ly in accordance with the Commission's own Uniform System of Accounts which defines it as follows (Ex. 58, R. III, 44):

> "34. 'Salvage value' means the amount received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale, *or, if retained, the amount at which the material recoverable is chargeable to Account 131, Materials and Supplies, or other appropriate account.*"

Thus the Commission specifically directs that recoverable material *retained* by a gas company in connection with "property which has been *removed*" be treated as salvage—which, of course, it is.

The point involved is not, however, one of definition but of practical conception of what result the Commission reached. The Commission wrote down *all* of Hope's existing well equipment for 3300 wells, and its 3000 miles of field line pipe to substantially less than the book cost of that *part* of all this well equipment and line pipe which Hope's actual experience shows will be in perfectly suitable condition for re-use, either by Hope or other people, many years in the future when the existing wells are abandoned and the existing field lines taken up (Ex. 21, 4). On compressor station equipment it did not go quite this far, but very nearly.

The Commission's brief also argues by footnote (p. 94) that "The depreciation rates are not applied to the original cost of the property, but rather against its 'service value'," namely original cost less salvage value. Hence it is a "mathematical impossibility" to arrive at a net book cost less than "salvage value." The writer of this footnote was not familiar with the record, because the Commission's Staff did apply its depreciation rates directly to the "Adjusted Book Cost," computing them "on the average investment for the year" and did not apply them to the "service value" of Hope's properties (Dunn, Ex. 61, R. III, 181; French, R. III, 172-173).

Both the Commission and Cleveland argue that this Court's decision in *Federal Power Commission v. Natural Gas Pipeline Co.,* 315 U. S. 575, somehow supports what the Commission did on accrued depreciation in this case (Com. Brief, 96; Cleve. Brief, 48-49). In that case depletion and depreciation of properties in a continuing business such as Hope's were not involved at all, but rather amortization on a sinking fund basis for "a business which can exist for only a limited time"—23 years in all from the beginning to the end of the business (315 U. S., 593, 594). The very question involved here—how much of the total service life of Hope's existing properties has *in fact* expired—was agreed to by the parties for the properties involved in the *Natural Gas Pipeline* case. There the beginning was admittedly 1932, the end admittedly 1954, and the present date an obvious fact (315 U. S., 578, 580, 593).

Concluding, we repeat. Neither in this Court, in the Circuit Court of Appeals, nor before the Commission has anyone claimed that the *results* reached by the Commission's Staff and the Commission *in fact* represents the accrued depreciation and depletion existing in Hope's properties. We also note that although the Commission's Staff worked a year after Hope's accrued depreciation study was presented and had available all of Hope's underlying data before presenting its own depreciation and depletion calculations (Tr. 879; R. II, 44; Tr. 3245), not one single Staff witness, engineer or accountant, either by written exhibit or orally, on either direct or cross examination, ever undertook to state that the results reached by Hope's witnesses did not in fact reflect fully the accrued depreciation and depletion actually existing in Hope's property. The plain truth is that Hope was subjected to the blind application of a depreciation formula, inherently requiring a check of results, whose actual results the Staff never checked and the Commission did not choose to check.

The Circuit Court of Appeals was clearly right in condemning the results in this case as arbitrary (R. IV, 189-193).

E. SUMMARY AND CONCLUSIONS AS TO RATE BASE.

As we have seen, the Commission's rate base in this case:

(1) Does not reflect any change in price levels since 1898 and understates by many millions of dollars the present value of Hope's property judged by any reasonable standard (*supra,* pp. 53-54);

(2) Does not include a substantial portion of Hope's properties now actually in service (*supra,* pp. 30-35);

(3) Does not set forth a rate base such as would be determined in California where the prudent investment theory has been practically applied (*supra,* pp. 67-73);

(4) Eliminates a large portion of the other properties by finding that the depreciation therein is substantially in excess of what it is in fact (*supra,* pp. 80-89); and

(5) Applies inconsistent accounting principles to its determinations of rate base and operating statements with the result of understating the rate base and so the cost of gas service (*supra,* pp. 42-46, 86-87).

This Commission rate base which neither represents the property in service nor the cost of this property, nor its present value, is one the like of which has never heretofore appeared in any decision. Probably the nearest approach to it is the District Court's rate base in *West v. The Chesapeake & Potomac Telephone, supra,* where it took merely book cost and deducted the book depreciation reserve, a rate base which this Court tersely condemned as arbitrary. 295 U. S., 678-679.

Actually the Commission's method results in a mere bookkeeping rate base. It ignores present property for past bookkeeping. It converts present physical property and property rights of the utility into mere claims to book-

keeping entries which the Commission's accountants and the Commission, in their own judgment, may decide are not "accounting errors" of the past. If generally applied this bookkeeping theory of rate making would produce grossly inconsistent, inequitable and arbitrary results, just as it has in this case.

For example, Company A's books have been kept for the last 40 years on the principle of capitalizing every item that could possibly be capitalized under accounting rules. Its depreciation reserves have been kept down to a minimum. This has enabled it to pay out large dividends on the largest amount of capital stock that could be issued. Company B on the other hand, the Hope Company, has followed a directly opposite principle. It declared no dividends for the first 10 years (Ex. 81, R. III, 13) of its history and plowed earnings back into the property. It has set up large depreciation reserves when its earnings were good, instead of paying dividends, not only to preserve but to develop its property. Its outstanding capital securities are less than half of its value as assessed for taxation by West Virginia. But on the Commission's theory because of its conservatism and the careful management of its financial affairs in the past Hope is now to have a rate base substantially less than Company A. Sound, conservative and thrifty business practices are to be punished.

Again, let us assume that the Hope properties belong to two separate companies, that Company X owns the one-half of its properties constructed prior to 1917 and Company Y owns the half of its properties constructed since that time. Company X would have an original cost of $25 million, Company Y an original cost of $45 million (*supra*, p. 22). Moreover Company X, being older, would have a higher per cent "depreciation reserve requirement" than Company Y. The result would be that on the Commission's theory Company X would have a rate base of less than half as much as Company Y and its rates would be substantially lower. It is certainly an arbitrary result if

two companies with like properties performing a like service with a like commodity in the same locality have widely different rates. They would have, however, if their rates were fixed by this Commission on its present bookkeeping theory.

In addition the application of this bookkeeping theory rests upon someone's notion as to what was proper accounting in the past and what is proper accounting now. As to this no two accountants have ever agreed—or will. Yet, as illustrated in this case, millions of dollars can be deducted from the rate base because the Commission's present chief accountant believes that well drilling costs are capital expenditures, rightly considered, but also believes it was not an "accounting error" to expense them in the past. Present property rights cannot, except arbitrarily, be allowed to rest on shifting notions of what is proper bookkeeping.

Moreover, this bookkeeping theory necessarily regulates retroactively. Here it has had the effect of determining that nothing is allowed in the rate base for many properties actually existing and in service—and costing and having a present value of many millions of dollars because in the years back to 1898 and long before the Natural Gas Act was even thought of Hope did not capitalize these properties on its books. Hope is thus now penalized millions of dollars because it kept its books in a particular way in the past. Had it kept its books less conservatively—on modern accounting notions—or if it had kept no books at all, it would not be subjected to this enormous penalty. The Natural Gas Act was certainly never intended by Congress to permit the Commission to impose enormous penalties by way of rate base deductions on natural-gas companies because they kept their books one way or another in the past—and to penalize particularly those companies which in the past kept their books most conservatively.

All of this arbitrary action by the Commission has followed in this case from its substitution of its own arbitrary

and untried bookkeeping rate base and rate making theories for the plain requirements of the Natural Gas Act and the Constitution that natural-gas companies must at least be permitted a fair return upon the present fair value of their properties.

II. OPERATING EXPENSES.

(Com. Brief, 99-110; Cleve. Brief, 52-55)

To a very large extent there was no disagreement as to Hope's actual and necessary operating expenses.[32] However, the Staff did, as it phrased it, "disallow" certain items or parts thereof. The Commission in its Opinion did not consider the 1937 and 1938 operating expenses included in the record but did find what it claimed were Hope's necessary operating expenses in 1939 and 1940 and projected future operating expenses on the basis of 1940 alone. In these findings it followed the Staff's "disallowances" and understated or eliminated Hope's operating expenses in substantial sums.

The evidence and the Commission's action on disputed items were as follows:

A. ANNUAL ALLOWANCE FOR DEPRECIATION AND DEPLETION.

(Com. Brief, 99-108; Cleve. Brief, 52-54)

1. Property In Existence In 1940.

Hope's determination of necessary annual depreciation was based on annual rates developed on the basis of a careful study of the entire depreciation experience of Hope from 1898 to date (Ex. 24, R. I, 465-477). Hope's method

[32] Hope's annual operating expenses for each of the years 1937 through 1940 were set forth as claimed by Hope in Exhibits 37, 126 (R. I, 479) and 130 and as claimed by the Commission's Staff in Exhibits 67 (R. III, 224), 67A (R. III, 258), 78 (R. III, 287) and 90 (R. I, 493 and R. III, 349) and in Commission counsel's briefs before the Commission.

served to correlate completely accrued and annual depreciation. As stated by Mr. Rhodes (R. I, 475):

> "These annual rates of depreciation as heretofore stated are determined from the Company's actual depreciation experience over the entire history of its properties and correlate annual depreciation with the accrued depreciation deducted in the Company's exhibits from reproduction cost new. * * *"

We call attention to this testimony because of the wholly erroneous and unfounded statement in the Commission's Opinion (R. I, 37) that Hope presented inconsistent claims on accrued and annual depreciation.

The Commission's Staff used the annual depreciation rates estimated by Commission engineer French (Ex. 65, R. III, 151). On the important property accounts these estimated annual rates were in fact larger than those determined from Hope's study because of the short service lives erroneously estimated for these properties (*supra*, pp. 26-27). The basic reason for the Commission's inadequate annual depreciation expense is, therefore, not in the annual depreciation rates used by the Commission but in the base to which they are applied.

Hope applied its rates to the present value of *all* of its properties (Ex. 24, R. I, 467), whereas the Commission applied its rates to its "Adjusted Book Cost" (Ex. 61, R. III, 175, 181). Since this adjusted book cost excluded the original cost of $17,000,000 of property owned by Hope and presently in service (*supra*, pp. 20, 33), the Commission allowed $0 for the actual depreciation and depletion occurring in these properties each year. Hope is thus compelled to sell off this property each year for nothing. Such action is arbitrary and obviously confiscatory.

In applying its depreciation and depletion rates to the book cost of the other property rather than to its present value the Commission of course defied the decision of this Court in *United Railways and Electric Company of Baltimore v. West*, 280 U. S. 234, where it said at pages 253-254:

"The allowance for annual depreciation made by the commission was based upon cost. The court of appeals held that this was erroneous and that it should have been based upon present value. The court's view of the matter was plainly right. One of the items of expense to be ascertained and deducted is *the amount necessary to restore property worn out or impaired, so as continuously to maintain it as nearly as practicable at the same level of efficiency for the public service.* The amount set aside periodically for this purpose is the so-called depreciation allowance. *Manifestly, this allowance cannot be limited by the original cost, because, if values have advanced, the allowance is not sufficient to maintain the level of efficiency.* The utility 'is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning.' *Knoxville v. Knoxville Water Co.*, 212 U. S. 1, 13-14. This naturally calls for expenditures equal to the cost of the worn out equipment at the time of replacement; and this, for all practical purposes, means present value."

The Commission and Cleveland urged upon the Circuit Court of Appeals that the decision in *Lindheimer v. Illinois Bell Telephone Company*, 292 U. S. 151, justified the Commission's action and the Commission argues here (Com. Brief, 103-104) that it "modifies the contrary holding in the earlier *West* case, 280 U. S. 234." What this Court actually held in the *Lindheimer* case we have already pointed out, *supra*, pages 82 to 83. We add only that what Mr. Justice Butler said in his concurring opinion in that case (292 U. S. 151, 176) was that the Telephone Company's practice of calculating depreciation charges on the straight line method applied to cost less salvage was not in harmony with the *West* case. The Circuit Court of Appeals obviously analyzed the *Lindheimer* decision correctly (R. IV, 195).

It might be noted that the *Lindheimer* case presents the converse of the present case. There depreciation

charges calculated on book costs produced current annual allowances far larger than necessary to reflect the current consumption of property at present values. This Court accordingly condemned them for rate fixing purposes. Here depreciation charges calculated on partial book costs reflecting low price levels of long ago produce current annual allowances far less than necessary to reflect the current consumption of property at present values. The Circuit Court of Appeals properly condemned them for rate fixing purposes.

It was also urged upon the Circuit Court of Appeals, as again here (Com. Brief, 101-103; Cleve. Brief, 52-53), that the Commission's action in calculating depreciation allowances on partial past costs was justified by the decision in the *Natural Gas Pipeline* case, 315 U. S. 575.

In that case the utility was not satisfied with an ordinary depreciation allowance based on the complete consumption of the property in public service. It claimed instead a larger allowance by way of an amortization charge to replace the property in 23 years. The larger allowance by way of amortization was given to it but was limited to the utility's investment. That the decision is confined to a property of limited life is clearly apparent from the opinion (315 U. S., 593).

In the present case no amortization allowance was claimed by Hope or allowed by the Commission, but only the usual depreciation and depletion allowance. Both Hope's engineers and the Commission's Staff treated Hope as the continuing property it is. In such a continuing property the function of a depreciation allowance is, in the language of this Court in the *West* case, to provide the utility with funds "necessary to restore property worn out or impaired so as continuously to maintain it as nearly as practicable at the same level of efficiency for the public service." Since the great and permanent increase in price levels following World War I, Hope can no longer replace at the cost of its

original construction property worn out in service and retired. On the average its replacement cost will now be at least 50% above its original cost. Unless Hope's earnings are sufficient to enable it to make these replacements at present prices the only alternative is to issue and sell, if it can, capital securities to raise money for that purpose. It must either do this or gradually let its properties disintegrate.

All this was stated more succinctly by Judge Parker (R. IV, 194-196).

Against this sound and common sense view of the court below the Commission's brief argues (pp. 102-103) that Hope and the company involved in the *Natural Gas Pipeline* case are really just alike, and the limited principle applied in that case should also be applied to Hope, because (1) Hope will be forced out of business it if does not extend its pipe lines as contemplated and (2) the *Natural Gas Pipeline* Company may continue in business after 1954 if it obtains more gas. With over 700,000 domestic consumers dependent upon Hope (*supra,* p. 5), Hope must and will continue in business so long as there is natural gas in the Appalachian area or elsewhere within transportation range in the United States. Whatever actually happens to the *Natural Gas Pipeline* Company, the Commission's rate determinations and this Court's ruling were made on the basis that "the business, by hypothesis, will end in 1954."

Next the petitioners argue that constitutional requirements are met because the Commission's annual allowances will "reimburse Hope to the amount" of its "existing investment," that Hope is "therefore made whole and the integrity of its investment maintained," and that it "ceases to have a right to a return upon the portion of the investment which has been consumed, and which is recouped from the rate payers through revenues covering annual depreciation allowances" (Com. Brief, 105-106). Here in one paragraph is the whole erroneous theory.

Hope's true "existing investment" is its existing properties. It owns nothing else. It is these properties that the Constitution protects. It is these existing properties that wear out in service and must be replaced. If Hope is not allowed sufficient money in operating expenses to replace these existing properties as they wear out at whatever the actual current cost of replacement is, "the integrity of its investment" is not, as a matter of fact, maintained, nor is Hope "made whole."

What the writer of the Commission's brief means by "existing investment" is not existing property but what it cost—or rather that part of the cost which the Commission has recognized—when installed. Cost, however, the Constitution does not protect. "The public have not underwritten the investment" (Mr. Chief Justice Hughes in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California*, 289 U. S. 287, 306). Cost, moreover, is not a stable thing. It only appears so because it is expressed in dollars and the symbol for $1 in 1898 or 1940 is the same. The pre-World War I dollars which were spent in building half of Hope's existing property were worth twice as much as the post-World War I dollars which were spent to build the remaining half. Thus when in 1942 Hope receives $1 by way of a depreciation allowance to replace pre-World War I property which then cost $1 to construct, it is as a matter of cold, hard sense getting only ½ of its "existing investment" in that pre-World War I property.

Finally the petitioners argue that to compute depreciation charges on cost is the accepted business and accounting practice (Com. Brief, 106-108). That is so as a matter of practical convenience. Hope did so as a matter of convenience even before its accounting was regulated. But business men are free to adjust their depreciation rates so that their annual depreciation allowances will not understate the actual consumption of their properties measured in terms of the existing, not the past, value of the dollar, just as Hope did.

The fundamental business reality which business men do and the courts have always recognized is that the dollar has a shifting value with a long run tendency to depreciate. Unless this is recognized in determining the annual depreciation expense for rate making purposes property is consumed in service without compensation. This is confiscation.

2. Property Added In 1941 and 1942.

The Commission failed to allow Hope annual depletion and depreciation on the property added after 1940 and in service by July 15, 1942 when its rate order became effective. The Commission estimated this added property at $1,392,021 although Hope claimed it was considerably more (R. IV, 193). The court below was obviously correct in condemning this arbitrary action by the Commission (R. IV, 196).

The Commission's brief by footnote 53 (p. 108) argues that the Commission was not required to make any allowance for *future* capital additions under the *Natural Gas Pipeline* case, and it therefore conferred a "benefit" on Hope, and that Hope "can hardly demand the additional boon of a depreciation allowance on this gratuity." Of course the Commission's allowance was no gratuity. The Commission included in its rate base only one-half of its estimated net increase in Hope's properties for the period 1941 through 1943 thus arriving at the additional property in service when its rate order became effective in the middle of 1942 (Opinion, R. I, 47; R. IV, 193). In the *Natural Gas Pipeline* case the Commission allowed capital additions to the end of 1942 although its rate order was to go into effect in 1940 (315 U. S., 587, 580).

B. ALLOWANCE FOR RETURN ON HOPE'S WEST VIRGINIA DISTRIBUTION PROPERTIES.

In allocating costs for the purpose of testing and fixing Hope's interstate rates the Commission allowed Hope a 6½% return on a rate base for its West Virginia distribu-

tion properties which it determined as follows: It took Hope's $3,109,994 book cost of these properties and deducted Hope's $1,393,107 book depreciation reserve therefrom to arrive at a rate base of $1,716,887, to which was added working capital of $150,000 (Ex. 90, R. III, 358).

Thus the Commission used as a rate base for all of Hope's West Virginia distribution properties exactly the rate base used by the District Court in *West v. The Chesapeake & Potomac Telephone Co.*, 295 U. S. 662, 668, 678, and as to which this Court said "This rough and ready approximation of value is as arbitrary as that of the Commission, for it is unsupported by findings based upon the evidence." (295 U. S., 679).

Here the record showed that a considerable portion of these properties was built at the low price levels prevailing before the end of World War I (Antonelli, Tr. 5060-5061). Also the Commission itself demonstrated that Hope's book depreciation reserves did not measure the actual depreciation on any basis. Finally, evidence was submitted that the distribution properties valued by the Commission at $1,716,887 were valued by West Virginia in 1941 for property tax purposes at approximately $2,859,000 (Chisler, Tr. 5433), but the Commission refused to receive this evidence (Tr. 5416).

The Circuit Court of Appeals was clearly correct in condemning this action of the Commission (R. IV, 197-198) and the petitioners do not undertake to support it here.

C. THE COMMISSION'S EXCLUSION FROM 1940 OPERATING EXPENSES OF $165,963 FOR AN EXPERIMENTAL DEEP-TEST WELL.

(Com. Brief, 109-110; Cleve. Brief, 54-55)

It is claimed (Com. Brief, 108-109) that Hope was not harmed by the Commission's exclusion of Hope's actual 1940 expenditures (not booked until 1941) in drilling a deep-test well which proved dry and which exclusion the Circuit Court of Appeals disapproved (R. IV, 198). Obvi-

ously Hope was directly harmed to the extent of $165,963 in the Commission's retroactive findings as to what rates it should have charged in 1940 which were based on its actual operations as the Commission found them for that year alone. The retroactive rate fixing of the Commission was overlooked by the writer of the Commission's brief at this point.

Actually Appendix B, Table 1, to the Commission's brief shows the exact extent to which Hope has been harmed by this Commission action. It shows Hope's "Exploration and dev. costs" per books for 1940, 1941 and 1942, which compares with the Commission's allowances as follows (Opinion, R. I, 65):

	Exploration and Development Costs	
Year	Per Books	Allowed by the Commission
1940	$ 427,233	$ 407,920
1941	761,568	600,000
1942	552,704	600,000
Total	$1,741,505	$1,607,920

Thus Hope would actually be deprived of over $133,000 of its actual exploration and development costs if all of the Commission's orders and findings were allowed to stand.

D. RETURN FROM GASOLINE AND BUTANE OPERATIONS OF AFFILIATE.

Although the Circuit Court of Appeals held that the action of the Commission in crediting almost all of the affiliated Hope Construction and Refining Company's earnings to Hope was not "so arbitrary and unreasonable as to be invalid" (R. IV, 196), we think it important to point out, as the evidence showed (Rhodes, Ex. 101), that on the rate base calculations used by the Commission for the property of this affiliate all of its gasoline plants existing at December 31, 1938 will be fully depreciated by 1944. At the end of 1938 their book cost was $1,459,000 and the Commission deducted a calculated depreciation reserve to write

them down at that time to $428,000 (Ex. 63, R. III, 389). It claimed they were depreciating at the rate of $70,000 annually (*ibid*). Thus by 1944 they would appear in the Commission's rate base at $0. The complete artificiality of this bookkeeping theory and this result is demonstrated by the photographs of these gasoline plants taken in June, 1941 which appear in Exhibit 113. These photographs were not reproduced in the printed record by reason of the difficulty of reproduction, but they are well worth examining as visual evidence of the departure of the Commission's rate base theories from fact.

E. FEDERAL INCOME TAX.

In view of its reversal of the Commission's orders the Circuit Court of Appeals found it unnecessary to determine exactly what federal income tax the Commission should have allowed Hope in determining its operating expenses for the various years past and for the future (R. IV, 197). Nevertheless it is apparent that its judgment setting aside the Commission's orders (R. IV, 207) cannot be reversed unless the arbitrary action of the Commission on Hope's federal income taxes meets the approval of this Court.

(1) *Taxes allowed in retroactive findings.* The Commission found Hope's actual federal income taxes in 1939 were $191,521 and in 1940 $912,313 (Opinion, R. I, 61). In the Commission's Opinion it is reported that these actual taxes are "allowed" (R. I, 61) and in its "Findings as to Lawfulness of Past Rates" it is stated in Finding (17) that "the actual operations for 1939 and 1940 are the reasonable and proper bases for determining lawful rates in those years * * *" (R. I, 11). The fact is, however, that in retroactively fixing Hope's rates for 1939 and 1940 the Commission allowed Hope only $39,716 of federal income taxes in 1939 and none whatsoever in 1940 (R. I, 61, 12; R. IV, 41) although it fails to say so.

For 1941 and following years the Commission allowed Hope only $76,579 for federal income taxes although Hope in 1940 had, as we have seen, actually paid $912,313 (Opinion, R. I, 65).

The Commission's Opinion is wholly silent as to any justification for this action. It apparently proceeded on the wholly artificial concept that if Hope's rates had been as low as the Commission now says they should have been for the years 1939 to 1942, Hope would have had no income tax in 1940 and substantially none in 1939, 1941 and 1942. Of course under the rates actually collected by Hope in these years, elsewhere in the Commission's brief (pp. 116-117) admitted to be the legal rates during these years, Hope owed and paid very substantial income taxes. The Commission apparently assumed that Hope should have avoided the $912,313 federal income tax payment for 1940, for example, by changing its rates at the *beginning* of 1940 to the greatly reduced rates the Commission now proposes for 1940 on the basis of the operating results for the full year 1940, although neither Hope nor the Commission itself could possibly have known until well after the *end* of 1940 what those rates should be on any rate making theory (see page 139, *infra*).

The effect of this action by the Commission is disclosed in Appendix B, Table 1, of the Commission's brief. Shown there are Hope's federal income taxes as accrued in these years on the basis of its revenues under its filed rate schedules. These rate schedules were the same until July 15, 1942 after which they reflected the Commission's reduced interstate rates. The actual taxes so shown as compared with what the Commission allowed in fixing Hope's rates retroactively are as follows (R. I, 61, 12, 65):

Year		Federal Income Taxes: Actual	Federal Income Taxes: Allowed by the Commission
1939		$ 191,521*	$ 39,716
1940		912,313*	0
1941		1,750,000	76,579
1942		2,020,000	76,579
	Total	$4,873,834	$192,874

* Appendix B, Table 1, shows $225,000 and $1,000,000 for 1939 and 1940 which we have adjusted in accordance with the Commission's adjustments (Opinion, R. I, 60, 61). The 1941 and 1942 accruals may be subject to similar adjustments to reflect final actual payments.

It will be observed that the difference between Hope's actual federal income taxes in these years and the amount the Commission allowed for the purpose of its retroactive rate fixing order is over $4,500,000. Thus Hope has already paid to the federal government over $4,500,000 of the so-called "excess" revenues which the Commission claimed Hope had received in 1939, 1940 and since 1940 and which it labeled "unjust, unreasonable, excessive, and therefore unlawful" (R. I, 12-13).

(2) *Taxes allowed in fixing future rates.* The Commission took the position that under its reduced rates Hope would in the future have to pay only $76,579 of federal income taxes annually at an estimated 40% future federal income tax rate (Opinion, R. I, 64-65). This it termed a "saving" of $1,443,943 a year in the income tax Hope would pay if its former interstate gas rates were continued (Opinion, R. I, 64). As to this we note:

(a) On even the Commission's theories Hope's interstate rates were the lowest possible rates in pre-preparedness and pre-war years.[33] Because of increased prepared-

[33] In 1937 the Commission's rate would have been 32.7¢ and in 1938, 39.1¢, or an average of about 36¢ (from Commission

(*Continued on next page*)

ness and war demands for gas and consequent excessive consumption of Hope's own gas reserves, *which are given no value,* the Commission seeks to reduce Hope's rates to such an extent that the federal government is deprived of all or substantially all income taxes from the largest business Hope has had since World War I. This "tax-saving" is then passed out in the form of a still lower interstate rate for gas—for the benefit of individual consumers not responsible for the increased sales and better able to pay for their consumption of a limited natural resource than ever before.

(b) The Commission arbitrarily assumed that under its reduced interstate rates Hope would still be entitled under the Internal Revenue Code to its existing depletion deductions. The fact is, as shown in Hope's income tax reports which the Commission's Staff examined, that the amount of depletion for income tax purposes allowed Hope by the Internal Revenue Bureau is dependent upon the ultimate sales price of the gas produced (Internal Revenue Code, Secs. 23(m), 114(b)(3); Reg. 103, Sec. 19.23 (m)-1(f); *Consumers Natural Gas Co. v. Commissioner,* 78 F. (2d) 161 (C. C. A. 2d, 1935) cert. denied 296 U. S. 634; *Greensboro Gas Co. v. Commissioner,* 79 F. (2d) 701 (C. C. A. 3d, 1935), cert. denied 296 U. S. 639). With the Commission's reduction in Hope's interstate rates Hope's depletion allowance for tax purposes would decrease proportionately. This means that the Commission should have found, on its own theories, considering the matter to which we here call attention, that Hope under the Commission's own future rates would have to pay a great deal more federal income taxes than the Commission's allowance of

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(Continued from preceding page)

Staff's Exs. 67, 67A, 90, R. III, 224, 258, 349; Commission Counsel's Brief before the Commission, Appendix E; Commission Counsel's Reply Brief before the Commission, Appendix A; Opinion, R. I, 51-65). Hope's interstate rates actually averaged 36¢ for those years (Ex. 90, R. III, 353; Ex. 2, 2; Ex. 2B, 3).

$76,579. Worked out in figures, the result would be a decrease in the Commission's so-called "income tax savings" and a decrease in the amount of total rate reduction calculated by the Commission of about $200,000 each year.[34]

III. RATE OF RETURN.

The Commission fixed a rate of return of 6½%, based entirely upon current factors affecting this matter (Opinion, R. I, 65-67). The Circuit Court of Appeals sustained this finding under this Court's test in *Bluefield Water Works & Improvement Co. v. Public Service Commission,* 262 U. S. 679, 692 (R. IV, 198-199), although it noted that "in view of the low rate of return allowed"[35] there was

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[34] The Commission's reduced rates reduce Hope's gross revenues by at least $3,600,000. This would reduce its average earnings at the well mouth, after deduction of amounts attributable to transmission, by the same amount. Divided by the 74,000,000 M.c.f. total gas handled (Ex. 2-B, p. 3), this would be a reduction in the computed well mouth value of gas of about 5¢ per M.c.f. The gross income for income tax purposes from the 25,000,000 M.c.f. produced (Ex. 2-B, p. 10) would be reduced $1,250,000. The income tax depletion allowance based on 27½% of the gross income would in turn be reduced about $350,000. This would increase the income tax due at a 40% rate by $140,000. Under the Commission's method of computing its total rate reduction by adding "excess earnings" and "income tax savings," any such increase in Hope's operating expenses results in a decrease in the amount of rate reduction by 140% of such increase. Accordingly the final effect of this depletion adjustment would be a decrease of about $200,000 in the Commission's rate reduction.

[35] That the rate of return in this case is very low was proved not only as a matter of expert opinion (Ex. 19, R. I, 394), but in addition as a matter of fact by a statistical study of the market appraisal of the risks in various groups of utility enterprises made by Mr. Paul B. Coffman, Vice President of Standard & Poors Corporation. He took the aggregate average market prices for the bonds, preferred stocks and common stocks of all utilities of various classes for which the statistics were available and divided this into the annual earnings available for distribution to these securities for the 4-year period 1937 to 1940. His direct testimony is contained in Exhibit 27-A (R. I, 440) and the results of this are set forth in the following table (R. I, 441):

(*Continued on next page*)

a "consequent lack of margin to take care of error in the base" (R. IV, 172).

The test in the *Bluefield* case is that a public utility is "entitled to such rates as will permit it to earn a return *on the value of the property* which it employs for the convenience of the public" equal to certain standards there set forth (262 U. S., 692). This is not a measure of the return on a rate base which does not reflect, and is not designed to reflect, the value of a public utility's property.

The Commission here used a low present rate of return in combination with its original cost rate base. This is clearly inconsistent with the prudent investment method and is unreasonable on any theory.

No one recognized that the prudent investment rate base went hand in hand with a rate of return fixed as of the date of the investment more fully than did Mr. Justice Brandeis. In his classic exposition of the prudent investment theory in *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri, supra,* in which Mr. Justice Holmes concurred, he said (262 U. S. 304-306):

(*Continued from preceding page*)

Investors' Appraisal of Capital Risk in Various Divisions of the Utility Business.

	1937	1938	1939	1940	Four Year Average 1937-1940
Electric Utility Operating Companies	5.47%	5.50%	5.41%	5.43%	5.45%
Water Companies	5.52	5.39	5.66	5.23	5.45
Manufactured and Mixed Gas Company	6.17	6.61	6.61	6.88	6.57
Natural Gas Companies	7.91	7.79	7.53	7.97	7.80
Natural Gas Companies excluding Pacific Lighting Corporation	8.32	8.05	8.32	9.34	8.51

It will be observed that the investors appraise the risks of natural gas companies substantially higher than they do the risks of either electric companies or manufactured and mixed gas companies and at a rate substantially higher than the 6½% allowed by the Commission.

"That part of the rule of *Smyth v. Ames* which fixes the rate of return deemed fair, at the percentage customarily paid on similar investments at the time of the rate hearing, also exposes the investor and the public to danger of serious injustice. If the replacement-cost measure of value and the prevailing-rate measure of fairness of return should be applied, a company which raised, in 1920, for additions to plant, $1,000,000 on a 9 per cent. basis, by a stock issue, or by long-term bond issue, may find a decade later, that the value of the plant (disregarding depreciation) is only $600,000, and that the fair return on money then invested in such enterprise is only 6 per cent. Under the test of a compensatory rate, urged in reliance upon *Smyth v. Ames*, a prescribed rate would not be confiscatory, if it appeared that the utility could earn under it $36,000 a year; whereas $90,000 would be required to earn the capital charges. On the other hand, if a plant had been built in times of low costs, at $1,000,000 and the capital had been raised to the extent of $750,000 by an issue at par of 5 per cent. 30-year bonds and to the extent of $250,000 by stock at par, and ten years later the price level was 75 per cent. higher and the interest rates 8 per cent., it would be a fantastic result to hold that a rate was confiscatory, unless it yielded 8 per cent. on the then reproduction cost of $1,750,000. For that would yield an income of $140,000, which would give the bondholders $37,500; and to the holders of the $250,000 stock $102,500, a return of 41 per cent. per annum. Money required to establish in 1920 many necessary plants has cost the utility 10 per cent. on thirty-year bonds. These long-time securities, issued to raise needed capital, will in 1930 and thereafter continue to bear the extra high rates of interest, which it was necessary to offer in 1920 in order to secure the required capital. The prevailing rate for such investments may in 1930 be only 7 per cent.; or indeed 6 per cent.; as it was found to be in 1904, in *Stanislaus County v. San Joaquin & Kings River Canal & Irrigation Co.*, 192 U. S. 201; in 1909, in *Knoxville v. Knoxville Water Co.*, 212 U. S. 1; and in 1912, in *Cedar Rapids Gas Light Co. v. Cedar Rapids*, 223 U. S. 655,

670. A rule which limits the guaranteed rate of return on utility investments to that which may prevail at the time of the rate hearing, may fall far short of the capital charge then resting upon the company.

"In essence, there is no difference between the capital charge and operating expenses, depreciation, and taxes. Each is a part of the current cost of supplying the service; and each should be met from current income. When the capital charges are for interest on the floating debt paid at the current rate, this is readily seen. But it is no less true of a legal obligation to pay interest on long-term bonds, entered into years before the rate hearing and to continue for years thereafter; and it is true also of the economic obligation to pay dividends on stock, preferred or common. The necessary cost, and hence the capital charge, of the money embarked recently in utilities, and of that which may be invested in the near future, may be more, as it may be less, than the prevailing rate of return required to induce capital to enter upon like enterprises at the time of a rate hearing ten years hence. *To fix the return by the rate which happens to prevail at such future day, opens the door to great hardships. Where the financing has been proper, the cost to the utility of the capital, required to construct, equip and operate its plant, should measure the rate of return which the Constitution guarantees opportunity to earn.*

"The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would give definitiveness to these two factors involved in rate controversies which are now shifting and treacherous, and which render the proceedings peculiarly burdensome and largely futile. Such measures offer a basis for decision which is certain and stable."

Again he said, page 307:

"In speculative enterprises the capital cost of money is always high; partly because the risks involved must be covered; partly because speculative enterprises appeal only to the relatively small number of investors who are unwilling to accept a low return on their capital."

In a note at the bottom of the same page he further said:

> "Of course, anyone who chances to have money to invest, when money rates are high, gets the advantage incident to investing in a favorable market. If he invests in utility bonds, the higher agreed return upon his capital would be provided for by a rule which measures fair return by capital charges, as suggested above. If he elects to invest in the stock, he would, under the rule suggested, have the opportunity of earning a return commensurate with the value of the capital at the time it was embarked as stock in the enterprise."

Mr. Justice Brandeis, of course, was talking about the cost of the outstanding capital securities of a public utility, having primarily in mind public utilities such as railroads which are largely financed by the sale of securities to the public. Where a corporation has no securities outstanding in the hands of the public, as in the case of Hope, it is not possible to determine from its records the cost of money to it. Mr. Justice Brandeis would be the first to recognize that in such a situation the cost of capital should be estimated precisely the same as he said original cost, where not shown by company records, should be estimated (see *supra*, pp. 36-37). In his opinion above quoted he recognized the obligation to pay interest on long term bonds at the contract rate over long periods of years in spite of a decline in interest rates and said that this was also true "of the economic obligation to pay dividends on stock, preferred or common" (262 U. S., 306).

Writing in 1923, he remembered that "money required to establish in 1920 many necessary plants has cost the utility 10 per cent. on thirty-year bonds." He intended to include that cost for bond money in the rate of return. Undoubtedly he contemplated that if common stock money at that time cost 12% or 15%, that also should be included. In other words he urged the rates of return necessary to

attract capital to the utility at the time it was attracted and invested in the property. He never urged the prudent investment rate base with a current rate of return.

As we have already seen practical application of this method of using a historical cost rate base undepreciated and a historical cost rate of return is made in California, *supra,* pages 68-73. There a higher return is used with the historical cost rate base than would be used by the same Commission on a fair value rate base. For example in the *Los Angeles Gas* case it was 7.7% on historical cost and 7% on fair value.

The Commission here determined a current rate of return to accompany its so-called "original cost" rate base. *It ignored entirely the historical cost of money that Justices Brandeis and Holmes recognized had to be reflected if an original or historical cost rate base were to be used.* Thus the Commission offers to the investor and to the public utility not a continuation of the rate of return they reasonably had a right to expect at the time the utility property was constructed, but whatever rate of return is current at the date on which rates are fixed. This is a departure from the prudent investment theory that robs it of all semblance of reasonableness.

Solely by way of rebuttal, after the Commission's Staff had testified to its rate base theories, Hope introduced testimony as to the rates of return that would have been necessary in various periods of Hope's existence (Brown, R. I, 443-464; Ex. 19, pp. 1-2, R. I, 395-396).

It is perhaps not important to review this testimony in any great detail since the Commission wholly ignored the historical cost of money. Briefly, it showed that in the "early development period" of Hope from 1898 to 1907, when it was a pioneer in a new and highly speculative industry, public financing was impossible and private investors would not have put money into such a property as that of Hope without prospective earnings of 15% to 20%; that in the period 1908 to 1926 when Hope had reached "a

certain stage of maturity and permanency'' but when there was little public financing of natural gas companies, capital could not have been attracted to it at any time in the period for less than 12% and ''some more than 12% in certain of those years.'' In fact the average earnings-price ratio of stocks of mining and smelting companies was 13% and of oil producing and refining companies was 14%. In the 1921 period the yield on Aaa bonds was 6% as against less than 3% today and on Baa bonds more than 8% as against 4½% today. In the third period beginning in 1927 when public financing of natural gas securities was practicable and until 1934 the capital requirements of Hope could not have been financed on the basis of less than 10%, and in the final period of lower money rates from 1935 to the present not at less than 8% (Brown, R. I, 446-464).

In Exhibit 136 the amount of plant existing on December 31, 1938 which was constructed in each of these four periods was applied against the minimum rates of return shown for those periods to get a weighted average historical rate of return. This weighted average on the basis of Hope's original cost was found to be 11.83% and on the basis of the Commission Staff's adjusted book cost to be 11.61%.

The Staff presented no study as to past or historical rates of return and the Commission ignored Hope's evidence.

The action of the Commission in taking an adjusted book cost rate base with a modern streamlined current rate of return is clearly arbitrary and unreasonable. It cannot be supported on the prudent investment theory or any other.

IV. VIEWED IN THEIR ENTIRETY THE RATES FIXED BY THE COMMISSION ARE TOO LOW BY ANY STANDARD.

(Com. Brief, 21-33; Cleve. Brief, 24-27)

Early in its brief the Commission claims that the rates prescribed by it, viewed in their entirety, ''meet every test of reasonableness and fall far short of confiscation'' (p. 25). In this section we shall first show that so viewed those rates are unreasonable on any standard and then consider the over-all matters to which the petitioners call attention.

A. THE COMMISSION'S PRESCRIBED RATES ARE TOO LOW BY ANY STANDARD.

Little need be said under this heading. All that the Commission allows in its future rates in this case for annual return, depreciation and depletion is (R. I, 12, 53):

For Return	$2,191,314
For Depreciation and Depletion	$1,460,037
Total	$3,651,351

For past rates it allowed even less (R. I, 12, 61).

This annual allowance for return is about 3.3% on the present value rate base of $66,000,000 claimed by Hope (Ex. 126, R. I, 481) and less than that return on the somewhat higher present value rate base found by the Ohio Commission as of June 30, 1937 (*supra,* pp. 8-9, 30). It is only slightly more than 4% of the over $50,000,000 true value in money of the interstate properties found for tax purposes by the State of West Virginia (*supra,* p. 30).

Moreover, it is equally inadequate if we test it by the prudent investment method of regulating rates as practiced in California where an undepreciated rate base is used and the annual depreciation allowance is based on the sinking fund method.

On the basis of the Commission's own findings as to "original cost" and using the California method of an undepreciated rate base the Commission's rate base for future rates would be as follows (R. I, 3-4):

Physical Properties and Operated Leaseholds	$51,957,416
Useful Unoperated Leaseholds	566,105
Working Capital	2,125,000
Net Capital Additions	1,392,021
Total	$56,040,542

On this undepreciated rate base the Commission's total allowance of $3,651,351 for annual return, depreciation and depletion is almost exactly 6½%. In other words by the California method and using the Commission's own findings it should have allowed Hope in rates at least as much *for return alone as it has actually allowed for both return and for depreciation and depletion.* Its own unadjusted figures thus show that upon its so-called prudent investment method it has included no allowance whatsoever for annual depreciation and depletion expense.

If in further pursuance of the California method we take an undepreciated rate base reflecting the true original cost of Hope's properties determined in accordance with the Natural Gas Act and consistently with the Commission's determination of operating expenses, that rate base for future rates would be as follows (R. I, 349, 364):

Original Cost[36]	$70,593,000
Working Capital	2,125,000
Net Capital Additions	1,392,000
Total	$74,110,000

On this undepreciated rate base the Commission's total annual allowance of $3,651,351 both for return and for

[36] Hope's original cost of physical properties and leaseholds as of December 31, 1938 plus 1939 and 1940 net additions as found by the Commission (R. I, 36).

depreciation and depletion is not quite 5%. Thus the Commission's total allowance not only includes nothing for depreciation and depletion expense but is 1½% shy of the rate of return the Commission allowed.

But this is not all. Had the Commission given any consideration whatever to a historical rate of return to accompany its "original cost" rate base it would have allowed a rate of return substantially higher than 6½%, in addition to depreciation expense on the sinking fund method of perhaps 1½%.

Thus it is clear that on either a present value or a prudent investment method of regulating rates, and even using the Commission's own findings, the rates fixed by its order are too low.

Moreover, in all the above computations no account is taken of the many respects in which the operating expenses of Hope were reduced and the amount available for return and depreciation consequently inflated. Thus, as heretofore shown, the Commission's allowance for depreciation and depletion expense omits all provision for depreciation and depletion of the well drilling and other costs that were not included in its rate base and for the net capital additions to 1942 that were included in its rate base. Hope's deep test well expenditures in 1940 are not included in expense. Federal income taxes as allowed are wholly inadequate. Net interstate revenues were arbitrarily increased by permitting Hope a wholly inadequate return on its West Virginia distribution plants. Hope's revenues were theoretically increased by appropriating to Hope practically all the earnings from the gasoline and butane operations of its affiliate, allowing substantially nothing for return on that property.

All of these matters and others only serve to accentuate the inadequacy of the rates fixed by the Commission.

B. THE COMMISSION'S RATES ARE TOO LOW ON THE BASIS OF THE PRICE ALLOWED FOR HOPE'S PRODUCED GAS.

There is another practical over-all test of the reasonableness of the Commission's order. The order in effect assumes that Hope can continue to sell abnormally large volumes of its own produced gas at prices reflecting costs over the last 45 years and which by any standard are unreasonably low.

The Commission's Staff's computation of Hope's net operating income from its interstate business at former rates was as follows (Ex. 133):

1937	$3,244,904
1938	1,186,435
1939	3,020,246
1940	5,576,982
3-year average—1937 to 1939	2,483,862
4-year average—1937 to 1940	3,257,142

It is obvious at a glance that the Commission could not have ordered a reduction of $3,600,000 in the interstate rates as it did on the basis of the experience of any year prior to 1940 or on either a 3 or a 4-year average. In fact such a reduction was greater than its own computation of Hope's income in any one of those years except 1940.

The Circuit Court of Appeals on this point said (R. IV, 197):

> "*Selection of 1940 as test year.* The Commission selected 1940 without regard to the experience of the years immediately prior thereto, as the test year for determining expense of operation in fixing future rates. It is ordinarily unsafe thus to adopt the experience of a single year as a guide. *United Gas Public Service Co. v. Teas,* 303 U. S. 123, 145; *West Ohio Gas Co. v. Public Utilities Com'n,* 294 U. S. 79, 81. We do not think that under the peculiar circumstances of the case, however, this action of the Commission can be condemned as arbitrary or unreasonable. The increased demand for gas resulting from war conditions,

> made the experience of 1940 a safer guide for the future than that of prior years. Hope makes much of the fact that the winter of that year was more than ordinarily severe and that the increased demand for gas resulted in a large percentage of sales representing gas from its own wells, which did not involve payment of the charge required by its contracts on gas purchased from others. The increased demand due to war conditions, however, must necessarily have the same effect, so far as this matter is concerned. The experience of 1940 was the only experience properly comparable. In further proceedings, the experience following 1940 can be added to the experience of that year to form a longer and more dependable test period.''

Our point on this is not concerned with total demands or sales. Obviously during the war period the industrial demand will be sufficient to maintain the 1940 and even higher volumes so long as they can be supplied. But the increased volumes above a normal amount to a considerable extent have had to be taken from Hope's own depleted reserves and the incremental cost allowed for this additional volume in the Commission's rates is so low by any standard as to discredit the Commission's whole rate-fixing formula and its results. This is a matter of crucial practical importance that requires some explanation.

The gas business in the Appalachian area is wholly unlike that in either the southwest or California. There are no longer any large wells. Hope's supply comes from 16,000 small wells widely scattered over the state, many of them producing oil as well as gas. Of these it owns 3,300 wells and purchases the production of the remaining 12,600 (*supra,* p. 5).

Its method of operation for many years has been to rely on purchased gas to meet the minimum demands of its daily market and to produce its own gas to supply the difference between the minimum and the extremely fluctuating maximum daily demands (Tonkin, Ex. 4, R. I, 132-142). This method enables Hope to buy purchased gas on a

steady load basis at a lower price than it would otherwise be required to pay (*ibid.*, 142). Thus in July, 1939, for example, on several days it produced substantially nothing from its own wells; in January, 1940 it produced large quantities in varying daily amounts ranging up to 175,000 M.c.f. per day (Ex. 2, Chart, 16).

Hope therefore uses its own wells as a balance on its system precisely as an artificial gas company would use a storage gas holder. So important is the maintenance of Hope's own reserves that in recent years it has during off-peak periods stored gas in some of its depleted fields nearest its markets with gas from more distant sources (Tonkin, Tr. 5813-5815).

When increased industrial activity arising from the preparedness program began to manifest itself in late 1939 and the daily demands upon it increased Hope could not provide itself with additional supplies from the Appalachian field because they are not available (Tonkin, R. I, 504). Accordingly in 1940 it was compelled to withdraw from its own reserves designed to maintain a balance on its system more than 10 billion cubic feet above the amount it had withdrawn in 1939 or does withdraw in any normal year.

The effect of these extraordinary withdrawals in 1940 upon costs when costs are computed as the Commission did in this case is most startling. Cleveland computed this cost in its reply brief before the Commission in a table which we reproduce as Appendix D, page 183, *infra*. The table is based entirely on figures taken from the Staff's exhibits. It shows that Hope withdrew from its own gas reserves in 1939 16.5 billion cubic feet and in 1940 26.8 billion cubic feet (as estimated by the Staff), an increase of 10.3 billion feet. It then shows in detail the direct costs of this gas for the two years 1939 and 1940 to be respectively 11.88¢ and 8.73¢ per M.c.f.

In addition Cleveland worked out the incremental cost to Hope of producing 10.3 billion cubic feet in 1940 over

and above the normal 16.5 cubic billion feet it produced in 1939. This it found to be, using the Staff's methods which were followed by the Commission, 3.64¢ per M.c.f. (Appendix D, page 183 *infra*).

Thus the Commission's order in this case is based on the assumption that Hope can continue for the indefinite future to produce from its own declining gas reserves 10 billion cubic feet more than average withdrawals of peace time and supply it at the well mouth or can purchase similar quantities, at a direct cost of less than 4¢ per M.c.f. And this in face of the admitted fact that Hope cannot replace this gas at any figure approaching this cost. Even its steady load purchased gas has been costing it an average of 18¢ per M.c.f. (Ex. 78, R. III, 309).

The Commission made findings that should have warned it that a rate order based solely on this war time experience was arbitrary. It found the following facts, the last column only being added as a matter of computation (R. I, 12):

	1939	1940	Increase 1940 over 1939
Revenues from Interstate Sales..	$14,866,894	$19,296,755	$4,429,861
Operating Deductions	11,845,649	12,997,845	1,152,196
Net Operating Income from Interstate Sales	$ 3,021,245	$ 6,298,910	$3,277,665

In addition the Commission found the total interstate sales in 1939 to be 41,350,569 M.c.f. and in 1940 to be 53,604,243 M.c.f., an increase of 12,253,674 M.c.f. (R. I, 51).

Thus it found that an increase in sales of 12.2 billion cubic feet was achieved by an increase in operating expenses, which it refers to as "Operating Deductions," of only $1,150,000, or at a cost to Hope of only 9¢ per M.c.f. That is, at a time when the average market cost to Hope of purchased gas in the West Virginia fields was 18¢ per M.c.f., the Commission in effect found that Hope could supply at delivery points 12 billion cubic feet from its own reserves or otherwise at a cost of only 9¢ per M.c.f.

Thus the Commission's order in this case is based on the assumption that Hope can continue for the indefinite future to supply 12 billion cubic feet at delivery points at a cost of 9¢ per M.c.f. These low costs are achieved of course in part by the omission of the drilling costs of the wells and by other rate base and operating expense findings by the Commission to which reference has been made. In part it is due also to the low initial cost of gas discovered over the years for the present value of which no allowance is made.

The Commission's order fails to recognize that the Hope system cannot function without a well maintained gas reserve to meet peak demands. The order requires Hope to sell what is an essential part of its plant at a fraction of its replacement cost and at a fraction of its value either in the market or to Hope. No matter what theories may be advanced to justify such a result the result condemns itself. It is the arbitrary application to an extractive industry with special problems of a strait-jacket rate making theory which the Commission itself points out it developed in connection with its regulation of electric companies (Com. Brief, 68).

C. THE COMMISSION'S CLAIMS AS TO THE OVER-ALL REASONABLENESS OF ITS ORDER.

(Com. Brief, 25-33)

The Commission brief's first claim is that Hope's financial history justifies its order. Unless it is proper for the Commission now retroactively to regulate Hope's rates over the last 45 years Hope's financial history clearly shows that its recent rates have been entirely reasonable. Previously in this brief, *supra,* pages 11 to 13, we have set forth Hope's financial history since 1926—the first year of full operation of its present extended property. This shows that while its earnings from year to year have been most irregular, fluctuating as they do with both weather and industrial conditions, nevertheless on the average Hope has

earned for return, depreciation and depletion $4,150,000 or 7.7% of the average book cost of its fixed assets. From this record we know that those fixed assets are understated to the extent of $17,000,000.

Certainly there is nothing in that financial history that would justify the rates fixed by this Commission which are lower than the rates prevailing at any time during that 15-year period.

The Commission's next claim is that Hope's actual experience under the prescribed rates is such that it would have been justified in making a $1,091,790 larger reduction in rates than it made (Com. Brief, 28). This it seeks to prove by bringing into this record for the first time the annual reports Hope made to the Commission and calculations made therefrom and printed as its Appendix B. That at this date the record cannot properly be supplemented in this way has been decided by this Court (*West Ohio Gas Co. v. Public Utilities Commission of Ohio (No. 1)*, 294 U. S. 63). Aside from this, it should be pointed out that the Commission's order did not become effective until July 15, 1942 and that in consequence none of these annual reports can be used as experience under the new rates without substantial adjustments which the Commission's brief assumes to make.

However, if we take the Commission brief's own calculations in its Appendix B and make two simple adjustments, both of which are necessary in the interests of accuracy, the result is to show that on the Commission's own basis and theories the rate reduction ordered proved excessive by $600,000 in the year 1942.

Those two adjustments are:

1. The Commission brief's calculation (p. 141) starts with the revenues Hope would have received in 1942 if its former rates had remained in effect and with the Commission's findings of expenses for the year 1939, to which it adds the book increase in expenses between 1939 and 1942

to determine what the Commission would have found for 1942. But the Commission itself in fixing Hope's rates based its determinations exclusively upon the year 1940 without reference to prior years. (Opinion, R. I, 70). Accordingly the brief's calculation should likewise have been based upon the findings for 1940.

In Appendix E, page 185 below, we have set up the calculation exactly as the Commission brief shows it at page 141 except that 1940 is the starting point rather than 1939. All calculations are made by exactly the same method used by the Commission's brief.

2. In the second place, as the Commission brief recognizes in the footnote on page 141 but does not mention in its discussion, the net operating revenues computed in its Appendix B included the results of operation of the former Reserve Gas Company properties, merged into Hope on December 30, 1939, which by stipulation were excluded from consideration in this case (*supra,* page 19). A ready means of eliminating the revenues and expenses of these properties is furnished by the stipulation (Ex. 77) which sets forth the amounts of revenues, expenses and earnings to be excluded from 1940 data as attributable to these Reserve properties. It is a conservative assumption that the revenues and expenses of these properties would have been at least as much in 1942 as the stipulated 1940 amounts. Accordingly in Appendix E we have eliminated the Reserve property revenues and expenses in the exact amounts stipulated and in the exact manner that the parties did in eliminating them for 1940.

The net result of these two simple and necessary adjustments of the Commission brief's calculations as shown in column (5) of Appendix E is that the rate reduction which the Commission would have computed if it had based its rates upon 1942 operations rather than upon 1940 would have been $4,159,253 instead of the $4,757,452 (Com. Brief, 28) reduction in 1942 revenues actually resulting from its rate order. Thus instead of "earning $1,091,790 annually

in excess of a 6½% rate of return, if the 1942 level is taken as the criterion,'' as the Commission's brief claims (p. 28), *Hope is actually earning $600,000 less than the Commission would have allowed if it had used 1942 operations.*

So long as the experience of other years has been referred to it may also be observed that had the rates fixed by the Commission's order been in effect for the years 1937 to 1939 Hope's net operating income from interstate sales, using the Commission's determinations, would have been as follows (from Staff's Exs. 67, 67-A, 90, R. III, 224, 258, 349; Commission Counsel's Brief before the Commission, Appendix E; Commission Counsel's Reply Brief before the Commission, Appendix A; Opinion, R. I, 51-65):

1937	$ 708,653	
1938	(1,394,164)	loss
1939	333,502	
3-year average	($117,336)	loss

These three years include the year the complaint was filed, 1938, and one year's experience on each side. It is beyond controversy that the new rates would not have met any test of reasonableness in any one of these three years or even on the four year average including 1940.

It is next claimed that the rate base sought by Hope does not square with its operating experience since if Hope's claims as to rate base and operating expenses were allowed in full it would have only made a return of 3.27% for the 4-year period 1937-1940. This percentage is misstated, as shown in the footnote[37] below, but aside from this

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[37] The 3.27% is the amount Hope claimed it would earn in the future on the basis of average 1937-1940 revenue and expense experience, but adding to expenses the substantially increased Federal income taxes, wage payments and other increased future expenses not reflected during 1937-1940. Its actual experience during these years, based on a $66,000,000 present value rate base, Hope claimed was as follows (Ex. 126, R. I, 481):

(*Continued on next page*)

the issue here is not whether the rate base and operating expenses as claimed by Hope are 100% acceptable. The Commission did not base its order on these claims.

The history of rate proceedings as set forth in the Statement, *supra,* pages 6 to 9, indicates a very clear reason why Hope did not attempt to secure a higher rate in the years immediately preceding 1940. The rates of East Ohio, its principal customer, and also the rates of Peoples, its second largest customer, were involved in litigation in those respective states (*supra,* p. 8; *Peoples Natural Gas Co. v. Pennsylvania Public Utility Commission,* 14 A. (2d) 133 (Pa., 1940)). In view of the affiliation between Hope and these companies it was not possible actually to make effective a higher rate even though the return being earned by Hope was not adequate.

Finally it is claimed with apparent seriousness (Com. Brief, 30-33) that doubtful items of substantial amount were resolved by the Commission in Hope's favor. As we understand what is urged here, the Commission could reasonably and not arbitrarily have done the following:

(1) Reduced the $33,712,000 rate base it allowed for the future by $26,000,000—to $7,712,000;

(2) Decreased its allowances for Hope's annual operating expenses by over $600,000;

(3) Allowed instead of its 6½% rate of return only 5½% or preferably 5%.

We apply these suggestions. A 5% rate of return on a $7,712,000 rate base amounts to less than $386,000. $560,000 of the operating expenses which it is suggested

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(Continued from preceding page)

1937	3.98%
1938	1.18%
1939	3.36%
1940	6.98%

Even on its theories the Commission's Staff determined that in 1938 Hope was earning only 4.38% on a net book cost rate base of $31,465,000 (Ex. 90, R. III, 352).

the Commission might properly have eliminated consist of actual out-of-pocket payments for operating wages, property taxes and exploration costs (Opinion, R. I, 62) and for current administrative costs on current property construction (Opinion, R. I, 49-50). If these actual out-of-pocket expenditures of $560,000 are not allowed in operating expenses they must be paid out of the $386,000 return now suggested as reasonable. That is, of course, insufficient by $174,000.

Thus the "acoustics of such liberality" referred to in the Commission's brief (p. 33) are created from the argument that the Commission should reasonably have compelled Hope to operate at a $174,000 annual loss.

D. CLEVELAND'S CLAIM THAT NO CONSTITUTIONAL QUESTION IS PRESENTED.

Cleveland's brief does not urge that the over-all results reached by the Commission are reasonable, except to state that "Nothing arbitrary was done by the Commission" (p. 56) and to reiterate that all of the Commission's findings "had a rational basis and are supported by substantial evidence" (pp. 38, 39, 46, 52 and 55). Instead, Cleveland argues that Hope is not injured because its parent corporation also owns the stock of East Ohio and Peoples, Hope's largest customers although its petition for certiorari raises no such question.

This argument proceeds upon the premise that Hope, as a corporation, is not a "person" within the meaning of the Fifth Amendment and hence is not in itself entitled to constitutional protection. That this premise is erroneous we need not say. *Covington and Lexington Turnpike Road Company v. Sandford,* 164 U. S. 578, 592; *Kentucky Finance Corporation v. Paramount Auto Exchange Corporation,* 262 U. S. 544, 550; *Grosjean v. American Press Co.,* 297 U. S. 233, 244. Cleveland's argument likewise assumes that the Ohio and Pennsylvania rate regulatory authorities will fail to reflect the Commission's rate reduc-

ing order, if it should be held valid, or will permit East Ohio and Peoples sufficient additional allowances to offset the confiscation of Hope's properties. The history of the effective rate litigation in these states to which we have called attention, *supra*, pages 6 to 9, denies this premise. In fact, the result of this regulation has been to prevent Hope from receiving fully compensatory rates in the pre-war years, a fact now attempted to be used by the petitioners to deny the force of Hope's evidence.

Irrespective of all this, the Natural Gas Act requires that rates be "just and reasonable" without regard to any question of affiliation and the validity of the Commission's orders under the Act is here in question. As the Commission's brief points out (p. 15), "In judicial review under the Natural Gas Act, the statutory and constitutional standards coalesce." Hence, the question is presented whether the Commission's rates are "too low" under constitutional standards, even assuming every argument made by Cleveland were correct.

V. THE COMMISSION'S FINDINGS AS TO LAWFULNESS OF PAST RATES.

(Com. Brief, 110-123; Cleve. Brief, 60-77)

In 1939 Cleveland amended its original complaint against Hope and requested the Commission to determine that to the extent that Hope had charged East Ohio more than 30¢ per M.c.f., Hope had violated the Natural Gas Act ever since June 21, 1938, the effective date of the Natural Gas Act (R. II, 15). The Pennsylvania Public Utility Commission's complaint filed in 1939 included a request that the Commission determine that Hope had violated the Natural Gas Act since June 21, 1938 by reason of its charges to Peoples, Fayette and Manufacturers (R. II, 20, 22, 24). Neither Cleveland nor the Pennsylvania Commission introduced any evidence in support of these or other charges.

As a part of its final determinations the Commission made its "Findings as to the Lawfulness of Past Rates" (R. I, 8) and argued its right to make these findings in its Opinion (R. I, 67-69). These findings, where specific, are directed to Hope's past rates to East Ohio only. They ignore the request of the Pennsylvania Commission.

It is to be noted that these are not findings that Hope's existing interstate rates are unreasonable, which finding is required before the Commission can fix future rates and was made in its "Order Reducing Rates" (R. I, 1), but are separate findings that Hope's interstate rates to East Ohio on file *in the past* were unreasonable and "unlawful" and, further, are separate findings as to precisely what the "lawful" past interstate rates should have been.

The Commission's lack of statutory authority to make these retroactive rate determinations, their otherwise unreasonable and arbitrary character, and their reviewability have been analyzed and stated so clearly by Judge Parker (R. IV, 199-203) that discussion here is not really required. Furthermore, in *Public Utilities Commission of Ohio v. United Fuel Gas Co.,* 317 U. S. 456, this Court analyzed the rate provisions of the Ohio public utility law applicable in that proceeding which are substantially identical with the rate provisions of the Natural Gas Act. It said (317 U. S., 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.*"

Nevertheless, in view of the extended arguments of the petitioners, we point out:

A. THE COMMISSION HAS NO AUTHORITY UNDER THE NATURAL GAS ACT TO MAKE THESE RETROACTIVE DETERMINATIONS.

1. Section 5(a) of the Natural Gas Act (15 U. S. C. 717d(a)) makes it crystal clear that the Commission's rate making authority is prospective only. As there stated, it may, after a hearing—

"determine the just and reasonable rate, charge, classification, rule, regulation, practice or contract *to be thereafter observed and in force,* and shall fix the same by order:"

The Commission admitted the statute in its Opinion, stating (R. I, 68):

"The Commission does not have the authority to fix rates for the past and to award reparations."

Despite this the Commission has in fact attempted "to fix rates for the past." It has determined that Hope's interstate rates were unlawful in designated amounts in 1939, 1940 and since (Finding (21), R. I, 12) and specifically as to Hope's rates to East Ohio it finds that they should have been 34¢ per M.c.f. in 1939 and 28.5¢ in 1940.[38] We note that during these years, and previously, Hope's actual filed rate to East Ohio was about 36.5¢ and that had the

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[38] Total allowed "compensation" shown in Finding (23) (R. I, 12) divided by quantities sold shown at page 40 of the Opinion (R. I, 51).

Commission applied its theories to 1937 and 1938 the East Ohio rates for those years on its own Staff's figures would have been 33¢ for 1937 and 39.5¢ for 1938,[39] or an average of almost 36.5¢.

What is intended to be done with these rates so fixed for the past is perfectly plain from the Commission's Opinion. They are to be reported to The Public Utilities Commission of Ohio in connection with its pending hearings as to the validity of certain 1939 and 1940 Cleveland rate ordinances specifying rates for East Ohio[40] (Opinion, R. I, 69) and the Ohio Commission is supposed to accept them as conclusive determinations of the rates East Ohio should have paid Hope in the past under the following pronouncement of the Commission in this case (Opinion, R. I, 69):

> "Since the enactment of the 1938 Natural Gas Act this Commission has had exclusive jurisdiction to determine the lawfulness of the interstate wholesale rates charged by Hope and other natural gas companies." [41]

Obviously the intended effect of the Commission's "Findings As to Lawfulness of Past Rates" in this case is "to

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[39] As shown *supra*, pages 104-105, the average rate for all of Hope's interstate sales which the Commission would have found on its own theories was 32.7¢ for 1937 and 39.1¢ for 1938. The Commission would have used the next even half cent, or 33¢ for 1937 and 39.5¢ for 1938, as the East Ohio rate. This is the way in which it derived its 34¢ East Ohio rate for 1939 and its 28.5¢ rate for 1940.

[40] As we pointed out in the Statement, *supra*, page 9, these ordinances are attempts by Cleveland to enforce beyond June 30, 1939 a rate which was held grossly confiscatory by the Ohio Commission in 1939 and by the Supreme Court of Ohio in 1940 (*Cleveland* case, *supra*, pp. 8-9). Cleveland's various claims (pp. 2, 63) that its consumers will be entitled to a $20 and a $13 per consumer refund if its views are sustained by this Court is merely a claim and nothing more.

[41] But see Section 22 of the Natural Gas Act, *infra*, pp. 133-134.

fix rates for the past'' and through action of the Ohio Commission, which is to recognize the Power Commission's ''exclusive jurisdiction'' since 1938, ''to award reparations,'' both of which the Commission frankly admits it has no authority to do. That Cleveland so construes its effect it states (Cleve. Brief, 63).

On this point the court below properly said (R. IV, 200):

> ''* * * As the Commission itself says, it was not given authority to fix rates for the past or to award reparations on account of past rates. If it was not given the power to fix past rates, or award reparations based upon their unreasonableness, it certainly was given no power to do the same thing indirectly by making findings of fact as to past rates to be given effect in rate proceedings before state commissions. No intention on the part of Congress to vest any such unusual power in a commission ought to be indulged unless conferred in the plainest terms; and not only is it not plainly given here, but such power cannot be spelled out of the statutes on any theory of interpretation with which we are familiar.''

2. That any such power would have to be found directly in the Act, and not by speculative implications from the general powers of the Commission under Sections 4(a), 5(a), 5(b), 14(a) and 17, which are the sections of the Act referred to by the Commission in its Opinion, is plain because Congress is well aware of the two separate kinds of rate making power—prospective and retroactive—and of the limitations that must be placed, as a practical matter, upon retroactive rate making powers if any such powers are granted. Congress's experience with these separate functions in connection with the Interstate Commerce Commission has been complete.

Originally the Interstate Commerce Commission was given no other power as to rates than the *quasi*-judicial power of investigating past rates on complaint of a shipper

and if it found them unreasonable to award reparation. The Hepburn Act of 1906 added to this *quasi*-judicial power the *quasi*-legislative power of fixing rates for the future if it found existing rates unreasonable (34 Stat. 589, 49 U. S. C. Sec. 15). But these two powers have always been regarded as separate and distinct. In *Baer Brothers Mercantile Company v. Denver & Rio Grande Railroad Company,* 233 U. S. 479, Mr. Justice Lamar said (p. 486):

> "But awarding reparation for the past and fixing rates for the future involve the determination of matters essentially different. One is in its nature private and the other public. One is made by the Commission in its quasi-judicial capacity to measure past injuries sustained by a private shipper; the other, in its quasi-legislative capacity, to prevent future injury to the public."

See also *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Railway Co.,* 284 U. S. 370; *Interstate Commerce Commission v. Cincinnati, New Orleans and Texas Pacific Railway Company,* 167 U. S. 479.

Had Congress intended to vest *quasi*-judicial power in the Commission to determine the reasonableness and lawfulness of past rates and declare them for use by State commissions or others, it would have done so in express language as it has done in the case of the Interstate Commerce Commission. If the analogy of the Commerce Act were followed, such a finding would be provided for only upon complaint by the customer directly affected, made *within some short fixed period of limitations.* Such a statute would either have made that finding *prima facie* evidence in a court in which it was to be enforced or have authorized the Commission itself to make an order respecting it. Its effect would not have been left an uncertain matter for future debate. Here the Commission's brief seems most doubtful as to their effect (pp. 113-114) and certainly not in agreement with the Commission and Cleveland.

3. The rate regulatory scheme of the Natural Gas Act set forth in Sections 4 and 5 is entirely clear and complete. Rates must be filed with the Commission and until they are changed for the future by or with the approval of the Commission they "prevail." This is precisely what the Solicitor for the Commission said in explaining the Natural Gas Act to the Congressional Committee before its adoption.[42]

Under such provisions as Sections 4 and 5 of the Natural Gas Act it is perfectly well settled that the rate which is filed with the Commission is the only rate the utility can accept or its customers can lawfully pay, regardless of any claim that it is unreasonable, until changed prospectively by the Commission. *Texas and Pacific Railway Company v. Abilene Cotton Oil Company,* 204 U. S. 426; *Louisville & Nashville Railroad Company v. Maxwell,* 237 U. S. 94; *Dayton Coal and Iron Company v. Cincinnati, New Orleans and Texas Pacific Railway Company,* 239 U. S. 446 and other cases.

Congress obviously recognized that to confer upon the Commission jurisdiction to say that wholesale rates legally received and paid in the past in accordance with filed schedules were nevertheless unlawful and in violation of the Natural Gas Act would leave both the selling and purchasing gas companies in the greatest confusion. It is significant that the first draft of the Public Utility Act of 1935, which was the model for the subsequently enacted Natural Gas Act, contained a provision (Sec. 213) authorizing the issuance of reparation orders. This section was eliminated from the Bill by the Senate Committee on Interstate Commerce, together with another section. As to these sections the Committee said:

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[42] *Hearing before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, Seventy-Fourth Congress, Second Session, on H. R. 11662,* pages 28-29 (U. S. Government Printing Office, Washington, 1936).

"They are appropriate sections for a State utility law but the committee does not consider them applicable to one governing merely wholesale transactions." (*Report of the Senate Committee on Interstate Commerce on the Public Utility Act of 1935,* 74th Congress, 1st Session, Senate Report No. 621, page 20, see Appendix H hereto, page 150.)

Reviewing these considerations the court below properly observed (R. IV, 202):

"When rates were filed with the Commission pursuant to section 4(c) of the Act they became the only lawful rates which the utility could charge or accept. Cf. *L. & N. R. Co. v. Maxwell,* 237 U. S. 94. Until changed by the Commission under the power granted pursuant to section 5(a) they were binding alike upon the company and its customers; and, in the absence of a provision for award of reparation, there could be no occasion for a determination of their reasonableness except as reason for changing them in an order prescribing rates for the future."

4. Finally, we note that the Natural Gas Act itself states that the Commission shall have no jurisdiction to find anything "unlawful" and hence a violation of the Act, except as basis for exercising its prospective rate fixing power (Section 5(a), 15 U. S. C. 717d (a)). If the Commission wants to secure a determination as to the claimed unlawfulness of Hope's past rates to help the City of Cleveland or others it must proceed in the District Court where Hope will have its day in court. Section 22 of the Act provides:

"Sec. 22. The District Courts of the United States, the District Court of the United States for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States *shall have exclusive jurisdiction of violations of this Act* or the rules, regulations, and orders thereunder, and of all suits in equity and actions at law, brought to enforce any liability or duty created by, or to enjoin any violation of, this Act or any rule,

> regulation, or order thereunder. Any criminal proceeding shall be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this Act or any rule, regulation, or order thereunder may be brought in any such district or in the district wherein the defendant is an inhabitant, and process in such cases may be served wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 225 and 347). No costs shall be assessed against the Commission in any judicial proceeding by or against the Commission under this Act."

Language could hardly be clearer. "Exclusive jurisdiction of violations of this Act" is vested in the District Courts and ergo is not vested in the Commission. If Hope has violated the Act by its former rate schedules as is claimed, jurisdiction to determine that matter is in the District Courts.

5. That *quasi*-legislative regulatory acts such as the Natural Gas Act do not confer the power to make any retroactive findings as to reasonableness of filed rates unless expressly so provided, is so clear that litigation has rarely been necessary. The theory adopted by the Commission in this case was once tried and promptly disposed of in *Great Western Portland Cement Co. v. Public Service Commission of Kansas,* 121 Kans. 531, 247 Pac. 881 (1926) where the court said (247 Pac. 883):

> "The language of the present statute does not appear to us to give authority, expressly or by fair or even liberal interpretation, for the commission to make findings as to the reasonableness of a rate previously charged or as to what rate would at that time have been reasonable."

More specifically, the very construction of the Natural Gas Act adopted by the Commission in its Opinion had

already been denied by the Supreme Court of Ohio in the *Cleveland* case, *supra,* page 9. During the course of the hearings before the Ohio Commission as to the reasonableness of the Hope-East Ohio rate, Cleveland requested the Ohio Commission to stay its decision until the Federal Power Commission had retroactively adjudicated the "lawfulness" of the Hope-East Ohio rate. The Ohio Commission denied this stay and the Ohio Supreme Court affirmed this action as proper, saying (137 O. S., 253-254, 28 N. E. (2d), 613):

> "Any river rate the Federal Power Commission might designate would be of an entirely prospective nature and would consequently be of no benefit or controlling force in the present proceedings."

No other interpretation of the clear provisions of the Natural Gas Act is possible and the Circuit Court of Appeals properly so held.

The arguments made by the petitioners here that jurisdiction in the Commission to adjudge and in effect fix rates in the past is to be "implied" from various general provisions of the Natural Gas Act (Com. Brief, 114; Cleve. Brief, 63-65, 67-69) were most carefully considered by the court below which said (R. IV, 201):

> "In none of these sections is any power granted to make findings as to reasonableness of past rates 'as an aid to state regulation'; and in all of them taken together and construed in the light most favorable to the existence of the power, there is no indication of any intention on the part of Congress to grant such power. We cannot escape the conclusion that, if it had been the intent of Congress to grant unusual power of this sort, it would have said so plainly."

It likewise carefully considered the argument here again advanced (Com. Brief, 117; Cleve. Brief, 69-76) that rate payers "may be left without a forum to challenge the lawfulness of interstate wholesale gas rates prevailing be-

tween the date of the Act's passage and the effective date of a Commission rate-fixing order.'' The rate payers' forum is of course the Federal Power Commission and, as the court pointed out, that forum can act forthwith ''in view of the provision of the statute for the entry of interim orders'' (R. IV, 202).

Had that forum in this case acted forthwith upon the filing of Cleveland's complaint in 1938 it would have found, as the record in this case shows, that Hope's filed rate was not only reasonable but too low. It should have been even on the Commission's present rate-making theories over 39¢; it actually was 36¢ (*supra,* p. 104). There is, therefore, no question involved here of Hope filing an unreasonable rate and keeping it in effect ''while defying the Federal Power Commission with its limited staff to determine and fix just and reasonable rates to be effective only after many years'' (Cleve. Brief, 69). We also note that the rate Hope filed was found reasonable by the Ohio Commission in 1939 and by the Ohio Supreme Court in 1940 (*Cleveland* case, *supra,* pp. 8-9).

It is likewise significant that Cleveland's motion for an interim order reducing Hope's rates to East Ohio in the sum of $662,000 a year filed in September, 1940, was denied by the Commission, after full consideration, on December 20, 1940, although without prejudice to its final determination (R. II, 43-44). All of Hope's evidence in chief was then in. Had the Commission granted Cleveland's motion no one would ever have claimed the Commission had authority to fix retroactively the very much larger reductions for 1940, 1941 and 1942 it has now made. *Arizona Grocery Company v. Atchison, Topeka & Santa Fe Railway Co., supra,* page 131. Certainly the Commission on any reasonable standard of administrative conduct should not be permitted greater retroactive powers because it then found no basis for reducing Hope's filed East Ohio rate in any amount.

The record also shows that the time involved in this case, referred to in Cleveland's brief, was not caused by Hope. All of Hope's direct evidence was in by the summer of 1940 and the Commission then delayed the presentation of its evidence until the spring of 1941 (Tr. 1970, 2175-2176). Thus what the petitioners are really contending for is that the Commission can commence an investigation of rates which at that time are wholly reasonable on any theory, continue it for years, and finally determine that in some of these years the rate was "unlawful" and fix a hindsight rate for these years retroactively and so Cleveland states (Cleve. Brief, 75).

Had Congress intended any such power in the Commission it could easily and would obviously have said that the Commission's rate order would be effective from the date of the filing of a complaint or the initiation of an investigation. This it did not do. If Cleveland desires to have the Natural Gas Act amended to accomplish this result its forum is Congress and not this Court. Congress, we submit, would not legislate as the petitioners request this Court to legislate.

Nor is there anything in *Atlantic Coast Line Railroad v. Florida,* 295 U. S. 301 and *United States v. Morgan,* 307 U. S. 183, referred to by the petitioners (Com. Brief, 120-121; Cleve. Brief, 66-69), which supports the Commission's usurpation of retroactive rate-making power in this case. In both cases the federal regulatory agency had issued rate orders which were subsequently held invalid, solely by reason of procedural defects. In both cases the lower court, sitting as a court of equity, had control of the disposition of the difference between the old rates and the new rates thus invalidly prescribed. In both cases the regulatory agency subsequently and validly held the rates prescribed in the original order reasonable. All this Court held was that the court of equity below should dispose of the differences arising during the period *after* the first order in

accordance with the findings made by the regulatory agency. There was, and could be, no holding substaining the power of a regulatory agency to determine and fix "lawful" rates for any period before the original rate order was entered, as the Commission sought to do here.

The Commission's excursion beyond its statutory rate-making powers in the present case was properly curbed by the Circuit Court of Appeals.

B. THESE RETROACTIVE DETERMINATIONS ARE ARBITRARY AND INVALID.

Wholly apart from its lack of statutory authority to make retroactive rate determinations, those made by the Commission in this case are otherwise arbitrary and invalid. As to this we note:

1. They are based upon the Commission's same unlawful, arbitrary and unconstitutional bookkeeping theories of rate regulation and findings as to rate base, rate of return and operating expenses which it applied in its "Order Reducing Rates." Everything we have heretofore said thereon applies equally to the Commission's figures as to past rates.

2. They are based on the arbitrary assumption that Hope has paid less than $195,000 of federal income taxes in the years 1939, 1940, 1941 and 1942 whereas as we have seen Hope's actual taxes were $4,500,000 more than this (*supra*, p. 104).

3. In addition, the Commission entirely ignored the recommendation of its own counsel that it use the average period 1937-1940 in considering the reasonableness of past rates. Instead it made separate and individual determinations solely for the years 1939 and 1940, considering each year singly and separately in retrospect, just as if each year's business was a wholly separate operation, which could be successfully predicted on January 1 of that year.

In so doing the Commission adopted what Commissioner Manly in the course of oral argument almost characterized as "the rubber ball theory" of fixing rates when he said to Cleveland's attorney (Tr. 6896):

> "* * * you do not have a rate bouncing up and down from year to year, do you?"

The Commission's "rubber ball theory" of retroactive rate making prescribes a standard of conduct under the Natural Gas Act with which no natural-gas company can possibly comply. The results of a year's operation are not known accurately until the company's books are closed in the spring of the following year. Nevertheless on this theory, on January 1 of 1937 Hope should have foreseen that its 36¢ average rate would be too high for that year as its business finally worked out and reduced it to 32.7¢. On January 1, 1938 it should have foreseen that 32.7¢ would be too low for 1938 and raised it to 39.1¢, and so on indefinitely. The Commission holds that Hope should have done just this and that it violated the Natural Gas Act because it did not.

This utter impracticability the Circuit Court of Appeals necessarily recognized (R. IV, 203).

Petitioners argue (Com. Brief, 122; Cleve. Brief, 77) that *West Ohio Gas Co. v. Public Utilities Commission of Ohio,* 294 U. S. 63, 79, demonstrates this holding by the court below as its "final error." There the Ohio Commission was acting under the special ordinance appeal provisions of the Ohio statutes, under which it is expressly given power retroactively to substitute just and reasonable rates for the specific ordinance period if it finds the ordinance rate appealed from is invalid (Ohio General Code, §§ 614-44 *et seq.*; 294 U. S., 66, 80). The utility can, as it there did, suspend the ordinance rate and continue collection of its pre-existing higher rate by giving bond to refund any excess over the rate finally fixed or approved by the Ohio Commission (*ibid*; see *Cleveland* case, *supra,* p. 9). Thus the utility

commits itself to abide by future retroactive rate orders, if valid, in exchange for the right to continue higher collections. It is of course entitled to have its refund liability determined on the facts actually prevailing during the ordinance period, as this Court held. But in absence of this commitment under these special ordinance appeal sections, it is not under the Ohio statutes subject to retroactive rate and refund orders, and is not expected to guess each year with absolute precision what the Ohio Commission would decide its rates should have been upon subsequent survey. *Public Utilities Commission of Ohio v. United Fuel Gas Co., supra,* pages 127-128.

This citation of the *West Ohio* case demonstrates that what Cleveland and the Commission attempted to do in the present case was to add to the Natural Gas Act the special features and to apply the particular considerations governing retroactive rate determination in the case of municipal rate ordinances in Ohio, with which Cleveland is familiar, but which in Ohio are added to the law by special statutory provision. The court below properly set aside this attempt.

CONCLUSION.

For the foregoing reasons it is respectfully submitted that the judgment below should be affirmed.

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October 12, 1943.

APPENDIX A.

The Legislative History of Section 6 of the Natural Gas Act.

Contents

Page

Summary of the History.......................... 142

Statements:

A. Senate Committee Report on the Public Utility Act of 1935................................ 146

B. House Committee Report on the Public Utility Act of 1935................................ 148

C. Statement by Congressman Lea on the Public Utility Act of 1935 in the House of Representatives, June 28, 1935......................... 149

D. Statement by Congressman Cole on the Public Utility Act of 1935 in the House of Representatives, June 28, 1935......................... 150

E. Conference Report on the Public Utility Act of 1935 152

F. Hearings Before the House Committee on the Natural Gas Act............................ 154

G. Statement by Congressman Lea on H. R. 6586 (the Natural Gas Act) in the House of Representatives, April 28, 1937.................... 158

THE LEGISLATIVE HISTORY OF SECTION 6 OF THE NATURAL GAS ACT.

Section 6 of the Natural Gas Act was copied directly from Section 208 of the Federal Power Act, which was enacted as part of the Public Utility Act of 1935. This Public Utility Act of 1935, as originally introduced (Senate Bill 1725 and House Bill 5423, 74th Congress, 1st Session), included a provision as to the rate base applicable both to Title II of the Act (the Federal Power Act) and Title III (regulating natural-gas companies), as follows:

> "Sec. 211. (a) The Commission shall have power to ascertain for the purposes of this title and title III the actual legitimate prudent cost of the property of every public utility, and every fact which in its judgment may or does have any bearing on the determination of such cost.
>
> "* * *
>
> "(c) In determining just and reasonable rates, the Commission shall fix such rate as will allow a fair return upon the actual legitimate prudent cost of the property used and useful for the service in question."

The Senate Committee on Interstate Commerce reported out a revised version of the Public Utility Act of 1935 (S. 2796), omitting Title III. The section quoted above was renumbered as Section 208 of the Federal Power Act and, as introduced, reported and passed by the Senate, provided as follows:

> "Ascertainment of Cost of Property; Rate Base
>
> "Sec. 208. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every public utility, the depreciation therein, and every fact which in its judgment has any bearing on the determination of such cost or depreciation.
>
> "(b) Every public utility 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.

"(c) In determining just and reasonable rates, the Commission shall fix such rate as will afford the public utility an opportunity to earn a fair return on a rate base not in excess of the actual legitimate cost of the property used and useful for the service in question less the accrued depreciation therein." [43]

The report of the Senate Committee on Interstate Commerce on this bill pointed out that this section represented an attempt to induce the Supreme Court to uphold prudent investment as the rate base (see Statement A, page 147 below).

The House Committee on Interstate and Foreign Commerce substantially amended the Senate Bill (S. 2796) and changed Section 208 of the Federal Power Act to read as follows, in which form it was passed by the House and eventually enacted by Congress:

"Ascertainment of Cost of Property

"Sec. 208. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every public utility, the depreciation therein, and, when found necessary for ratemaking purposes, other facts which bear on the determination of such cost or depreciation, and the fair value of such property.

"(b) Every public utility 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." (49 Stat. 853, 16 U. S. C. Sec. 824g)

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[43] Quoted from the three printed copies of S. 2796 in the Senate as follows: S. 2796, introduced, read twice and referred to the Committee on Interstate Commerce May 7 (calendar day, May 9), 1935; S. 2796 (Report No. 621), Calendar No. 651, reported to the Senate, May 13 (calendar day, May 14), 1935; S. 2796, passed the Senate May 13 (calendar day, June 11), 1935.

The report of the House Committee pointed out that the provision in Section 208(c) of the Federal Power Act as passed by the Senate, quoted above, that cost be used as the rate base, was omitted from the revised bill reported to the House (see Statement B, p. 148 below). In explaining this change in Section 208 upon the floor of the House, Congressmen Lea and Cole, respectively chairman and a member of the sub-committee which redrafted the bill, pointed out that the change was necessary in order to make the section constitutional and that it would require the consideration of reproduction cost as well as original cost in the rate base (see Statements C and D, pages 149 and 150 below).

In the conference between the Senate and the House upon the various amendments, Section 208 of the Federal Power Act as passed by the House was not changed but was accepted by the Senate, and was enacted in the form quoted last above (see Statement E, page 152 below).

The Natural Gas Act itself was enacted in the 75th Congress, 1st Session, as H. R. 6586, originally introduced by Congressman Lea as H. R. 4008. Section 6 of the Natural Gas Act as initially introduced and as finally enacted was identical with Section 208 of the Federal Power Act as finally enacted except for the substitution of "natural-gas company" for "public utility." Section 14 of the Crosser Bill, H. R. 5711, which was introduced as an alternative to Mr. Lea's bill and considered by the House at the same time, was likewise identical with Section 208(a) of the Federal Power Act.

At the hearings on the Natural Gas Act before the House Committee on Interstate and Foreign Commerce on March 24, 1937, Mr. Harry R. Booth, counsel for the Illinois Commerce Commission, and Dr. Milo R. Maltbie, Chairman of the New York Public Service Commission, appeared as advocates of the Act. In the discussion between them and the members of the Committee it was apparent that everyone considered that under the Act the present fair value of

a natural-gas company's properties, determined upon consideration of original cost and reproduction cost, would be the rate base (see Statement F, p. 154 below). In the Committee report to the House and the debate upon the Natural Gas Act there was little discussion of the rate base but Congressman Lea, then Chairman of the House Committee, referred to the Committee's previous consideration of the provisions of Section 6 and stated that it had decided to cut out detailed provisions as to the rate base and "stay with the safe and unquestionably constitutional provision we have here" (see Statement G, page 158 below).

Section 6 of the Natural Gas Act was passed by the House and by the Senate without further comment.

Statement A

SENATE COMMITTEE REPORT ON THE PUBLIC UTILITY ACT OF 1935

"74th Congress 1st Session	SENATE	Report No. 621

"PUBLIC UTILITY ACT OF 1935

"May 13 (calendar day, May 14), 1935.—Ordered to be printed

"Mr. WHEELER, from the Committee on Interstate Commerce, submitted the following

REPORT

(To accompany S. 2796)

* * * * *

(Page 20):

"G. *Rates.*—Section 205 (b), transferred from section 202 (c) of the original bill, has been modified by prohibiting merely undue, instead of all, preferences or prejudices in rates. The provisions defining with particularity the power of the Commission to investigate single rates and to fix standards of service (former secs. 208 (b) and 210) and the section authorizing the issuance of reparation orders (former sec. 213) have been eliminated. They are appropriate sections for a State utility law, but the committee does not consider them applicable to one governing merely wholesale transactions. The provision requiring the fixing of rates upon the basis of the actual cost of the property devoted to the service in question (now sec. 208 (c)) has been modified so as to make clear that the rate base is to be no higher than the actual legitimate cost of the property. Furthermore, it is expressly provided that the accrued depreciation of property is to be deducted from the rate base, and the section (302 of S. 1725) requiring the sinking-fund method of depreciation accounting has been

eliminated. This practice is contrary to that of most of the States in the country and the committee is of the opinion that its introduction in a Federal statute would cause unnecessary confusion and hardship.''

* * * * *

(Page 52):

''Section 208. Ascertainment of Cost of the Property

''Subsection (a) authorizes the Commission to investigate and ascertain the actual legitimate cost of the property of every public utility and the depreciation therein.

''Subsection (b) provides that every public utility upon request shall file with the Commission an inventory 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.

''Subsection (c) provides that in determining just and reasonable rates the Commission shall fix such rate as will afford the utility an opportunity to earn a fair return upon a rate base not in excess of the actual legitimate cost of the property used and useful for the service in question, less the accrued depreciation therein.

''Rate regulation must eventually be based on prudent investment. Recent decisions of the Supreme Court, and the respect which the Court has always paid to the constitutional interpretations of the coordinate branches of the Government, afford grounds for 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. This would present the case to the Court in an entirely new light.''

* * * * *

Statement B

HOUSE COMMITTEE REPORT
ON THE PUBLIC UTILITY ACT OF 1935

"74th Congress 1st Session	HOUSE OF REPRESENTATIVES	Report No. 1318

"PUBLIC UTILITY ACT OF 1935

"June 24, 1935.—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed

"Mr. Rayburn, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

(To accompany S. 2796)

* * * * *

(Page 30):

"Section 208. Ascertainment of Cost of Property

"The Commission is authorized under subsection (a) to ascertain the actual legitimate cost of the property of public utilities, the depreciation therein, and, when necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property. As an aid to such ascertainment, the public-utility companies may be required, under subsection (b), to file with the Commission an inventory of all or any part of their property, a statement of its original or historical cost and to keep the Commission advised as to the cost of additions, betterments, extensions, and new construction.

"In the Senate bill subsection (c), making the cost as ascertained under subsection (a) the base upon which the Commission shall fix rates, is omitted from the bill as reported."

* * * * *

STATEMENT BY CONGRESSMAN LEA ON THE PUBLIC UTILITY ACT OF 1935 IN THE HOUSE OF REPRESENTATIVES, JUNE 28, 1935.

(Congressional Record, Vol. 79, Part 9, p. 10378, 74th Cong., 1st Sess.):

* * * * *

"RATES

"This bill also involves the question as to the rate base that should apply in governing the rates for public utilities. The bill contains the general rule that rates must be just and reasonable. The committee would like to have been able to provide a better standard of valuation as a rate-making base, but after considering the question fully we determined it would be a futile thing to do. After the recent decision of the Supreme Court in a Maryland telephone case it is practically a futile thing, in my judgment, for any legislative body to try to write a rate-making base.

"The Constitution has established a rate-making base that cannot be decreased or minimized; so when a legislative body attempts to write a rate-making base, we may add to the burden that may be placed upon the consumers of electricity, but we cannot subtract from their burden on account of anything that we may write in the way of a rate base. So without attempting to go any further, we have provided that rates shall be reasonable and just, and under the Supreme Court decision that means that the valuation must be based upon the current value of the property.

"Cost is an element of the rate base, but only an element. The cost of reproduction might be an element, but only an element. The one question is the current value of the property, and the Supreme Court will permit no deviation from this principle."

* * * * *

Statement D

STATEMENT BY CONGRESSMAN COLE ON THE PUBLIC UTILITY ACT OF 1935 IN THE HOUSE OF REPRESENTATIVES, JUNE 28, 1935.

(Congressional Record, Vol. 79, Part 9, p. 10384, 74th Cong., 1st Sess.):

* * * * *

"* * * The Commission is empowered to determine the value of properties used in production and transmission of electric energy and to fix the rates and charges therefor. This is confined, naturally, to such part of the business as the Commission controls, leaving to the States that which is of intrastate character. The recent decision of the Supreme Court in the case of West and others against Chesapeake & Potomac Telephone Co. of Baltimore City, delivered June 3, 1935, has been most helpful in connection with framing this important section. There is nothing more important, in our judgment, when we come to deal with this entire subject than the setting up of necessary machinery whereby the Federal Government can appraise and value, for rate-making purposes, that part of the electric-utility business which is interstate in character and beyond the jurisdiction of the State regulatory agencies. Much of the delay and expense incident to rate cases conducted by the States has been directly attributable to the technicalities raised and the expense necessary for the State commission to properly cope with the matter.

"The bill was originally drawn on the theory that for the purpose of just and reasonable rates the Commission should determine the actual and prudent cost of the property less accrued depreciation thereon. Mr. Justice Roberts, in delivering the opinion of the Court in the Telephone case, *supra,* made it very clear that such a provision would be unconstitutional and it was therefore stricken out. In lieu thereof there is new language and while that may not be entirely clear, it was inconceivable to those of us serving on the subcommittee that any State or National commission establishing valuation of a public utility for rate purposes should do other than follow the very clear formula or standard now established by the Court. No one con-

sideration alone as to value such as legitimate cost or prudent cost, is sufficient; but all elements must be taken into account, such as reproduction value, actual cost, going value, proper depreciation allowance, so that in the end, after considering the aforegoing and such other elements of value as are essential, leave a figure upon which the rate established thereon will not be confiscatory. The dissenting opinion by Mr. Justice Stone on this case was also most helpful in clearing up the difficulties the commissions and courts have had in stating with definiteness that the theory of rate making outlined in Smith and Ames is still the rule, and if not, how it has been changed, by later decisions.''

* * * * *

Statement E

CONFERENCE REPORT ON THE PUBLIC UTILITY ACT OF 1935

"74th Congress 1st Session	HOUSE OF REPRESENTATIVES	Report No. 1903

"PUBLIC UTILITY ACT OF 1935

"August 23 (calendar day, August 24), 1935.—
Ordered to be printed.

"Mr. Rayburn, from the committee on conference, submitted the following

CONFERENCE REPORT

(To accompany S. 2796)

"The committee of conference on the disagreeing votes of the two Houses on the amendment of the House to the bill (S. 2796) to provide for the control and elimination of public-utility holding companies operating, or marketing securities, in interstate and foreign commerce and through the mails, to regulate the transmission and sale of electric energy in interstate commerce, to amend the Federal Water Power Act, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

"That the Senate recede from its disagreement to the amendment of the House and agree to the same with an amendment as follows:

"In lieu of the matter proposed to be inserted by the House amendment insert the following:

"That this act may be cited as the 'Public Utility Act of 1935.'

* * * * *

(Page 53):

"Ascertainment of Cost of Property

"Sec. 208. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of

every public utility, 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 public utility 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."

* * * * *

Statement F

HEARINGS BEFORE THE HOUSE COMMITTEE ON THE NATURAL GAS ACT

"NATURAL GAS

HEARING

Before

THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

Seventy-Fifth Congress

First Session

on

H. R. 4008

To Regulate the transportation and sale of natural gas in interstate commerce and for other purposes

MARCH 24 AND 25, 1937

Printed for the use of the
Committee on Interstate and Foreign Commerce

United States
Government Printing Office
Washington: 1937

135605

* * * * *

(Page 34):

"Mr. Mapes. Both the Crosser and the Lea bills propose to give the Commission the power to fix a just and reasonable rate for gas.

"What do you consider a just and reasonable rate?

"Mr. Booth. Well, if you will excuse me, Mr. Mapes, I am merely a lawyer, and the question as to what is a fair and reasonable rate is normally left to experts of a technical character.

"You mean what is the fair and reasonable return upon the investment, or do you mean what is a reasonable, fair, and reasonable wholesale rate?

"Mr. Mapes. You are the attorney for the Illinois Public Utility Commission.

"Mr. Booth. That is correct.

"Mr. Mapes. The bills provide that the Commission shall have the authority to fix a just and reasonable rate.

"Does that mean a 5-percent return upon the investment, or a 10- or a 15-percent return?

"Mr. Booth. Well, that all depends upon the individual circumstance. It will—the Commission will undoubtedly allow a fair return upon the fair value of the property of the pipeline company or a producing company devoted to public service."

* * * * *

(Page 36):

Mr. Cole. Your amendment, as proposed to this bill, provides for a temporary rate which is pretty much of a guessing proposition, is it not?

"Mr. Booth. Oh, no; not at all.

"Mr. Cole. Why not?

"Mr. Booth. As a matter of fact, it is much less of a guessing proposition than the determination of the final rate case as laid down by the decisions of the courts, because that amendment suggests that a temporary rate be fixed upon the original cost less accrued depreciation of the physical property of said company used and usable in the gas service plus a reasonable amount for working capital, * * *.

"* * *

"* * * the fixing of the tentative rate base, which is to be determined on the basis of the original cost, eliminates the guesswork that is usually involved in determination of fair value based upon reproduction cost basis and that is a determination arrived at from the testimony and estimates of engineers. Our courts have held that in the determination of fair value, original cost and reproduction cost is to be considered in arriving at the fair value of the

property of the utility company. The New York Court of Appeals has recently sustained the temporary rate provision just referred to."

* * * * *

(Page 37):

"MR. BOOTH. I am suggesting this, that because of the time and the delay which usually occur in determination of a final rate that the Commission arrive at a tentative or temporary rate base by taking one of the factors which the courts have said must be considered, in determining fair value, namely, the original cost, and since the original cost can be determined and should be determined with a high degree of accuracy, and since it will give the utility company or the company that is being regulated, presumably, a return upon the money that actually has been expended in the construction of its property and facilities, there does not seem to me anything highly unfair about that.

"Now, it is true that when the Commission determines the final rate, it will then give consideration both to the original cost, less depreciation, and the reproduction cost, less depreciation, and arrive at the final rate base.

"MR. COLE. Yes; and those elements which you say the Commission would consider in establishing a final rate, as I understand the law, are required to be taken into consideration.

"MR. BOOTH. That is right.

"MR. COLE. You cannot establish a rate solely on original cost."

* * * * *

(Pages 114-115):

"THE CHAIRMAN. In brief, how do you fix your temporary rate?

"MR. MALTBIE. The temporary rate is fixed upon the basis, according to the law, of the original cost of the physical properties, less depreciation.

"Now, we make an investigation. In some cases the books of the company show the original cost of the property and we have an order out now which will require all of the utilities outside of the railroads in the State of New

York to produce an inventory and show the original cost of their property before the end of this year.

''So, if the book shows we get original cost from the books. If the books do not show we are allowed to estimate the original cost.

''Also the depreciation, if the books show accrued depreciation, we take that from the books. If we do not think that they do, we can quickly make an estimate or fix the minimum amount that we will deduct and deduct that from the original cost, getting the original cost less depreciation, taking all of the physical property, material, supplies, as well as plant. Then, an analysis of the operating expenses show what the revenue should be and we can fix a rate of return on it and do fix it. So far there has not been a temporary rate fixed on that basis reversed in the State of New York; not one.

''The Chairman. In effect you give consideration to every fact that you do in fixing the final rate, but you act hurriedly and save yourselves as to the constitutional question in the final rate where you pay the company any deficiency that may be found due.

''Mr. Maltbie. No, Mr. Chairman; I have not included reproduction cost less depreciation.

''Now, according to the law of the land original cost and reproduction cost less depreciation must be taken off of each one and must be considered. There are a number of other things that might be considered before fixing a final rate, but in a temporary rate we do not need to give any consideration to reproduction cost less depreciation; none at all.''

* * * * *

Note: The persons participating in the foregoing discussion were:

Mr. Mapes, Congressman Carl E. Mapes, member of the Committee.

Mr. Booth, Harry R. Booth, Acting Counsel for the Illinois Commerce Commission.

Mr. Cole, Congressman William P. Cole, Jr., member of the Committee.

Mr. Maltbie, Milo R. Maltbie, Chairman, Public Service Commission of New York.

The Chairman of the Committee, Congressman Clarence F. Lea.

STATEMENT BY CONGRESSMAN LEA ON H. R. 6586 IN THE HOUSE OF REPRESENTATIVES, APRIL 28, 1937.

In the course of the reading of the Natural Gas Act (H. R. 6586, Seventy-Fifth Congress, 1st Session), Congressman Poage offered an amendment to Section 6 requiring the Commission in valuing a natural-gas company's properties for rate case purposes to exclude the value of the properties used for industrial gas, and further providing that it should be conclusively presumed that such property was a percentage of the total property equal to the ratio of the industrial gas to all gas sold by the company. Congressman Lea, Chairman of the House Committee on Interstate and Foreign Commerce, opposing the amendment, said (Congressional Record, Vol. 81, Part 6, p. 6729):

"* * * I think the standard proposed here to cover the action of the committee, in the exercise of its powers, is not authorized by the Constitution.

"* * * I believe under the definition of fair value as defined by the Supreme Court, the amendment would make it the duty of the Commission to do a thing that is not justified by the interpretation of the term 'fair value.' We spent a great deal of time on this section, and we had before us another section, such as the gentleman has here suggested, going into more detail, but, in the meantime, a Supreme Court decision came out that made it very clear we should cut out such details and stay with the safe and unquestionably constitutional provision we have here."

APPENDIX B.

Original Cost is a Matter of Actual Expenditures, Not of Bookkeeping, and Where Not Shown by Records is to be Estimated.

Treatises.

Spurr, Henry C. *Guiding Principles of Public Service Regulation,* Volume I, pp. 290-299.

"The term 'original cost' has been defined as the sum of money expended for the property in use at the time of the valuation for the benefit of the public. It has been said to be not what the original property cost, but rather what the present property cost."

* * *

"Original cost of construction does not necessarily mean book cost. * * * It means actual bona fide cash cost of existing property.[46] The cost shown by the books sometimes referred to as book value may not fairly represent the amount of the investment because the capital account may be overcharged or the operating account undercharged.[47] In the early days there was no uniform system of accounting and, whereas frequently items were unfairly added to the assets column, to balance the liabilities, on the other hand, items which should properly have been classified as fixed capital expenditures were frequently included in the operating expenses.[48]

* * *

"If for any reason the actual cost cannot be obtained from the books or records, it may be estimated. This estimated cost has been called historical cost, probably because the estimate is based upon a history of prices prevailing at the date of the installation.

"[46] *Re Mid-Crosstown R. Co.* (1914) 5 P. S. C. R. (1st Dist. N. Y.) 22;
Re Indianapolis Water Co. (Ind.) P. U. R. 1917 E, 556."

"[47] *Re Madison City Water Works* (1909) 3 Wis. R. C. R. 299.

"[48] *Re New York State Railways* (N. Y.) P. U. R. 1921 C, 496;
Mairies v. Flatbush Gas Co. (N. Y.) P. U. R. 1920E, 930."

This would seem to be a proper use of the term, but it has not always been employed in this sense. It has sometimes been considered as synonymous with original cost.

* * *

"The method of estimating original cost is the same as that employed in determining reproduction cost except that in the case of original cost there may be and usually are applied several average unit costs varying in amounts according to the period during which the particular portions of the plant were constructed, whereas, for reproduction cost, there is but one average unit cost applicable to all units of the same kind.[59] In estimating original cost, current prices may be obtained from information gathered from the company's original vouchers and contracts, manufacturers' quotations as of the time when the installations were made, catalogues, market reports, and prices current for similar material in other locations. Labor unit costs may be computed from information gathered from the company's pay roll and rates of pay in effect in other states during the period.[60]"

"Out of the Mail Bag," *Public Utilities Fortnightly,* Vol. 17, No. 4, Feb. 13, 1936, p. 250.

"Standardized definitions of the various kinds of 'cost' should simplify regulatory proceedings. The following suggestions are tendered for consideration:

" 'Original cost' to mean the total outlay of actual dollar costs (or equivalent) of the now existing property, from the date of the initial expenditure to the date of inquiry. This information to be actually obtained from the vouchers, invoices, etc., for the entire period, and applying only to those properties where there are continuous, reliable, accurate, detailed records of construction costs throughout the entire history and bearing no relation to changes in ownership.

"[59] *Public Service Commission v. Nevada-California Power Co.* (1913) 3 Ann. Rep. Nev. P. S. C. 261, 276.

"[60] *Re Flint* (Mich.) P. U. R. 1922A, 385, 393."

"'Historical cost' to mean an inventory of the physical property as it actually exists at the date of inquiry, to which is applied the correctly weighted average prices that prevailed during the construction period. This plan may be used where the records of original capital expenditures are not obtainable or where they are so generally inadequate as to be unreliable. Changes in ownership to be given no consideration.

"'Original-historical cost' to mean 'original cost' as first defined above, in so far as dependable construction records are available for a substantial period of time, and for that time in which there is a partial lapse of such records, a list of the now existing property which was constructed during such lapse periods shall be made and correctly weighted average prices of labor and material, etc., effective during such period applied thereto. This also ignores changes in ownership."

Whitten, Robert H. *Valuation of Public Service Corporations. Legal and Economic Phases of Valuation for Rate Making and Public Purchase. Supplement.* (New York: The Banks Law Publishing Co., 1914.) pp. 834-836.

"The term 'actual cost' may possibly be taken in three senses: (1) book cost; (2) the first cost of the original units; (3) the first cost of the identical units now in use. The confusion has arisen from identification of actual cost with book cost or first cost of original units, or both. Properly speaking, actual cost is the first cost of the identical units now in use. In the past both the terms 'actual cost' and 'original cost' have been used, the term 'original cost' being most frequently employed. The term 'actual cost' should be substituted, as the term 'original cost' appears to mean the first cost of the original units.

"Book cost would be the same as actual cost, *i.e.*, the first cost of the identical units now in use, assuming that approval accounting principles had been strictly applied from the initiation of the enterprise. Correct accounting principles are, however, of comparatively recent acceptance and application. Book costs as actu-

ally developed often include discount on securities issued, exorbitant profits to promoters, cost of replacing wornout or superseded property, dividends paid out of capital and money sunk in unsuccessful experiments. On the other hand, book cost may exclude various actual costs, such as improvements and betterments constructed out of earnings and overhead construction charges included in operating expenses.

* * *

"Assuming that existing accounts and records may be only partially relied upon, an estimate of actual cost can be ascertained by much the same methods as and with greater accuracy than an estimate of reproduction cost. The first essential in either case is a complete inventory of property units in use. A second requirement in both cases is the determination of the approximate time at which each such unit was installed. This information is essential under the reproduction method in order to determine the age and accrued depreciation of each unit or class of units. It is essential under the actual cost method in order that unit costs varying with the period of purchase may be applied. Records are available showing for any period the prevailing prices of labor and materials entering into construction costs. From such records, supplemented in many cases by fragmentary data obtainable from the books of the company, it is possible to apply unit costs."

Willard J. Graham and Wilber G. Katz, *Accounting in Law Practice* (Callaghan and Company, Chicago, 1938), p. 228.

"Literally, original cost is the total amount (in dollars) that has been expended by the utility at one time or another in the construction or acquisition of the properties which are at the time of the inquiry included in the rate base as being 'used and useful' in the operation of the business. This amount is readily determinable from the books of account, if they have been properly kept since the founding of the business. In the absence of proper records it is often necessary to substitute an estimate of what the cost of the prop-

erties should have been at the date of their acquisition."

Bemis, Edward W., "Original Cost as the Chief Basis for Fair Value." 1 *Utilities Magazine,* No. 3 (1915) p. 36:

"By original cost in the case of physical assets is meant the actual cost of the property now in use."

Erickson, Halford, "Relation Between the Valuation and the Rate of Return Thereon." *N. A. R. C. Proceedings of 25 Annual Convention,* 1913, p. 435.

"The original cost of the plant and of its business may be defined as the amount of money judiciously expended on the property used and useful in the service and on the development of the business."

Smith, Nelson Lee. *The Fair Rate of Return in Public Utility Regulation.* (Boston and New York: Houghton Mifflin Company, 1932), p. 22.

"The original cost method has been styled 'original cost to date,' 'historical cost,' and 'investment' or 'prudent investment' cost. Although these various terms are not always uniform in meaning, the original cost appraisal yields, not the cumulative costs of superseded as well as existing properties, but, rather, the sums actually paid for the units now in service when those items of property were acquired. But before values are assigned according to either one of these price methods, a physical count, or inventory, of the property must be made."

Hartman, Harleigh H., *Fair Value* (The Meaning and Application of the Term "Fair Valuation" as used by Utility Commissions) (Houghton Mifflin Company, The Riverside Press, Cambridge, 1920) p. 109.

"The campaign to discredit original cost failed because the propaganda could not obscure the fact that such valuation is not dependent upon a complete record, but may be estimated just as reproduction cost is calculated, and with as great or even greater accuracy. Original cost can be figured upon the same inventory as reproduction cost by merely substituting prices of

material and labor, which were current at the time the items inventoried were put into the plant, for the present or normal price used in the reproduction cost appraisal. The original prices may be secured in part from the records of the firm and in part from the market quotations of the period."

United States Supreme Court.

City of Knoxville v. Knoxville Water Company, 212 U. S. 1.

"When, therefore, a public regulation of its [a utility's] prices comes under question the true value of the property then employed for the purpose of earning a return cannot be enhanced by a consideration of the errors in management which have been committed in the past." (p. 14.)

Doyle v. Mitchell Brothers Company, 247 U. S. 179.

"Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case are not in dispute." (p. 187.)

Lincoln Gas & Electric Light Company v. City of Lincoln, 250 U. S. 256.

"Again, we question the propriety of the master's treatment of 'going value,' which he seems to have estimated at less than otherwise he would have placed it upon the theory that the company's business had been developed, at the expense of the public, in the expenditure of past earnings exceeding a fair return upon the capital invested, and this without any finding, or any clear evidence to which our attention has been called, that past earnings were excessive." (p. 267.)

State of Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission of Missouri, 262 U. S. 276.

(See quotation at pp. 36-37 above.)

Board of Public Utility Commissioners v. New York Telephone Company, 271 U. S. 23.

(See quotation at pp. 50-51 above.)

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398.

> "Leases bought with income, proceeds of the sale of gas, and *thus paid for in the last analysis through the contributions of consumers,* ought not in fairness to be capitalized *until* present or imminent need for use as sources of supply *shall have brought them into the base* upon which profits must be earned." (p. 407)

Federal.

Garden City v. Garden City Telephone, Light & Mfg. Co., 236 Fed. 693, P. U. R. 1917B, 779 (C. C. A. 8th, 1916).

The Court rejected the city's claim that the utility was not entitled to a full return upon the present value of its property because it had been paid for from earnings, saying:

> "No judicial authorities are cited on this point. In the first place there is no evidence that the company ever charged excessive rates until about the commencement of the controversy out of which this litigation arose; but, if it did so, the various parties from whom they were extorted had a cause of action against the company to recover the excessive rates until the statute of limitations had run. Presumptively they were not the identical persons who are now the consumers from the appellee. It is the practice of courts to try cases one at a time, and if the appellee has put money into the development of the plant, the court in this case could not stop to inquire just how it acquired the title to the money. Such a system would involve an investigation into the wholly collateral matter of the entire past life of litigants and the manner in which they acquired the money invested in a private enterprise." (p. 697.)

Brooklyn Borough Gas Co. v. Prendergast, 16 F. (2d) 615, P. U. R. 1927A, 200 (D. C., E. D. N. Y., 1926).

"Book cost in a confiscation rate case is not decisive of value, and quite properly, for it indicates the price of acquisition of property, which is one thing, and not present value, which is quite another thing." (p. 625.)

City of Minneapolis v. Rand, 285 Fed. 818, 822-824 (C. C. A. 8th, 1923).

Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission, 292 Fed. 139, 147, P. U. R. 1923E, 661 (D. C., E. D. Mich., 1923).

Indiana Bell Telephone Co. v. Public Service Commission of Indiana, 300 Fed. 190, 197, P. U. R. 1925A, 363 (D. C., D. Ind., 1924).

Wichita Gas Co. v. Public Service Commission of State of Kansas, 3 F. Supp. 722, 726 (D. C., D. Kans., 1930), modified and affirmed, 290 U. S. 561.

Illinois Bell Telephone Co. v. Moynihan, 38 F. (2d) 77, 86, P. U. R. 1930B, 148 (D. C., N. D., Ill., 1930), reversed, *Smith v. Illinois Bell Telephone Company,* 282 U. S. 133.

Pacific Gas & Electric Co. v. Railroad Commission of California, 26 F. Supp. 507, 514, 26 P. U. R. (N. S.) 1 (D. C., N. D. Calif., 1938).

Interstate Commerce Commission.

Texas Midland Railroad, 75 I. C. C. 1 (1918).

In determining the $2,892,361 "original cost" or "investment" as evidence of fair value, the Commission included substantial sums which had originally been charged to expense or to income. The Commission explained the method followed by its staff as follows:

"When the bureau realized that it was impossible to obtain accurate information from the books of the com-

pany concerning original cost to date, it reconstructed the accounts upon what it believed to be a proper basis. To accomplish this it was necessary to examine every voucher which had been issued by the carrier for the payment of money since 1893, the date when its operations began." (p. 10.)

"It became evident that the investment account of this carrier had not been correctly kept and an attempt was made to restate that account in accordance with our accounting rules now in force. For this purpose the entire books of the Texas Midland Railroad were in effect rewritten, every voucher being examined and reassigned as far as possible." (p. 98.)

Elgin, Joliet & Eastern Railway Company, 84 I. C. C. 587, 592 (1924).

New York, Philadelphia and Norfolk Railroad Company, 97 I. C. C. 273 (1925).

"The question to be determined is whether the voluntary act of the carrier in charging only a portion of the cost of road and equipment to its investment account estops it from thereafter claiming as investment the additional cost not charged out properly in the first instance. Under the mandate of the statute we are required to find the value of the property of the carrier. The investment account, when properly stated, constitutes evidence of value to which consideration must be given. In this case the investment in property being devoted to carrier purposes on valuation date is incompletely stated in that costs incurred therefor were entered as charges to income. If our present system of accounting had been in force when the entries were made the investment account would have included the amount here claimed as proper.

"In previous cases instances have been found where the investment account has been incorrectly kept, capital expenditures being recorded in operating expenses or as charges to income. In order to obtain an accurate statement of investment it has been necessary in such instances to reconstruct the accounts. Here the carrier has presented evidence of costs that have not been in-

cluded in our restated investment figure, although the property was found in ownership and use on date of valuation, was inventoried and is included in our estimates of cost of reproduction new and less depreciation. The evidence is persuasive that the investment figure should be increased by the amount of $733,846.13 and our tentative report will be revised accordingly. * * *'' (p. 279.)

Chicago, Burlington and Quincy Railroad Company, 134 I. C. C. 1, 19 (1927).

Hamilton Belt Railway Company, 149 I. C. C. 126 (1928).

Depreciation Charges of Telephone and Steam Railroad Companies, 177 I. C. C. 351, 407 (1931).

California.

Re Los Angeles Gas & Electric Corporation, P. U. R. 1917 F, 717 (Calif. R. R. Comm., 1917).

''In arriving at the sum upon which to calculate the fair return to the company, I have used an estimate of original cost of the entire plant which is now found in use, and have not depreciated this cost. In other words, I have concluded that the just and reasonable thing to do in this proceeding is to allow the company a return upon its actual investment in this property. This includes money invested regardless of the source from which such money came. For instance, no deduction has been made because a part of the depreciation reserve has been invested in plant, nor has any deduction been made because a part of the earnings of the company in times past have been invested in plant.

''Reinvested earnings are legally as much a part of the stockholders' equity in the property as is the property represented by a direct investment by the stockholders.'' (pp. 722-723)

Re City of Los Angeles, P. U. R. 1916F, 593, 601 (Calif. R. R. Comm., 1916).

Re Napa Valley Electric Company, P. U. R. 1925A, 724, 730 (Calif. R. R. Comm., 1924).

Colorado.

Re Mountain States Telephone & Telegraph Company, P. U. R. 1917B, 198 (Colo. P. U. C., 1917).

"The experience of this Commission discloses that book values of public utilities are of very little assistance in obtaining fair value for rate-making purposes. The methods adopted by the various public utilities in building book values are not uniform, and the accounting methods in the past have been far from uniform, as no regulatory boards were in existence to prescribe the methods of accounting, from which book values could be ascertained. Some public utilities build up enormous book values based on many erroneous assumptions; other utilities—of which class the present utility is one—have not taken into consideration proper methods in building up an adequate book value, as has been disclosed from the testimony in this case." (pp. 286-287)

District of Columbia.

Re Washington Gas-Light Company, 11 P. U. R. (N. S.) 119 (D. C. P. U. C., 1935).

Idaho.

Boise Artesian Water Co. v. Public Utilities Commission, 236 Pac. 525, P. U. R. 1926A, 195 (Idaho, 1925).

The Commission excluded overheads from the rate base because there was no evidence that they had actually been expended. The Court reversed, saying:

"The value of a property is not necessarily its cost. Even though constructed economically, the construction cost is a mere evidence of value. The fact, even if it be admitted, that the system was largely built from profits, would not deprive the owner of his right to have the property given its present fair value. And ordinarily, even though the system was built up gradually and out of the profits of the company, and conceding that there is no evidence that any sum was ever actually expended for overheads, we do know that there is a value in the completed property in addition to the mere

naked cost of labor and materials necessarily used in its construction." (pp. 529-530)

Illinois.

Illinois Commerce Commission v. Chicago Telephone Company, P. U. R. 1924A, 213 (Ill. C. C. 1923).

In holding that original cost could not be ascertained entirely from a consideration of book value, the Commission said:

"Furthermore, it appears that the book value now includes some overhead charges but that others have not been properly charged thereto. There is evidence of record to indicate that some costs of an overhead nature have previously been charged to operating accounts instead of to plant account. While this is an erroneous procedure it does not warrant the Commission in eliminating them from consideration when finding the original cost of the existing property." (p. 226)

Indiana.

Re Indianapolis Water Company, P. U. R. 1917E, 556, 612 (Ind. P. S. C. 1917).

Maine.

Rich v. Biddeford & Saco Water Company, P. U. R. 1917C, 982, 999 (Me. P. U. C. 1917).

Missouri.

City of Jefferson v. Capital City Water Company, 27 P. U. R. (N. S.) 69 (Mo. P. S. C. 1938).

"The city objects to the inclusion of this item [construction overheads] in the estimated original cost on the ground that it was not an actual or recorded cost item, and if it had been incurred, it had previously been charged to operating expenses."

"(1) We are endeavoring to arrive at a proper amount for the estimated original cost of the property as one of the elements to be considered in arriving at present fair value. This being true, the disposition of costs in the accounts of the company are immaterial. If the en-

tire costs of the property had been charged to operating expenses, we would still be obliged, to arrive at a figure for the estimated original cost." (p. 74)

New York.

People ex rel. New York State Rys. v. Public Service Commission, 202 App. Div. 576, 195 N. Y. Supp. 174, P. U. R. 1922E, 675 (3d Dept. 1922).

"With the exception above noted, the commission disallowed these items [overheads], because:

'Otherwise it would be necessary to revise the operating expense accounts by excluding a portion of the salaries of the officials concerned, and such revision would produce larger net earnings.'

"The 'larger net earnings' thus produced would relate to the period when the particular portion of the road under consideration was being organized, constructed, and developed, and would in no way affect present net earnings. It has been held that past losses are not to be considered in determining the rate base and whether the present rate is confiscatory. *Galveston Electric Co. v. City of Galveston,* 257 U. S. ..., 42 Sup. Ct. 351, 66 L. Ed. ... (decided April 10, 1922); *City of Knoxville v. Knoxville Water Co.,* 212 U. S. 1, 14, 29 Sup. Ct. 148, 53 L. Ed. 371. It would seem to follow as a necessary corollary that, if past losses may not be considered in fixing a rate base, neither should past profits be so considered, nor what would have been past profits or 'larger net earnings' by a readjustment of operating expenses.

"We think, therefore, the commission has proceeded on an erroneous principle in excluding these overhead expenses." (p. 176)

Village of Wellsville v. Maltbie, 257 App. Div. 746, 15 N. Y. Supp. (2d) 580, 32 P. U. R. (N. S.) 436 (3d Dept., 1939).

Village of Boonville v. Maltbie, 245 App. Div. 468, 283 N. Y. Supp. 460, 466-467, 14 P. U. R. (N. S.) 93 (3d Dept. 1935), affirmed 4 N. E. (2d) 209 (N. Y., 1936).

New Rochelle Water Co. v. Maltbie, 248 App. Div. 66, 289 N. Y. Supp. 388, 397, 15 P. U. R. (N. S.) 32 (3d Dept. 1936).

Pennsylvania.

City of Erie v. Public Service Commission, 123 Atl. 471, P. U. R. 1924D, 89 (Pa. 1924).

"Time has usually wiped out much of the evidence to show original cost. The records then kept did not account for all the various items entering into it, nor do the books of today, though kept with meticulous care, exactly cover such items. As stated by Mr. Justice Brandeis in his concurrence in the *Southwestern Bell Case,* wherein the present value method is assailed in what may be termed the last word on the subject:

" 'Ordinarily, stocks and bonds did not indicate the amount of capital embarked in the enterprise. Depreciation accounts were unknown, and * * * book values or property accounts furnished no trustworthy evidence either of cost or of real value.'

"It is here that a part of the difficulty is met, if original cost were adopted as the rule of value. * * *." (p. 475)

Borough of Verona v. Suburban Water Company, P. U. R. 1920F, 942 (Pa. P. S. C., 1920).

"Original cost, one of the elements to be considered by the Commission in determining fair value, is the actual cost of the property. Historical cost may be defined to be the cost ascertained by applying to the property of the company the prices prevailing at the time the plant was constructed or property acquired. It is only ascertained when original cost is not available. Historical cost, therefore, may be more or less than original cost and neither should be confused with fair value, as they are only elements ascertainable in the manner indicated, to be considered by the Commission in reaching its determination. The cost submitted to the Commission in this case was original cost, so far as it was obtainable from the books of the company, and where original cost could not be obtained it was supplemented

by historical cost. It is, therefore, a combination of the two. Book value is that which is placed upon the property of the company for accounting purposes. It may be the same or more or less than original or historical cost.'' (p. 945)

Re Philadelphia Rapid Transit Company, 26 P. U. R. (N. S.) 65, 105 (Pa. P. U. C., 1938).

Wisconsin.

Re City of Milwaukee, P. U. R. 1927B, 229, 244 (Wis. R. R. C., 1926).

APPENDIX C.

Analysis of Cases Cited in Commission's Brief (Pages 79-82) Said to "Prohibit Reaccounting and Support the Principles Employed by the Commission" in Determining "Original Cost."

The only three federal cases cited on this point in the Commission's brief not merely for comparison ("Cf.") are the decision of the Supreme Court in the *Natural Gas Pipeline* case, the decision of the District Court in the *Los Angeles Gas & Electric* case, and the decision of the Circuit Court of Appeals for the Ninth Circuit in the *Northwestern Electric* case. As to these three cases we note the following:

1. *Federal Power Commission v. Natural Gas Pipeline Company,* 315 U. S. 575. Here the rate base actually used by the Commission was the reproduction cost new of all of the utility's physical properties, plus the present value of its gas reserves, its estimated capital additions, and working capital (315 U. S., 586-587). The discussion at page 590, specifically referred to in the Commission's brief, deals with the claim for $8,500,000 for going concern value as a separate allowance. There was no exclusion from the rate base in this case of any part of the cost or value of any items of physical property by reason of the past accounting practices of the utility. In excluding a separate allowance for going concern value, the Court pointed out that the only items excluded were "expenditures for securing new business" and costs of carrying "non-productive capacity" (315 U. S., 588).

2. *Los Angeles Gas & Electric Corp. v. Railroad Commission,* 58 F. (2d) 256 (D. Ct., S. D. Calif. 1932). This is the case that ultimately reached the Supreme Court in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California,* 289 U. S. 287. The rate base found non-confiscatory by the Supreme Court was one of $65,500,000,

undepreciated, "on the basis of fair value." This was almost $5,000,000 in excess of historical cost (289 U. S., 310). The views of the California Commission and the District Court as to whether overheads in excess of those actually capitalized should under the particular circumstances of that case be included in the historical cost, the Supreme Court did not pass upon, pointing out that even if the $2,000,000 claimed by the utility had been added to the historical cost allowed by the Commission the result would still be substantially below the Commission's "fair value" rate base (289 U. S., 309-310).

The decision of the District Court that there should not be included in historical cost larger overheads than the utility had capitalized was based upon the principles of estoppel. In the initial valuation proceeding for this company in 1917, *Los Angeles Gas & Electric Corp.*, P. U. R. 1917 F, 717 (1917), the California Commission capitalized and included in the rate base overheads at approximately the 24.27% claimed by the company fifteen years later in the rate proceeding which finally reached the Supreme Court (P. U. R. 1931A, 132 (1930); P. U. R. 1933E, 317 (1933)). Thus, to use its own language, the Commission apprised the company that it could capitalize overheads at a substantial figure, even though part of them had been carried as operating expenses. The company, however, rejected the Commission's suggestion, and continued to capitalize overheads at slightly less than 6%, charging the balance to operating expenses. In this manner the company over a period of some fifteen years after the initial valuation and *in a succession of almost biennial rate hearings obtained increased rates on the basis of the operating expenses shown by its books, including the overheads* which the Commission had originally suggested that it might capitalize. Thus the company was actually *allowed* increased rates to take care of the enhanced operating expenses due to the overhead items it later sought to capitalize.

3. *Northwestern Electric Co. v. Federal Power Commission,* 125 F. (2d) 882 (C. C. A. 9th, 1942). This is a pure accounting case. The Federal Power Commission had ordered the utility not to place certain interest during construction in its capital accounts on its books, and the court held that the Commission was within its jurisdiction in requiring it so to account. The court was careful to point out (at p. 886) that "the system of accounts takes nothing from petitioner."

The two federal cases marked "Cf." in the Commission's brief are not relevant. *Helvering v. Wilshire Oil Company,* 308 U. S. 90, at pages 95, 97, was an income tax case in which the taxpayer sought both to deduct development costs from gross revenues in order to determine taxable net income and not to deduct them for the purpose of computing the depletion allowances. *Chicago & N. W. R. Co. v. Commissioner,* 114 F. (2d) 882, 886 (C. C. A. 7th, 1940), was also an income tax case, involving the right of the taxpayer to shift from the retirement to the straight line method of computing depreciation without complying with relevant regulations.

As to the two state court cases cited we note the following:

1. *Peoples Gas Light & Coke Company v. Slattery,* 373 Ill. 31, 25 N. E. (2d) 482, 493 (1940), app. dism. 309 U. S. 634, was a case in which the commission and court approved a rate base of $120,000,000 as against the historical cost (undepreciated) of the property as claimed by the company of $111,000,000. The case furthermore involves the application of the principle of estoppel since the utility had long been under regulation and had obtained higher rates by reason of the increased operating expenses due to the inclusion of the overheads which the company sought to capitalize.

2. *Natural Gas Company of West Virginia v. Public Service Commission*, 95 W. Va. 557, 121 S. E. 716 (1924). In this case the court disapproved the inclusion in the rate base of overheads and well drilling costs formerly charged to operations by means of which the company had obtained higher rates from the state commission. The court expressly approved the fair value rule for the fixing of a rate base and remanded the case to the Commission for its failure to give proper consideration to reproduction cost. In order to test the company's claim of confiscation, the court reconstructed a hypothetical rate base in which it added 52% to the historical cost of the company's property to determine its current fair value. The company claimed an allowance of 18% for overheads which the court found was not supported by the facts; but the court directed the commission on remand to make proper allowance for overhead costs.

In addition to the foregoing federal and state court cases the Commission's brief cites decisions by various commissions. Only three of these are by federal commissions. Two are the Federal Power Commission's own decisions. The *Canadian River Gas* case (43 P. U. R. (N. S.) 205 (1942)) is a rate case decided by the Commission shortly before the *Hope* case, and it applied exactly the same theories being tested here, but to a new property. The *Northwestern Electric* case (36 P. U. R. (N. S.) 202 (1940)), reviewed by the Circuit Court of Appeals in the opinion previously discussed, is a case involving the Commission's application to purely accounting problems of its own interpretation of its system of accounts.

In addition the decision of the Interstate Commerce Commission in the *Elgin, Joliet & Eastern Railway Company* case is cited (84 I. C. C. 587 (1924)). What this case actually holds is that capital costs formerly charged to operating expenses, when properly identifiable, should be transferred to capital account for the purpose of determin-

ing the actual original cost of a railroad property. As we noted in Appendix B at pages 166 to 168 above the Interstate Commerce Commission has uniformly taken this position and as the oldest federal regulatory body its interpretation of what is meant by the term "original cost" is of controlling significance.

The balance of the cases cited in the Commission's brief are all State commission cases which fall into one or more of the following general classes:

1. Cases where the rate base fixed was present fair value, substantially in excess of the depreciated original or historical cost of the property.

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) also cited in classes 2 and 4.

District of Columbia:

Re Potomac Electric Power Co., P. U. R. 1917D, 563 (1917) also cited in class 2.

Hawaii:

Re Hawaiian Electric Co. Ltd., 33 P. U. R. (N. S.) 161 (1940).

Illinois:

Illinois Commerce Comm. v. Pub. Serv. Co., 4 P. U. R. (N. S.) 1 (1934) also cited in class 2.

Illinois Commerce Commission v. Commonwealth Edison Co., 15 P. U. R. (N. S.) 404 (1936) also cited in class 2.

Indiana:

Re Indianapolis Water Co., P. U. R. 1919A, 448 (1918).

Michigan:

Re Eaton Rapids, P. U. R. 1922D, 94 (1922).

Missouri:

Re West St. Louis Water & Light Co., P. U. R. 1922E, 805 (1922) also cited in class 3.

Aluminum Goods Mfg. Co. v. Laclede Gas Light Co., P. U. R. 1927B, 1 (1926) also cited in class 4.

New York:

Re Brooklyn Borough Gas Co., 21 P. U. R. (N. S.) 353 (1937) also cited in classes 2 and 3.

Herman v. Newtown Gas Co., P. U. R. 1916D, 825 (1916).

Maires v. Flatbush Gas Co., P. U. R. 1920E, 930 (1918) also cited in class 2.

Moritz v. Edison Electric Illum. Co., P. U. R. 1917A, 364 (1916) also cited in class 2.

Pennsylvania:

Public Utility Comm. v. Duquesne Light Co., 20 P. U. R. (N. S.) 1 (1937).

West Virginia:

Re Clarksburg Light & Heat Co., P. U. R. 1928B, 290 (1927) also cited in class 2.

Re West Virginia Central Gas Co., P. U. R. 1924E, 24.

Re West Virginia Central Gas Co., P. U. R. 1918C, 453 also cited in class 3.

Re Clarksburg Light & Heat Co., P. U. R. 1917A, 577 (1916) also cited in class 4.

Wisconsin:

Re Reedsburg Telephone Company, 7 P. U. R. (N. S.) 389 (1934).

2. Estoppel cases where the circumstances were similar to those in the Los Angeles case.

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) (Municipal Regulation) also cited in classes 1 and 4.

Re Los Angeles Gas & Electric Corp., P. U. R. 1931A, 132 (1930) (Commission decision under review in *Los Angeles* case above. Commission included interest during construction not previously capitalized).

Re Los Angeles Gas & Electric Corp., P. U. R. 1933E, 317 (1933) (Accounting case).

District of Columbia:

Re Potomac Electric Power Co., P. U. R. 1917D, 563 (1917) (Congressional Regulation) also cited in class 1.

Illinois:

Illinois Commerce Comm. v. Pub. Serv. Comm., 4 P. U. R. (N. S.) 1 (1934) also cited in class 1.

Illinois Commerce Comm. v. Commonwealth Edison Co., 15 P. U. R. (N. S.) 404 (1936) also cited in class 1.

New York:

Moritz v. Edison Electric Illum. Co., P. U. R. 1917A, 364 (1917) also cited in class 1.

Maires v. Flatbush Gas Co., P. U. R. 1920E, 930 (1918) also cited in class 1.

Re New York State Railways, P. U. R. 1922B, 75 (1921).

Re Westchester Lighting Company, 15 P. U. R. (N. S.) 299 (1936).

Re Brooklyn Borough Gas Co., 21 P. U. R. (N. S.) 353 (1937) also cited in classes 1 and 3.

Pennsylvania:

Public Utility Com. v. Peoples Natural Gas Co., 43 P. U. R. (N. S.) 82 (1942).

West Virginia:

Re Clarksburg Light & Heat Co., P. U. R. 1928B, 290 (1927). (Where well drilling costs were being charged to expense, Commission said they "should not be included in the present valuation of its property, *provided the same policy of accounting is continued*," p. 297) also cited in class 1.

Wisconsin:

Re Mondovi Telephone Co., P. U. R. 1933B, 319 (1932); P. U. R. 1933D, 142 (1932).

3. Cases where the items excluded from the rate base comprised for the most part intangible overheads and not direct property costs and the claims for such overheads were wholly unsupported by the facts:

Missouri:

Re West St. Louis Water & Light Co., P. U. R. 1922E, 805 (1922) (Contractor's fee) also cited in class 1.

New York:

Re Brooklyn Borough Gas Co., 21 P. U. R. (N. S.) 353 (1937) also cited in classes 1 and 2.

West Virginia:

Re West Virginia Central Gas Co., P. U. R. 1918C, 453 (1918) (20%) also cited in class 1.

4. Cases where the items excluded from the rate base were not proper capital costs but were regarded as current operating expenses:

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) (expense involved in location of street lamps) also cited in classes 1 and 2.

Colorado:

Re Leadville Water Co., P. U. R. 1921D, 172 (1921).

Idaho:

Re Kootenai Power Co., P. U. R. 1924E, 831 (1924) (Donations, advertising, etc.).

Missouri:

Aluminum Goods Mfg. Co. v. Laclede Gas Light Co., P. U. R. 1927B, 1 (1926) (Cost of records) also cited in class 1.

Montana:

Public Service Commission v. Montana Petroleum Company, P. U. R. 1924B, 364 (1923).

West Virginia:

Re Clarksburg Light & Heat Co., P. U. R. 1917A, 577 (1916) (Drilling costs excluded because treated as operating expenses by Commission for future) also cited in class 1.

The only case cited by the Commission which is not included in any of the foregoing categories is *Re Central Maine Power Co.,* P. U. R. 1918C, 792 (1918), which was not a rate case at all but involved simply the authorization of the issuance of securities.

As a matter of fact, many of the cases cited by the Commission expressly permit the inclusion of overheads not previously carried in capital account or expressly approve the inclusion in the rate base of property purchased from income, including the following cases:

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) (10% for overheads; see also page 519).

Michigan:

Re Eaton Rapids, P. U. R. 1922D, 94 (1922) ($31,000 acquired from profits as against $185,000 rate base).

Missouri:

Aluminum Goods Manufacturing Company v. Laclede Gas Light Co., P. U. R. 1927B, 1 (1926) (15% for overheads and also donated property included).

Montana:

Public Service Commission v. Montana Petroleum Company, P. U. R. 1924B, 364 (1923) (20% for overheads).

West Virginia:

Re West Virginia Central Gas Co., P. U. R. 1918C, 453 (1918).

Re West Virginia Central Gas Co., P. U. R. 1924E, 24 (1924).

APPENDIX D.

HOPE NATURAL GAS COMPANY

"Direct Costs of Production of Gas (Exclusive of Return) and Increment of Direct Costs Year 1940 Over 1939."

[Copy of Table 12 of Cleveland Reply Brief before the Commission (p. 104)]

	Exhibit 67, 1939	Exhibit 78, 1940	Increment Costs—1940 over 1939
"Direct Expenses of Producing Gas, Excl. of Depreciation and Depletion (Ex. 67, pp. 17, 39; Ex. 78, pp. 17, 23)			
734.1 Gas Well Labor	$ 330,338.52	$ 347,147.21	
735.1 Gas Well Supplies and Expenses	130,999.56	164,662.01	
741 Maint. of Prod. Gas Well Equip.	53,457.92	83,242.02	
745 Gas Well Royalties	828,851.62	885,841.27	
Total Direct Gas Well Expenses	1,343,647.62	1,480,892.51	
Gross Production Tax	144,633.15	221,908.58	
Total, Incl. Production Tax	1,488,280.77	1,702,801.09	
"Depreciation and Depletion (Ex. 78, p. 54)			
Operated Acreage	$ 36,772.47	$ 57,084.00	
Gas Well Construction	182,755.43	286,492.00	
Cost of Abandoning	69,813.58	105,860.00	
Total Depletion	289,341.48	449,436.00	
Depreciation of Gas Well Equipment (Ex. 61, p. 21; Ex. 78, p. 26)	188,482.85	186,702.97	
Total Depreciation and Depletion	$ 447,824.33	$ 636,138.97	
Volume of Gas Produced—M.c.f. (Ex. 78, p. 54)	16,546,230	26,800,000	10,253,770
"Direct Expenses per M.c.f. Produced			
734.1 Gas Well Labor	2.00¢	1.29¢	
735.1 Gas Well Supplies and Expenses	.79	.61	
741 Maint. of Prod. Gas Well Equip.	.32	.31	
745 Gas Well Royalties	5.01	3.31	
Total Direct Gas Well Expenses	8.12	5.52	
Gross Production Tax	.87	.83	
Total, Incl. Production Tax	8.99¢	6.35¢	
"Depreciation and Depletion per M.c.f. Produced:			
Depletion	1.75¢	1.68¢	
Depreciation of Gas Well Equipment	1.14	.70	
Total Depreciation and Depletion	2.89¢	2.38¢	
"Total Direct Costs of Producing Gas, Incl. Depreciation and Depletion:			
Amount	$1,966,105.10	$2,338,940.06	$372,834.96
Per M.c.f. Produced	11.88¢	8.73¢	3.64¢"

APPENDIX E.

HOPE NATURAL GAS COMPANY.

Indicated Rate Reduction Based on Findings of the Commission for the Year 1940 and Reported Changes in Plant, Revenues, and Expenses to December 31, 1942.

(Excluding former Reserve Gas Company Operations)

	1940 per Commission Findings (R. I, 12)	Increase on Commission's Method	1942	Less former Reserve Gas Company (Ex. 77)	1942 excluding former Reserve Gas Company
	(1)	(2)	(3)	(4)	(5)
Operating Revenues from Interstate Sales	$19,296,755	$5,933,028	$25,229,783	$1,210,973	$24,018,810
Operating Deductions:					
Operating Expenses except Federal Income Tax	12,997,845	4,452,813	17,450,658	716,942	16,733,716
Federal Income Tax	912,313	1,627,704	2,540,017	71,207	2,468,810
Total	$13,910,158	$6,080,517	$19,990,675	$ 788,149	$19,202,526
Net Operating Revenues from Interstate Sales	5,386,597	(147,489)	5,239,108	422,824	4,816,284
Return at 6½%	2,088,756	231,976	2,320,732	(Note A)	2,320,732
Excess Earnings before Income Tax Saving	3,297,841	(379,465)	2,918,376	—	2,495,552
Income Tax Savings	912,313	1,033,271	1,945,584	—	1,663,701
Total Indicated Rate Reduction	$ 4,210,154	$ 653,806	$ 4,863,960	—	$ 4,159,253

NOTE A: No adjustment of the 1942 return computed by the Commission's brief is made since there is no way of determining what if any amount is included therein on account of the Reserve Gas Company's properties. The $3,377,171 net addition to the average 1938-1939 rate base used by the Commission's brief in computing the return would include at the most the very low net book cost of the Reserve properties, a 6½% return on which would be less than $150,000.

( ) Parentheses denote losses.