) (Italics ours.)

Error in Determining "Original Cost"

In determining what was the "original cost" of a utility's property there can be no dispute as to whether the majority of expenditures are properly chargeable to operations or to capital. There are, however, certain expenditures that lie on the border line, and under different systems of accounts or under different accounting procedures might properly be included as either an operating expenses or a capital

charge. As to these border line items the books and records of the company are important, for if a particular expenditure was at the time it was incurred properly charged as an operating expense and was so paid and so entered upon the utility's books, it must remain, even though under present practices it would be entered as a capital charge. Such an item cannot be an operating expense when paid and a capital charge for the purpose of a rate proceeding. This is one distinction between a determination of original cost and a determination of the cost of reproducing utility property.

Error in the holding that these Expenditures were "Erroneously Charged to Expense"

It is unnecessary to here argue the fairness or propriety of allowing a company that has in past years inflated its operating expenses by including therein amounts that *should concededly* have been charged to capital to include these amounts in the company's rate base. No such situation is presented. It is our understanding that the opinion of the Federal Power Commission, involved in this cause, in no way finds or requires that any conceded capital expenditure should be excluded in fixing rates, even though such an expenditure had been charged to operations.

The disputed items excluded by the Commission and included by the Court were only those that the Commission found had been properly charged to operating expenses under the accounting procedure in force at the time such costs were incurred. It, therefore, appears that the discussion contained in the opinion of the Court that "Consumers pay for service not for the property

used to render it." and that "the revenue paid by the customer for service belongs to the company" and other similar statements have no relevancy. Such discussion would only be material if the Power Commission had based its findings on the theory that proper capital charges must be disregarded in fixing rates if they had originally been charged against operations and therefore paid by the company's customers. It is our position that the proper rule is that if at the time it was incurred a particular expenditure could, under accounting practices then in effect, be considered an operating expense, and if it was so paid and so recorded it must remain on the books of the company as an operating expense and cannot for the purpose of a rate proceeding be considered a capital charge.

If we are correct, and we believe we are, in this argument, the question before this Court narrows to a determination of whether the action of Hope Natural Gas Company in paying as an operating expense the labor and equipment cost of drilling wells was authorized under the practice of natural gas company in effect at the time.

We will restate our position:

The Labor and Equipment Cost of Drilling Wells by a Natural Gas Company can Properly be Considered an Operating Expense

In considering the accounting practices of natural gas companies, their specialized operating method must always be kept in mind, and the practices of other types of utilities have little if any application. New gas wells must continually be drilled, not to enlarge or extend the company's operations but simply to maintain its operations and to

enable it to continue to supply gas to its customers. If no new wells were drilled the company's available supply of gas would rapidly decrease and its investment in transmission and distribution mains would be reduced to their scrap value. The drilling of new wells is therefore required if the utility's investment is to kept intact. The labor cost of such well drilling in no way corresponds to expenditures made by an electric, manufactured gas or water company in extending its system to secure additional consumers or to make available increased production. The labor cost incidental to the placing in operation of new wells is in a very true sense an operating expense of a natural gas company. It corresponds to the labor cost required to operate the generating plant of an electric company and so provided the product that the utility is selling or the labor cost required to produce gas at a gas plant of a manufacturing gas company. In the natural gas business the operating company must meet the payroll of men employed in securing a continuing supply of gas to be distributed to the utility's customers. In a manufacturing gas plant the company must similarly meet the payroll of men employed in operating its gas manufacturing plant and so securing a continuing supply of manufactured gas to be distributed to its customers. Can it be said that such labor cost of a manufacturing company is not an operating expense?

That these labor costs can properly be considered as operating expenses is not a novel theory advanced for the first time by the Federal Power Commission. It was the practice of the Hope Company for many years, and it had been the almost universal practice of the natural gas industry. This was pointed out by the Commission when it stated: "It was the consistent practice of the Hope Company up to 1923 to charge the cost of drilling wells to

operating expense. This likewise was the general practice of the new gas industry."

In this connection it appears that the Circuit Court misconstrued the West Virginia law requiring that these types of expenditures be charged directly to capital. Such a requirement does not mean that the accounting practice that had been so uniformly followed was improper. It simply amounted to a determination that the new accounting practice was more desirable. This is understandable. In a regulated utility wide fluctuations in operating expenses should, if possible, be avoided, and since new wells must be drilled, if the continued flow of gas is to be maintained, the utility may during short periods engage in extensive drilling, and if such new wells are productive, may for other short periods temporarily curtail expenses. Operating expenses would increase and decrease, depending on whether or not wells were required.

In view of the peculiar business of natural gas companies, and in view of the almost uniform practice of the industry, we urge that this Court should not hold that the payment by Hope Natural Gas Company through operating expenses of the cost of well drilling was improper at the time these expenditures were incurred, or that the Federal Power Commission improperly excluded such expenditures in its determination of the original cost of the company's property.

Decisions of State Courts and Regulatory Commissions

The question of whether any expenditure charged by a utility to operating expenses should be included in the rate base has been considered in numerous proceedings by

state courts and regulatory commissions. Reference to these decisions is included to demonstrate that the accounting practice followed by Hope Natural Gas Company prior to 1923 has received the approval of these state bodies.

District of Columbia

In *Re Potomac Electric Power Co.*, P. U. R. 1917D, 563, 607, the Commission pointed out:

> "Without deciding as to the accuracy of the proposed percentage basis, it appears to this Commission to be contrary to the best interests of all concerned to permit the company thus to revise its operating expenses. Much confusion must inevitably result from such a modification of what has heretofore been understood as 'operating expenses' in the sense in which the term has been used by the company. Owing to the peculiar position occupied by statements of operating expenses in published reports, it is the opinion of this Commission that it is subversive to the intent and purpose of effective regulation to acquiesce in any policy which would deprive such statements of their *bona fide* character, whether in the past or in the future."

Idaho

In *Re Kootenai Power Company*, P. U. R. 1924E, 831, 833, the Commission said:

> "When funds are paid out as operating expenses and deducted from gross earnings in determining the net earnings of the company, such expenses should not later be segregated and capitalized against future generations. If this were to be done, such expenses had as well be charged to the capital account in the first place. If these are operating expenses, and are paid as such, that is what they are. They are not operating charges when paid, and capital charges for the purpose of capitalization at a later date by this Commission."

Illinois

In *Illinois Commerce Commission v. Commonwealth Edison,* 15 P. U. R. (NS) 404, 405-406, the Illinois Commission said:

> "The company contended that the cost of its physical property as shown by the books did not report the true or actual cost of the company for such property, inasmuch as many items of cost had not been charged to the property account * * *
>
> "* * * These expenditures represent largely items which the company paid during these years for general administrative and supervisory services. It is evident that the company considered these expenditures as a part of its daily operating expenses because it so charged them upon its books and so reported them in its reports to the Commission. It would be improper to allow the company to capitalize on its books now any items (apart, of course, from mere accounting errors) which were charged to operating expenses and so reported in reports to the Commission for the period from July 1, 1913, to the present."

In *Illinois Commerce Commission v. Public Service Commission,* 4 P. U. R. (NS) 1, the Commission pointed out:

> "* * * Neither as a matter of equity or law is it proper for the Commission to permit the inclusion in a rate base of charges already paid for by customers. For the Commission now to sanction this policy would be to result in placing a premium upon charging to operating expenses charges properly belonging to fixed capital accounts, and destroying the purpose and functions of the uniform classification of accounts."

In *People Gas Light & Coke Co.,* 19 P. U. R. (NS) 177, 196, the Illinois Commission said:

> "* * * The practice of the Company in charging administrative, legal, engineering, * * * expenses to operating expenses rather than to fixed capital, did not arise from a mere incidental error upon the part of the company, but seems, rather, to have represented a fixed policy on the part of the management.
>
> "The original cost of the property for rate making purposes may not be increased because of a change in

> the company's policy with respect to the charging of overhead items as between operation and cost of the property * * *."

Maine

In *Re Augusta Water District*, P. U. R. 1917B, 653, 656, it appeared that the Commission was fixing the cost of an extension upon which consumers were required to guarantee a certain return. The Commission excluded, among other charges made, salaries paid for superintendence which had been charged to operating expenses, saying:

> "It can make no difference that some of these charges might, under some conditions, go into plant account. They do not do so under the practice pursued by this utility, and cannot be allowed in this case."

Numerous other decisions could be cited but we believe the quoted cases are representative of the attitude of the state courts and regulatory commissions.

CONCLUSION.

From the foregoing arguments we believe it has been shown that the labor and equipment cost of Hope Natural Gas Company incurred prior to 1923 in drilling wells should not now be added to the company's capital account in determining the original cost of property of that company used in the public service.

Respectfully submitted,

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September, 1943.