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In the Supreme Court of the United States

OCTOBER TERM, 1942.

FEDERAL POWER COMMISSION, CITY OF AKRON AND PENNSYLVANIA PUBLIC UTILITY COMMISSION, PETITIONERS, v. HOPE NATURAL GAS COMPANY.	No. 890
THE CITY OF CLEVELAND, *Petitioner,* v. HOPE NATURAL GAS COMPANY, *Respondent.*	No. 891

BRIEF ON BEHALF OF HOPE NATURAL GAS COMPANY

In Opposition to the Petitions for a Writ of Certiorari.

Both of the above cases involve the same matter and we therefore file one brief.

OPINIONS BELOW.

The opinion of the Circuit Court of Appeals (R. IV, 169-207) is now officially reported in 134 Fed. (2d) 287. The opinion of the Federal Power Commission (R. I, 16-89) is reported in 44 P. U. R. (N. S.) 1.

STATEMENT.

We supplement the statement made by the petitioners as follows:

Hope's present natural gas properties, all in West Virginia, were constructed and put into use over a period of nearly fifty years. Approximately one-half were con-

structed prior to 1917 at a cost of about $25,000,000 and the other half since that time at a cost of about $45,000,000 (R. IV, 171). This statement of original cost totaling nearly $70,000,000 as of December 31, 1938 (Ex. 20, R. I, 167, 193) conforms to the definition of original cost of Mr. Justice Brandeis, namely, "the amount actually paid to establish the utility" (R. I, 174, 300, II, 205-206). It was determined, as he said it should be determined, "by inspection of books and vouchers, and by other direct evidence. If this class of evidence is not complete, it may be necessary to supplement it by evidence as to what was probably paid for some items, by showing prices prevailing for work and materials at the time the same were supplied." (Concurring opinion of Mr. Justice Brandeis in *State of Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission of Missouri,* 262 U. S. 276, note at page 295; R. I, 183-189.) To the extent of 94% this original cost was shown by books, vouchers and other direct evidence. 6% was estimated (R. II, 184).

The expenditures included in this $70,000,000 actual cost admittedly showed the original cost substantially as it would have appeared on Hope's books had it kept them from the beginning of operations pursuant to the Federal Power Commission's present Uniform System of Accounts, in accordance with which all annual operating statements submitted in this case were prepared (R. I, 300).

The cost actually recorded in Hope's capital accounts on its books as of the same date, December 31, 1938, was $52,730,000 (Ex. 20, R. I, 197). The difference between these book costs and the original cost is accounted for by property items which under modern systems of accounts are required to be charged to capital but which Hope in times past charged to expense. The largest single item, about $13,000,000, represents the drilling cost of 2633 wells now in use which, prior to the effective date of the West Virginia System of Accounts in 1923, had been charged to

expense (R. I, 349, 353). Hope's book costs thus do not reflect the money actually paid to drill 2633 of the wells now in use and to construct various pipe lines, measuring stations, small buildings, telephone lines and other physical property now in use (R. I, 353).

Hope also introduced a reproduction cost new estimate as of the same date of $97,000,000 (R. III, 206) prepared by a widely experienced engineer. This estimate includes nothing for the cost of developing the business or for going concern value or for the discovery value of the great gas fields developed by Hope (Ex. 16A, R. I, 162). In other words, it includes only the estimated cost of reproducing the physical property with all gas leaseholds included at actual cost.

Hope also introduced a trended original cost which merely substituted in the original cost the 1938 prices of labor and materials in lieu of the prices prevailing at the time the construction was made. This trended original cost is $105,000,000 (Ex. 20, R. I, 193, 197), thus indicating a weighted average increase in price levels of 50% over the original cost of $70,000,000.[1]

The Commission gave no weight to any of this evidence in its finding. It ignored all evidence of the vouchers and other direct proof of the "cost to establish the utility," all evidence of present value, all judicially known facts as to the increase in price levels, and started its rate base cal-

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[1] In a note to the Commission's petition, No. 890, at page 17, the reproduction cost new estimate of $97,000,000 and the trended original cost of $105,000,000 are contrasted with what is called the "actual legitimate" cost of $52,000,000. The correct comparison is not with $52,000,000 but with $70,000,000. Obviously the $52,000,000 does not include all or part of the cost of many items of property that are included in all of the figures used by Hope. The Public Utilities Commission of Ohio found the reproduction cost new of Hope's physical property as of June 30, 1937 to be $100,257,000, and its then present value to be $66,166,000 (Exs. A and C, p. 99, to Cleveland's "Supplement to Petition and Complaint as Amended," Docket No. G-100).

culation with the book cost of $52,730,000, adjusted for so-called accounting errors to $51,207,000 as of December 31, 1938 and to $51,957,000 as of December 31, 1940 (R. I, 36, 50). From the latter figure it deducted its estimate for accrued depletion and depreciation to arrive at $29,629,000, added allowances for working capital, useful unoperated leaseholds and net capital additions, and arrived at a rate base, for fixing future rates, totaling $33,712,000 (R. I, 50). The same physical property which appears in the Commission's rate base at $29,629,000 was valued for 1941 taxation by the State of West Virginia at over $50,000,000 (R. I, 391-393, Transcript, pp. 5431-5433, all erroneously excluded by the Commission).

The rate bases used as a basis for the Commission's action as to Hope's past rates were similarly determined.

REASONS FOR DENYING THE WRIT.

It might have been, as the petitioners claim, a matter of great public significance if the Circuit Court of Appeals had approved the Commission's utter disregard of both present value and actual cost in fixing Hope's rates. But it did not. Instead it merely made a particular application of general principles that have repeatedly been applied by this Court.

Separately discussing the five points assigned by the petitioners for inviting review:

I. The Commission's Right to Use a Prudent Investment Rate Base.

(No. 890 Pet., pp. 15-19; No. 891 Pet., 11-16.)

The Circuit Court of Appeals' reasons for its decision are fully set forth in its opinion (R. IV, 172-193) and need no repetition.

We merely call attention to the fact that its holding does not confine the Commission to any single formula or

group of formulas, that it has left the Commission free to reject estimates of reproduction cost and trended original cost or any other single formula, and free to adopt original cost or historical cost "as representing present fair value where under all the circumstances of the case it is not unreasonable to do so" (R. IV, 183-184).

The petitioners claim (No. 890 Pet., p. 15; No. 891 Pet., p. 11) that this case presents the general question of whether the Federal Power Commission "may employ the prudent investment method of rate-making." The plain fact is that the Commission did not use a "prudent investment rate base" or employ the "prudent investment method of rate-making." Its opinion does not claim to have done so. It started its rate base calculation with the approximately $52,000,000 which admittedly did not reflect the actual cost of or even all of the property presently devoted to public service. This figure in the Commission's exhibits is variously called "adjusted book cost" and "original cost" (Ex. 57, R. I, 219, 212; 265-270). In the Commission's opinion it is called "actual legitimate cost or gross plant investment" (R. I, 34-36, 50). Only in the briefs of counsel does it become "prudent investment." Actually these terms are all applied to the same figure, which is merely an incomplete adjusted book cost.

Had the rate base been determined either in accordance with the prudent investment rate-making views of Mr. Justice Brandeis, or in accordance with the practice of the California Commission, the Commission's calculation would have started with a figure of about $70,000,000. Also, and of exceeding importance on the rates fixed, the rate of return would have been based on what Mr. Justice Brandeis called the "necessary cost" of money *at the time it was invested* and not upon conditions controlling the money market at the time the rate order was made (262 U. S., pp. 304-307, 307 note).

What the Commission insisted upon, and what the Circuit Court of Appeals rejected, was the unrestricted right to rest a base calculation on book costs. The Commission also insisted upon the right to use a present low rate of return in combination with these partial past costs, instead of determining the rate of return on the basis of the historical cost of capital at the time it was invested.

It was the results of this rigid bookkeeping method of determining the rate base solely on the way individual books happened to have been kept prior to regulation, without making "pragmatic adjustments"—a method that penalizes conservative accounting of the past by eliminating present property from the rate base; that ignores permanent changes in the value of the dollar and other known facts; that destroys consistency of results in rate regulation; and that requires that utilities shall suffer from inflation and profit from deflation—that were disapproved by the Circuit Court of Appeals.

Nor is it necessary to review this case to assist the Commission and other courts in the disposition of pending cases (No. 890, Pet., pp. 15-16, notes). Few, if any, present natural gas properties are as old as Hope's. It was the pioneer operating company in the Appalachian area. All of the companies referred to in the Commission's petition are in the west and the southwest where the natural gas business has been developed largely in the last twenty years. Certainly it is true of those companies that substantially all, and in most cases all, of the investment in their properties was made after the permanent increase in price levels that occurred as a result of World War I and after the regulation of accounting by various State Commissions. With such companies the disparity between "book cost" and "original cost" and between both and present value are of minor importance compared with other matters entering into rates.

II. Well Drilling and Other Omitted Property.

(No. 890 Pet., pp. 19-22.)

As previously noted, the Commission's application of its rigid bookkeeping formula resulted in the omission from the rate base of all or part of the costs of 2633 wells and other items of physical property now in service. The original cost of this omitted property was approximately $17,000,000. This omission was an automatic result of the Commission's formula due to the fact that prior to regulation Hope charges these costs to operating expense.

The Circuit Court of Appeals merely held that property now devoted to public service must be included in the rate base whether that rate base is measured by value or cost. That in so doing it followed principles long established by this Court and in this respect in conformity with the rate base views of Mr. Justice Brandeis is clear from its opinion (R. IV, 184-189).[2]

Entire omission from the rate base of the value or cost of physical property presently in service was not involved, as the Commission's petition seems to claim, either in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, or *Railroad Commission of Louisiana v. Cumberland Telephone & Telegraph Company,* 212 U. S. 414. The quotation from the *Natural Gas Pipeline* case (No. 890 Pet., p. 21) refers to the subject of going concern value, where the Court refused to accord that company "the privilege of capitalizing the maintenance cost of excess

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[2] The Circuit Court of Appeals carefully considered and disposed of the arguments made in a footnote in the Commission's petition (No. 890, p. 22) as to the effect of the 1921 rate proceedings before the West Virginia Public Service Commission (which affected only Hope's intrastate rates, then only 4% of its business) and the alleged "recoupment" of well drilling costs from earnings (R. IV, 188). We add only that the alleged earning figures stated in the footnote are grossly misleading, as we pointed out to the Circuit Court of Appeals.

plant capacity'' as a measure of such value (315 U. S., pp. 590-591). There was no issue in the present case as to going concern value.

III. The So-Called ''Economic-Service-Life'' Principle of Estimating Accrued Depreciation.

(No. 890 Pet., pp. 22-23.)

The Circuit Court of Appeals did not condemn the depreciation formulas used by the Commission but, on the contrary, said that they ''are undoubtedly important matters for it to take into consideration'' (R. IV, 190). But when the blind application of those formulas resulted, for example, in a depreciation of well equipment to 42.4% of its cost whereas its then salvage value, measured by Hope's experience, was 65.2% of its cost, the court properly held the results arbitrary and unreasonable (R. IV, 189). The difficulty with the Commission was that it paid no attention whatever to the salvage history of the Company's equipment or to the testimony of witnesses who had inspected the property and observed its actual condition. It applied its formulas without checking the results against known facts, a procedure which this Court has condemned in numerous cases cited in the opinion of the Circuit Court of Appeals (R. IV, 190-192).[3]

Nor is there anything in the former decisions of this Court to the contrary. Indeed in *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, which the Commission's

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[3] The argument in a footnote on page 23 of the Commission's petition, No. 890, that the Commission's deduction for accrued depreciation was ''some $24,000,000 less'' than Hope's book depreciation reserve is factually incorrect (R. I, 86), ignores the Commission's finding that Hope's book depreciation reserve greatly overstated the actual depreciation in its present properties in terms of book cost (R. I, 39-40, 46), and ignores the evidence that Hope's book depreciation reserve is only moderately larger than the accrued depreciation found by Hope's engineers expressed in terms of present value (R. III, 24, 206).

petition claims is contrary, the Court said of estimated annual depreciation charges, page 170:

> "The necessity of checking the results is not questioned. The predictions must meet the controlling test of experience."

IV. The Determination of Annual Allowances for Depreciation.

(No. 890 Pet., pp. 23-25.)

The Circuit Court of Appeals found the Commission's annual depreciation allowance inadequate for exactly the same reasons that it found the rate base inadequate, namely, (1) the allowance was based on book costs of a very old property without any reflection of present value, and (2) it omitted any consideration of property costing $17,000,000 excluded from the rate base. Additionally, the Commission failed to include any depreciation allowance whatsoever for property added by Hope after 1940 and included in the rate base.

That the holdings in these respects are in accordance with the former decisions of this Court, including those with which the Commission's petition claims they are in probable conflict, is made clear in the opinion of the Circuit Court of Appeals (R. IV, 194-196).

V. The Commission's Power to Adjudge Retroactively the Lawfulness of Hope's Filed Rates.

(No. 890 Pet., pp. 25-27; No. 891 Pet., pp. 16-21.)

The Commission claims that the decision of the Circuit Court of Appeals as to the Commission's "Findings as to the Lawfulness of Past Rates" is anomalous (No. 890 Pet., pp. 25-27). The real anomaly is in the Commission's assertion of such clearly undelegated power in this one case at the instance of the City of Cleveland.[4] A similar request by the Pennsylvania Public Utility Commission in these

same proceedings was ignored by the Power Commission (R. II, 20, 22, 24). In no other case before it has the Commission asserted any such retroactive power, although if it exists there has not been an interstate natural gas rate in the country since June 21, 1938, the effective date of the Natural Gas Act, which could not have been, or which cannot now, or 20 years from now, be adjudged "unlawful" and in violation of the Act. Even the *Natural Gas Pipe Line* case (No. 890 Pet., p. 15) is still open for such action for the period June 21, 1938 to September 1, 1940, the date the rate reduction prescribed by the Commission's interim order became effective (315 U. S., p. 580). The existence of any such retroactive power, except under legislatively prescribed safeguards, would be wholly anomalous and the Circuit Court of Appeals was clearly correct in holding that "such power cannot be spelled out of the statutes on any theory of interpretation with which we are familiar" (R. IV, 200).

Cleveland claims (No. 891 Pet., pp. 18-21) that the decision of the Circuit Court of Appeals in this case is in conflict with the following decisions of this Court: *Arizona Grocery v. Atchison Railway,* 284 U. S. 370; *Atlantic Coast*

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[4] The pending proceedings before the Public Utilities Commission of Ohio referred to by Cleveland (No. 891 Pet., p. 17) constitute an attempt by Cleveland to enforce beyond June 30, 1939 an ordinance rate which was held grossly confiscatory by that Commission in 1939 and by the Supreme Court of Ohio in 1940. *East Ohio Gas Company v. City of Cleveland,* 27 P. U. R. (N. S.) 387 (1939); *The East Ohio Gas Company v. Public Utilities Commission of Ohio, City of Cleveland v. Public Utilities Commission* (2 cases), 137 O. S. 225, 28 N. E. (2d) 599 (1940). Cleveland's claim that its consumers will be entitled to a $3,600,000 refund under the pending proceedings is merely a claim and nothing more. The rate presently collected in Cleveland under bond is the rate fixed by the Ohio Commission in 1939 and approved by the Ohio Supreme Court in 1940 in the cases cited. This rate in Cleveland and the rate of The Peoples Natural Gas Company in Pittsburgh are the lowest natural gas rates in effect in any of the 25 largest cities in the United States (Ex. 25, p. 5; Ex. 50, Table 1).

Line Railroad Company v. Florida, 295 U. S. 301; and *United States v. Morgan,* 307 U. S. 183. As to these cases we point out:

(1) In none was there any consideration of the lawfulness of a filed rate schedule prior to the effective date of a regulatory body's first order fixing rates for the future.

(2) The regulatory bodies involved were given by the statutes creating them power to make reparations, a power not included in the Natural Gas Act.

(3) The sole issue in the *Arizona Grocery* case was whether the Interstate Commerce Commission, after an order fixing a rate, could later order reparations of moneys collected under that rate upon a subsequent finding that the rate originally fixed was too high. The issue in the *Atlantic Coast Line* case was whether a court of equity could refuse restitution to shippers of increased rates collected by carriers under an order of the Interstate Commerce Commission which had been set aside solely for procedural defects. The issue in the *Morgan* case was whether a court of equity having control of a fund impounded with it could distribute that fund in accordance with subsequent findings of the Secretary of Agriculture, which findings however did not antedate the first order he made and on suspension of which the Court had ordered the fund impounded.

The Circuit Court of Appeals' decision on this point is supported by the recent decision of this Court in *Public Utilities Commission of Ohio v. United Fuel Gas Co.,* 317 U. S. 456. The only specific provision as to the power of the Commission to fix rates in the Natural Gas Act is that when it finds existing rates unreasonable it may fix the rate "to be thereafter" collected (No. 890 Pet., Appendix, p. 30). This is also the provision of the Ohio Public Utility Act considered in the case last cited. Construing this provision the Court said, page 464:

> "If, after such hearing, the Commission finds that the rate or charge is unjust, unreasonable, or otherwise unlawful, it must 'fix and determine the just and reasonable rate, fare, charge, toll, rental or service *to be thereafter* rendered, charged, demanded, exacted or collected for the performance or rendition of the service, and order the same substituted therefor.' § 614-23 (italics added). The statute in terms thus gives the Commission power to prescribe such rates prospectively only. If, after notice and hearing, the Commission finds rates to be unlawful, it can then fix the just and reasonable rates 'to be thereafter' charged. The establishment of new rates must be preceded by a finding that the old rates are unjust and unreasonable, and the new rates are prospective as of the date they are fixed. There is no basis in the statute for concluding that the Commission's orders can be retroactive to the date when the Commission's inquiry into the rates was begun; on the contrary, the explicit language of the statute precludes such a construction."

The Commission's excursion beyond its statutory rate-making powers in the present case was properly curbed by the Circuit Court of Appeals and it is not necessary to add the authority of this Court to prevent further excursions. Indeed, the Commission has restrained itself in all cases but this.

CONCLUSION.

For the foregoing reasons it is respectfully submitted that the petitions for a writ of certiorari should be denied.

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