commission which required capitalization of well drilling expenditures. That Association took the view that such expenditures were necessary operating expenses. In fact, Hope did not change its practice in this respect until it was required to do so by the provisions of the system of accounts for natural gas companies promulgated by the Public Service Commission of West Virginia, effective in 1923. It is significant that West Virginia's system of accounts did not require and evidently did not permit the Hope Company to re-account for its past expenditures, but merely required a change as to treatment of well drilling expenditures beginning with its effective date.

The Company's practice of charging well drilling expenditures to operating expenses, therefore, conformed to the principles and practices of the time. One of the obvious purposes of keeping books of account is to inform management so that proper managerial decisions may be made. One of the first functions of management, of course, is to endeavor to fix prices so that revenues will cover operating expenses and yield a profit. Where it is the general practice of the industry to treat certain expenditures as operating expenses, it is manifest that such expenditures will be considered as expenses in its rate negotiations and determinations.

If there were any doubt about this matter, it would be dispelled by the action of the Hope Company itself. In 1921 the Hope Company was involved in a rate proceeding before the Public Service Commission of West Virginia. It was a proceeding in which Hope sought to increase its rates. In that proceeding the Company claimed well drilling and other expenditures now sought to be included in the rate base, as operating expenses. They were allowed as such by the Public Service Commission of West Virginia.[10] No further proof is needed to show that Hope

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[10] *Re Hope Natural Gas Co.*, P. U. R. 1921 E 418, 433, 439-440.

considered the expenditures in question as operating rather than plant items, in its efforts to recover full operating costs plus a profit in the conduct of its business.

No greater injustice to consumers could be done than to allow items as operating expenses and at a later date include them in the rate base, thereby placing multiple charges upon the consumers.

The other direct material and labor costs of $996,543 appear, to the extent they can be identified, to have been charged in the past to maintenance and repairs.

The adjustments for cost of labor in laying mains, constructing compressor stations and other property totaling $1,295,953, and the adjustment of $8,764 to the cost of leases are treated later.

In addition to well drilling expenditures, other items now sought to be included in the plant accounts which were previously included in expenses, if they were incurred at all (the Company's method makes it impossible to determine whether or not certain of the expenditures were incurred) are as follows:

Unloading, Hauling and Warehouse Handling Costs	$ 383,454
Indirect Field Costs	396,141
Other Overhead Costs	2,866,414

As to these items, here again the Company followed a consistent practice, and the practice of the industry, in charging such expenditures to expense accounts. It was not customary for the natural gas industry or other extractive industries to load the plant accounts with overhead items, such as shown above. Even under the relatively definite requirements of the Commission's present Uniform System of Accounts, considerable discretion and latitude are allowed management in accounting for overhead expenditures. Accordingly, the allowance of the items mentioned would not represent the correction of past

errors, but merely the substitution of present judgment for the judgment exercised at the time the expenditures were incurred, which covered a period of forty years. The important rule is that once discretion has been exercised, subsequent action must be consistent with the decisions previously reached. There is no settled principle controlling the determination of the exact amount of overheads, if any, which should be applied to the cost of plant items.

Besides claiming large additional costs for property constructed by the Company, Hope claims a net sum of $1,599,730 representing alleged additional original cost of property acquired from other utilities. These properties, acquired chiefly from affiliated utilities, were accounted for by Hope at the cost to it, which was the cost to the predecessors. Hope now claims that the costs accounted for as plant by the predecessors were in error in that the predecessors followed the same allegedly erroneous practices that Hope followed. It, therefore, claims that well drilling costs in the amount of $1,364,087, other direct material and labor costs of $286,173, unloading, hauling and warehouse handling costs of $18,557, indirect field costs of $38,519, other overhead costs of $122,043 and leasehold costs of $6,388, all of which, if incurred at all, the predecessors had charged to expense, should be added to its plant investment figure and included in the rate base.[11] Since these predecessor companies kept their books and records exactly as did Hope, in accordance with the general practice of the industry, the proposed adjustments, except for leasehold costs, are in the same category as the items which Hope now attempts to restate in its plant accounts.

In the course of its study, the Hope Company determined that considerable property which was recorded in its plant accounts, was no longer in existence. In other

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[11] There were also inventory, transfer and correcting adjustments which decrease the book cost by $236,037, and they are discussed hereinafter.

words, there were unrecorded retirements. Offsetting the unrecorded retirements were certain items of existing property for which the Company found no costs in its plant accounts. More than likely, certain of the latter merely represented the failure to identify items which were determined to be unrecorded retirements. The net effect is a substantial adjustment ($1,821,581 for constructed property, and $232,930 and $3,107 for acquired property) for unrecorded retirements and miscellaneous corrections. The adjustment is not controverted and should be made.

Impropriety of Including in Rate Base Items Previously Charged to Expense

It has been shown that the Company's claim of additional plant cost over and above what is recorded on its books as plant investment represents largely expenditures previously charged to expense in accordance with the discretion of management. The Company, in other words, now impeaches its books and its former financial statements to regulatory bodies, tax authorities, investors, and others. It impeaches the decisions of management made at the time the expenditures were incurred. It does this in spite of the fact that its past decisions conformed to its own consistent practices, until required to change them by a regulatory agency, and to the general practice of the natural gas industry, as well as the extractive industry. The adjustments proposed, therefore, do not reflect the correction of errors in the past. Errors as to these items were not made.

The past determinations of the items constituting plant investment were deliberate, conscious acts on the part of management at the time of the transactions. A decision obviously must be made when an expenditure occurs as to whether it represents an investment in plant or an expense. There must also be some finality to these

decisions.[12] If they are treated as expenses at one time and as plant investment subsequently, chaos in rate-making and in corporate finance will prevail. It is no answer that many of the expenditures in question were incurred prior to the effective date of a prescribed uniform system of accounts. The Company kept plant and expense accounts throughout its history and conformed to the general business practices of the industry and like business institutions. It was evidently thoroughly convinced as to the propriety of its decisions, as witness its claim before the West Virginia Commission in 1921, that the very expenditures in question were operating expenses. The Company is now estopped from re-accounting for those expenditures.

With the decline in favor of the doctrine of "fair value" as the only mode of public utility rate regulation, its keystone, reproduction cost, crumbles. Bona fide investment figures now become all important in the regulation of rates. Immediately, however, we find an effort to tamper with these. There is in progress an attempt to make the reproduction cost *process* survive in the determination of actual cost of or investment in plant. Thus, in this case an inventory was taken and then units were priced at the estimated "actual cost." The method should be condemned at the threshold. For in addition to being permeated with conjectural estimates, it gives no heed to the realities of past events. Consistent treatment of expenses and plant investment costs is indispensable to the successful operation of the regulatory system.

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[12] Costs of exploration for and development of future gas reserves are considered current operating costs by the industry and Hope has included such costs in its current operating expenses. If retroactive accounting were allowed then the Company might restate these costs as capital investment in the future productive acreage. The Commission will allow $600,000 in annual operating expenses for exploration and development costs in fixing rates. If this item were permitted to be restated in plant cost ten years from now $6,000,000 would be added to the rate base resulting in multiple charges to consumers.

This is not to say that genuine errors in the investment accounts should not be corrected and the true figures given recognition in the rate base. Where real errors are made, they probably should be corrected. A distinction must be made, however, between genuine errors and a change in point of view, whereby past, deliberate decisions within the scope of an accepted principle are sought to be impeached to the pecuniary benefit of the Company.

The courts and commissions which have considered this matter have generally refused to include in the rate base amounts previously charged to expense in accordance with discretion of management. In the instant case, large parts of the claimed additions to book costs relate to well drilling expenditures and alleged overheads. The very question at issue has been passed upon twice by the Supreme Court of Appeals of West Virginia. In the first case in 1924, the Natural Gas Company of West Virginia sought to include such expenditures in the rate base after they had been charged to expense. The Public Service Commission of West Virginia refused to allow them. The Supreme Court of Appeals sustained the Commission.[13] The question was raised again in 1934 by the Natural Gas Company of West Virginia. The Public Service Commission of West Virginia then concluded that the inclusion of such expenditures in the rate base was required as a matter of law. The City of Wheeling, West Virginia, appealed the Commission's decision. The Court reversed the Commission and again held that items previously charged to operating expenses should not be included in the rate base.[14]

Thus, by far the weight of authority in court and commission decisions sustains the principle, sound in equity

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[13] *Natural Gas Company v. Public Service Commission,* 95 W. Va., 557, 121 S. E. 716, 720, P. U. R. 1924 D 346, 361.

[14] *Wheeling v. Natural Gas Company,* 115 W. Va. 149, 175 S. E. 339, 343-4, 5 P. U. R. (N. S.) 471, 479, app. dis. 296 U. S. 659.

and justice, that items previously charged to operating expenses under the allowable discretion of management should not later be included in the base on which customers are required to pay a return and depletion and depreciation allowances.[15]

The Hope Company's earnings over the years have been ample to provide for all operating expenses, including the $17,800,000 which it attempts to add to actual cost, an excessive reserve for depletion and depreciation, taxes, and large returns to investors. During the period 1898 to 1923 for which the Company seeks to re-account and expand its recorded plant costs by approximately $12,600,000 for well drilling costs alone, the average rate of earnings on the annual average invested capital (capital stock and surplus) was more than 15%.

Actual Legitimate Cost Or Gross Plant Investment

Accordingly, we begin with the book cost in the determination of the actual legitimate cost or investment in the facilities used in the Company's interstate business. We have already found that such book cost at the end of 1938 amounted to $52,730,666. There must be deducted from the book cost the unrecorded retirements, or inventory adjustments in the amount of $2,057,618. There is added to the book cost the amount of $15,152 ($8,764 for constructed property and $6,388 for acquired property) representing

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[15] *Re Los Angeles Gas & Electric Corp.*, P. U. R. 1931 A, 132, 143-4, aff. 58 Fed. (2d) 256, 261, 267, 289 U. S. 287; *Re Peoples Gas Light & Coke Co.*, 19 P. U. R. (N. S.) 177, 196-8, aff. 373 Ill. 31, 25 N. E. (2d) 482, 493, 31 P. U. R. (N. S.) 193, 207, app. dis. 309 U. S. 634; *Re West Virginia Central Gas Co.*, P. U. R. 1918 C, 453, 464-6; *Re Mondovi Telephone Co.*, P. U. R. 1933 B, 319, 321-3; See *Re Northwestern Electric Co.*, 36 P. U. R. (N. S.) 202, 208-213, aff. 125 Fed. (2d) 882; *Re Canadian River Gas Co., et al.*, F. P. C. Op. 73; cf. *Chicago & N. W. R. Co. v. Com'r. Int. Rev.*, 114 Fed. (2d) 882, 886, cert. den. 312 U. S. 692.

adjustments due to errors in stating the cost of leases, and an amount of $1,295,953, representing plant costs properly capitalized and then arbitrarily charged off to operating expenses.

There is considerable question as to whether the latter amount should be restored to book cost in determining the rate base. The amount arises as follows. From 1918 to 1923 Hope followed the peculiar practice of capitalizing the cost of direct labor incurred in laying pipe lines, constructing compressor stations and in installing equipment, but at the end of each year, arbitrarily charged off the amount thus capitalized during the year. This practice was peculiar to the Hope Company and was not a general practice of the industry. It did not conform to sound accounting principles. Hope followed the correct practice during all of its existence except for the few years mentioned. Under the circumstances, the amount is restored to the investment figure and is allowed in the rate base. The allowance in this instance, however, is not to be construed as a precedent.

As of December 31, 1938, the cost of unoperated acreage ($584,382) and the cost of certain wells and field lines ($192,150) then not in service were contained in the accounts. These items are eliminated from gas plant in service as of December 31, 1938, and appropriate adjustments for the use of such property and facilities are made subsequently.

After considering the evidence based upon the vouchers, books and records of the Company, and as a result of the application of fundamental principles of accounting, cost determination and equity, the Commission finds, in the words of Section 6(a) of the Act, the actual legitimate cost as of December 31, 1938 in plant used in the interstate business was $51,207,621, composed as follows:

Book Cost 12/31/38	$52,730,666
Less Inventory adjustments (unrecorded retirements)	2,057,618
Less Wells and Field Lines Not in Service	192,150
Less Unoperated Acreage	584,382
Sub-total	49,896,516
Plus Correction to Cost of Leases	15,152
Plus Capitalized Costs Charged Off in Error	1,295,953
Actual Legitimate Cost of Plant in Interstate Service	$51,207,621

There were more retirements than additions in 1939, so the actual legitimate cost was $51,099,024 at the end of 1939. The record shows net additions of $965,533 in 1940 to produce a total actual legitimate cost of $52,064,557. Certain inactive wells with the connected field lines became active in 1940 and the cost of this property is $110,316. We find that the actual legitimate cost, including such currently used property, aggregates $52,174,873 as of December 31, 1940.

This actual legitimate cost is predicated upon facts and it is the best evidence in these proceedings, so we will employ it for determining the proper and allowable rate base.

Depletion and Depreciation

In determining the allowable rate base in these proceedings the actual existing depletion and depreciation should be deducted from the actual legitimate cost of the property devoted to the interstate service. See *Los Angeles Gas & Electric Corp. v. R. R. Comm.*, 289 U. S. 287, 312. Actual existing depletion and depreciation is the extent to which the service life, that is the economic life, of the property has been consumed due to such forces as exhaustion of the natural gas supply, wear, inadequacy, and

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obsolescence.[16] Annual depletion and depreciation measure the economic service life consumed in one year, actual existing depletion and depreciation are the accrued consumption of the utility's economic service life on a certain date; the annual allowance for depletion and depreciation must, therefore, be correlated with the actual existing amount to avoid injustice to the utility or rate payer. *Re Canadian River Gas Co., et al.*, F. P. C. Op. 73; *Re Chicago District Electric Generating Corp.*, 39 P. U. R. (N. S.) 263, 275; *Re Interstate Power Co.*, 32 P. U. R. (N. S.) 1, 10.

The Company presented inconsistent claims in this respect. It alleged a relatively small amount of accrued or existing depletion and depreciation to be deducted in fixing the rate base, but claimed large annual amounts for future operating expenses.

The Company contends that the accrued depletion and depreciation in its property equaled approximately 35% of the reproduction cost at the end of 1938. We have weighed the estimate of reproduction cost and found it wanting. In addition, it is inequitable to predicate depletion and depreciation upon the delusive reproduction cost. The integrity of the investment will be maintained by basing depletion and depreciation upon actual legitimate cost and the Supreme Court has approved that method.[17]

The Company determined accrued depreciation primarily by the observation process and obtained what is called a "per cent condition" of the property. For annual expense purposes, it weighted the observed depreciation with retirement of property up to the date of the study. The fallacy of the "per cent condition" theory of accrued

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[16] *Lindheimer v. Illinois Bell Tel. Co.*, 292 U. S. 151, 167; *Re Canadian River Gas Co., et al.*, F. P. C. Op. 73; cf. *Depreciation Charges of Telephone and Steam Railroad Companies*, 177 I. C. C. 351, 408, 422.

[17] *Lindheimer v. Illinois Bell Tel. Co.*, 292 U. S. 151, 167-9, 176; *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. .....

depreciation is plain here. To illustrate, under the hypothesis of the Company's witness, in determining the "per cent condition" of certain compressor station equipment, the property would be found to have depreciated only 25% throughout its life or be in 75 "per cent condition," and then suffer a precipitous loss in the brief final stage of service. Such a theory is opposed by reason and facts. *Los Angeles v. Southern California Telephone Co.*, 14 P. U. R. (N. S.) 252, 273-4. The Company's estimate of existing depreciation was based primarily upon a sporadic visual inspection of physical deterioration. Most of Hope's production and transmission property is not visible and the extent to which the service life has been consumed can not be determined from observation alone. Also, the functional causes of the retirement of property are given little consideration by the Company's visual method which samples physical causes. *Re Rochester Gas & Electric Corp.*, 33 P. U. R. (N. S.) 393, 468-490. The Commission concludes that the so-called accrued depletion and depreciation claimed by the Company does not give full or proper consideration to all factors contributing to the retirement of property, and that it does not reflect the actual existing depletion and depreciation or diminished service life of the property in service.

The Required Reserve For Depletion and Depreciation

The same factors that cause annual depletion and depreciation cause the actual existing depletion and depreciation to be deducted from the property in fixing the rate base. In our opinion, where reasonable and proper depletion and depreciation accounting practices have been observed by a natural gas company, the resulting reserve is the best measure of the depletion and depreciation existing in the property, i.e., the accumulated cost of property which has been consumed in service.

It is well known that many electric and gas utilities have not observed sound depreciation and depletion practices. The Hope Company is in this category. For many years most of Hope's business was not under regulation. Its practices as to depreciation and depletion, like the practices of many other utilities, were inconsistent and haphazard. Its book reserve does not measure the actual existing depreciation and depletion.

This Company has actually accumulated an excessive reserve. We are confronted, therefore, with the question as to whether that excessive reserve, or the reserve requirement (actual existing depreciation and depletion), should be deducted in determining the rate base.[18] We have formerly indicated that public utilities ought to set up proper depreciation (and depletion) expense and that the resulting reserve should be deducted from the gross cost in the rate base determination.[19] We reiterate that view.

We believe, however, that under such circumstances as exist in this case, where a large part of the Company's business is brought under regulation for the first time and where incorrect depreciation and depletion practices have prevailed, the best procedure is to deduct the reserve requirement in computing the rate base. This procedure will permit us to be consistent in those cases where utilities have deliberately failed to observe sound practices and as a result have deficient reserves. Thus, in the *Interstate Power Company* case, where the company had been negligent in accounting for depreciation and had a deficient reserve,

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[18] There are those who argue that excessive reserves should be deducted. *Pennsylvania Public Utility Comm. v. The Peoples Natural Gas Co.*, Nos. 11380, 12683 (1942) Buchanan, dissenting; See *Chesapeake & Potomac Tel. Co. v. Whitman*, 3 Fed. (2d) 938, 951-953; *New York Telephone Co. v. Prendergast*, 36 Fed. (2d) 54, 66.

[19] *Re Interstate Power Co.*, 32 P. U. R. (N. S.) 1, 10; *Re Chicago District Electric Generating Corp.*, 39 P. U. R. (N. S.) 263, 275.

we deducted the higher reserve requirement, as the measure of actual existing depreciation.

It should be borne in mind, however, that the deduction of the reserve requirement, rather than the actual book reserve, is for the purpose of getting a sound basis for future regulation and control of rates. Hereafter, the Company, in accordance with this Opinion and under our System of Accounts, is required to record proper depreciation and depletion expense. Hence, the books of this Company, as well as the books of others subject to our jurisdiction, after once having the reserve requirement determined, should reflect in substantial degree the proper depreciation and depletion. Use of the reserve requirement in this case will produce a proper starting figure so that the book reserve can be deducted hereafter as the proper measure of the actual depreciation and depletion. This treatment will then be consistent with the view that the book reserve is the proper deduction from the gross cost in determining the rate base.

It becomes necessary, therefore, to ascertain the best measure of the reserve requirement. The purpose of depletion and depreciation accounting is to offset diminution in service value[20] of property being used in service, and to determine as accurately as possible another element of the cost of service for a particular period. All of Hope's physical property, except certain land, will be depleted or depreciated completely when it reaches the end of its useful or economic life. Physical and functional forces, whether their effects are visible or not, are constantly reducing the service life of the Company's property. Service life is the equivalent of economic life or the utility of the property. Hope incurs plant costs to provide for future

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[20] "Service value" is the difference between original cost and the net salvage value of gas plant. Depletion and depreciation signify the consumption of service life of property and when that is translated into dollars it shows the loss in service value.

service and to make production possible. As natural gas service is rendered, the economic value of property is gradually consumed, and the property is finally retired at the end of its service life. The cost of the property consumed annually in rendering that service should be charged to operating expenses to reflect the depletion and depreciation incurred.

The Commission's Staff presented a depletion and depreciation reserve requirement study in these proceedings. Estimates were made of the over-all service lives of the properties by classes; those average service lives were converted into depreciation rates, and then applied to the cost of properties to determine the portion of the cost which had expired, that is, which related to the consumed service lives. The study covers the operations of the Company from its beginning in 1898 to December 31, 1940. It shows annual amounts for each group of property from the date installed to the date of retirement, and it concurrently provides the necessary reserves for property retired and for the ultimate retirement of existing property. The fundamental principle that annual expense for depletion and depreciation must be harmonized with accrued depletion and depreciation has been applied here. The straight-line service life method was used to compute the reserve requirement for all of the material, equipment and structures of the Company, and the unit-of-production method was applied to plant costs which are associated with the gas supply, i.e., gas producing lands and leases, field line and gas well construction, rights-of-way, and costs of abandoning gas wells.[21] The service life study was made by a properly qualified Staff engineer who analyzed Hope's past experience, including the retirement of property over the years. He gave consideration to relevant service life data on other pipe lines. He also considered the functional and physical aspects of depreciation. As an aid in the deter-

[21] As defined in the Uniform System of Accounts.

mination of service lives he made a field inspection of the Company's physical properties. The unit-of-production method used by the Staff was related to the gas reserves of the active wells of the Company. This case is free from the usual complexities involved in the estimate of gas reserves because the geologists for the Company and the Commission presented estimates of the remaining recoverable gas reserves which were about one per cent apart. The permeability and porosity characteristics of the region cause isolated pools of natural gas, and the Company's gas production properties are intermingled with non-productive areas and other companies' properties. This situation necessitated the segregation of Hope's property into gas producing areas for the depletion and depreciation reserve requirement study. Gas rights, well construction and connected field line construction costs are consumed in service proportionately with the depletion of the associated gas supply. Well equipment and field pipe line material are recovered and used again when the various sources of gas supply are exhausted. These facts of operation have been recognized in the ascertainment of the required reserve for depletion and depreciation.

The Staff recommended the depletion and depreciation reserve requirement for Hope's production, transmission and general plant in the amount of $23,520,561 as of December 31, 1940.[22] After a careful analysis of the evidence we have accepted certain adjustments advocated by the Company and find that the depreciation and depletion reserve should be not less than $22,328,016 as of December 31, 1940. These adjustments are as follows: (1) Due to

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[22] That recommended required reserve is after a deduction of $1,162,710 for cost of abandoning property. The depreciation rates used in the reserve requirement study make proper provisions for the inevitable cost of abandoning property. But during the period 1898-1931 Hope charged the cost of abandoning property to maintenance expense, rather than to the depreciation reserve as a part of the net salvage.

the plant inventory adjustment made by the Company, as of December 31, 1938, and accepted by all parties, a net reduction in the plant accounts was made which represents property retired prior to December 31, 1938, but not so recorded on the books. The Company contends that 10 years is a fair approximation of the average period by which these retirements have been accumulating, hence the depreciation provisions should be reduced for the 10-year period. Had the retirements been made on the books as soon as the property was retired the depreciation base would be reduced and the annual provisions would be less. It is impossible to determine the actual dates the property was retired and we accept the 10-year period as a reasonable estimate of the average time from the date the property was retired to December 31, 1938. This adjustment results in a reduction of $31,106 in annual depreciation expense for each year and a reduction of $311,060 in the reserve requirement as of December 31, 1938. (2) In the case of lines lifted, Hope has usually retired labor cost and charged it to the depreciation reserve. But in the case of pipe retired in connection with a replacement the original labor was not always retired and the renewal labor was charged to operating expense. The depreciation rates applied by the Staff include provisions for the retirement of all labor and materials, hence its reserve requirement computation includes accruals for construction labor cost on the main pipe lines which has been retired and not charged to the depreciation reserve. The Company has estimated an amount of $272,693 representing the additional retirements of labor cost which we will allow as a reduction in the reserve requirement. (3) The group depreciation rate of 2.5% employed by the Staff in its study should be reduced to 2.22% for gas well equipment. As revised the rate for gas well material is the same as for field line

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[23] Total provisions from 1898 to 1938, inclusive, amount to $5,060,456 at a 2.5% depreciation rate and $4,493,685 at a 2.22% depreciation rate for gas well equipment.

material, although the evidence indicates that a somewhat shorter average life has been experienced for gas well material than for field line material. At the rate of 2.22% the annual depreciation expense will be reduced $21,110 for 1939 and $20,911 for 1940. Consistent with the reduction in the annual depreciation expense the reserve requirement at the end of 1938, 1939 and 1940 will be reduced $566,771, $587,881, and $608,792, respectively.

The first two of the above-mentioned adjustments are the result of certain accounting practices of Hope prior to December 31, 1938 and do not affect depreciation expense for the years subsequent to that date. The reserve requirement which the Commission finds to be reasonable and proper is summarized as follows:

Depletion and Depreciation Reserve Requirement

	Dec. 31, 1938	Dec. 31, 1939	Dec. 31, 1940
Amount Computed by Staff	$23,501,356	$24,072,167	$24,683,271
Less Staff Adjustment for Cost of Abandoning Property	1,162,710	1,162,710	1,162,710
Amount Recommended by Staff	22,338,646	22,909,457	23,520,561
Less: Unrecorded Retirements	311,060	311,060	311,060
Unretired Labor on Transmission Line Replacements	272,693	272,693	272,693
Change in Depreciation Rate for Gas Well Equipment	566,771	587,881	608,792
Total Adjustments	1,150,524	1,171,634	1,192,545
Required Depreciation and Depletion Reserve	$21,188,122	$21,737,823	$22,328,016

The required depletion and depreciation reserve, as we have determined it upon the record, is the best evidence of the measure of actual existing depletion and depreciation, and it will be deducted from the actual legitimate cost of the Company's property for rate-making.[24] The reserve re-

[24] See *Re Long Island Lighting Co.*, 18 P. U. R. (N. S.) 65, 146-151, 189-191; aff. 249 App. Div. 918, 292 N. Y. S. 807, 809, 18 P. U. R. (N. S.) 225, 226; *Re Rochester Gas & Electric Corp.*, 33 P. U. R. (N. S.) 393, 489, 502-3; National Association of Railroad and Utilities Commissioners, Proceedings of Fiftieth Annual Convention (1938) pp. 473-4.

quirement on any selected date is the total of the annual provisions for depletion and depreciation less the actual retirements of property. The method used here determines the amount required annually to reimburse the Company for property consumed in service, and it results in a correlation of the annual expense and the accumulated reserve. The method is just and consistent for each operating period because the costs utilized are matched with the revenues produced by the property in service.

As we have noted, the Company has built up an excessive reserve by charging large annual allowances for depletion and depreciation to operating expenses in the past.

The book reserve for interstate plant at the end of 1938 amounted to about $39,000,000 which is $18,000,000 in excess of the amount we determined as the reserve requirement. In addition, twice in the past the Company has transferred amounts aggregating $7,500,000 from the depreciation and depletion reserve to surplus. When these latter adjustments are taken into account, the excess becomes $25,500,000, which has been exacted from the rate payers over and above the amount required to cover the consumption of property in the service rendered and thus to keep the investment unimpaired. *Lindheimer v. Illinois Bell Tel. Co.*, 292 U. S. 151, 169, 174.

Estimated Additional Fixed Capital Expenditures.

To make the rate base figures current, the Company presented an estimate of $8,956,500 in "capital expenditures" which it planned for production, transmission and general plaut during 1941, 1942 and 1943. Obviously these proposed gross additions should increase the allowable rate base only to the extent that net actual legitimate cost will be increased. Also, $1,270,000 was estimated for 1943 additions to meet the demands of new or increased business. The Commission has not given direct effect to those ex-

pected 1943 additional revenues in the forecast of revenues for rate-making, so that $1,270,000 will not be included in the rate base. The determination of the estimated increase in net plant cost requires the consideration of additions and retirements of plant and the effect on the depletion and depreciation reserve of future accruals and retirements. Giving due weight to all these factors the increased net actual legitimate cost, averaged for the period 1941-1943, is $1,392,021.[25]

The Company presented a general plan which it has for the construction of a pipe line from West Virginia to Louisiana to supplement its present source of supply of gas and to meet predictable increased demands for natural gas. Due mainly to the shortage of materials caused by this war, the status of that proposed line is so uncertain that it need not be considered in these proceedings. When the proposed line is constructed and definite information is presented concerning its effect on the rate base and net income, the Commission will give the matter timely and appropriate consideration.

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Estimated Fixed Capital Expenditures 1941-1943		$8,956,500
Less: Expenditures in Expectation of New or Increased Business	$1,270,000	
Gross Property Retirements	2,700,000	3,970,000
Estimated Net Change in Plant		4,986,500
Deduct: Estimated Net Change in Depletion and Depreciation Reserve—Depletion and Depreciation Accruals 1941, 1942, 1943	4,362,500	
Less: Retirement Losses Chargeable against Reserve	2,160,042	2,202,458
Estimated Increase in Net Actual Legitimate Cost		$2,784,042
Average for the period ($2,784,042 ÷ 2)		$1,392,021

Other Used and Useful Property

The Company's geologist grouped the unoperated acreage[26] into three classes: (1) protective acreage within a mile of producing wells comprised 64%; (2) prospective acreage for shallow-sand production within three miles of producing wells comprised 14%; and (3) prospective acreage for deep-sand production within three miles of producing wells comprised the remaining 22%. The total unoperated acreage as of December 31, 1940, was 539,285 acres. The Company has undertaken an extensive drilling program, including deep-test wells, and it is a reasonable expectation that within a few years nearly all of this unoperated acreage will become productive, or will be proved unproductive and cancelled. There is no evidence that Hope has acquired large blocks of unoperated acreage to obtain a monopoly on the source of supply, and there is evidence that all of its unoperated acreage is necessary and useful, or imminently useful, in rendering gas service. The cost of unoperated acreage will be included in the rate base. The Commission finds that the actual legitimate cost of unoperated acreage was $584,382 as of December 31, 1938, $567,152 for the end of 1939, and $566,105 as of December 31, 1940.

Materials and Supplies Plus Cash Working Capital

There is no controversy over the amount of materials and supplies required by the Company. The monthly average of materials and supplies on hand is the most accurate measure of the Company's requirements. The Commission finds that $1,228,599 is the necessary average amount for materials and supplies in 1939, 1940 and the future. This is sufficient, on the average, to meet requirements for more than a year.

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[26] Operated gas acreage is any acreage that is being drained by producing gas wells and all other acreage is considered as unoperated. Hope has held less than two unoperated acres to one operated acre during the last ten years.

A witness for the Company used a period of 45 days as the lag in the receipt of revenues. He stated that 45 days of operating expenses, including gas purchased, would measure the cash working capital required by the Company on a practical operating basis and he computed the amount to be $1,754,008.

A period of 45 days is ample to measure the amount of cash required for payment of operating expenses. Cost of gas purchased must be excluded from the computation because revenues from gas sales are received before the payment for purchased gas is due. The Company has approximately $500,000 on hand at all times representing taxes which are not paid until many months after they are accrued and these tax funds are available for bank balances and working capital requirements. The Commission will allow cash working capital in the amount of $871,401 for 1939 and $896,401 for 1940. This is the maximum allowable amount computed on 45 days of operating expenses, excluding cost of gas purchased, and allowing prepaid expenses in full.

The Commission finds that $2,100,000 was required for materials and supplies and cash working capital in 1939, and that $2,125,000 was necessary for 1940 and will be adequate for the future.

Conclusions With Respect to the Rate Base

There is a further matter with respect to plant investment which the Commission will consider before making the final determination of the rate base. Prior to January 1, 1939, the Company charged all administrative and general costs to operating expense. Beginning January 1, 1939, the Company tentatively adopted the practice of capitalizing a portion of its administrative and general expenses. This discretion by the management is permissible under the Commission's Uniform System of Accounts. This tentative capitalization of administrative and general expenses was

reconsidered by the Company and it has informed the Commission that it wishes to resume the regular practice of including all general and administrative costs in operating expenses. This change in the tentative accounting policy is reflected in the verified annual report for 1941 filed with this Commission. The amounts of $79,439 for 1939 and $138,018 for 1940 are removed from plant costs and included in operating expense for the respective years. Theoretically, adjustments to annual depreciation expense and to the reserve requirement should be made on account of the foregoing, but the amounts are so insignificant in a case of this magnitude that no inequity will result from not making them.

The analysis of the evidence which we have discussed with respect to the components of the rate base and our conclusions may be summarized thus:

	Dec. 31, 1938	Dec. 31, 1939	Dec. 31, 1940	Future
Gross Investment in Gas Plant in Service (Exclusive of Distribution Plant, and Property Used to Transport Coke-oven Gas)	$51,207,621	$51,019,585	$51,957,416	$51,957,416
Less: Actual Existing Depletion and Depreciation	21,188,122	21,737,823	22,328,016	22,328,016
Net Investment	30,019,499	29,281,762	29,629,400	29,629,400
Add: Net Capital Additions 1941, 1942, 1943				1,392,021
Useful Unoperated Acreage	584,382	567,152	566,105	566,105
Working Capital	2,100,000	2,100,000	2,125,000	2,125,000
Interstate Rate Base	$32,703,881	$31,948,914	$32,320,505	$33,712,526

The Commission, therefore, adopts the foregoing amounts as the interstate rate base for the dates indicated, for the Company's property assembled as a whole and doing business as part of an integrated system. The Commission finds that the rate base for 1939 was the average of the rate base amounts at the beginning and the end of that year or $32,326,398, that the rate base for 1940 was the average of the rate base amounts at the beginning and the end of that year or $32,134,710, and that the rate base for fixing future rates is $33,712,526.

OPERATING REVENUES AND EXPENSES

For rate-making purposes the Commission has given consideration to the actual operating revenues and expenses of the Company for 1937-1940, inclusive, and has also considered the income statements since 1898. In testing the reasonableness of existing rates the latest experience of the Company, as disclosed by the record, is the closest reflection of the present and future operations.

Interstate Gas Service Revenues

There is no controversy over the volume of gas sold or the revenues received by Hope. The Commission finds that during the years 1939 and 1940 the interstate gas sales to the five customer companies were as follows:

	1939		1940	
	M.c.f. billed	Revenues	M.c.f. billed	Revenues
East Ohio Gas Company	33,907,672	$12,359,500	40,376,091	$14,726,736
Peoples Natural Gas Company	3,864,104	1,371,757	9,738,612	3,457,207
River Gas Company	237,640	83,174	388,750	136,063
Fayette County Gas Company	840,398	264,725	859,106	270,618
Manufacturers Light and Heat Company	2,500,755	787,738	2,241,684	706,131
	41,350,569	$14,866,894	53,604,243	$19,296,755

Interstate Operating Expenses

The Commission has considered the Company's operating expenses as recorded on its books, as claimed for rate-case purposes, and as recommended by the Staff. The subsequently discussed adjustments to the Company's operating expenses are made to the amounts as actually recorded on its books for the years 1939 and 1940.

Depletion and Depreciation Expenses

The annual allowance for depletion and depreciation included in operating expenses is determined by the same rates and methods used to determine the depletion and depreciation actually existing in plant.

The Commission finds that $392,500 for 1939 and $624,440 for 1940 is the proper allowance for depletion expense. The present and prospective demands upon the production system indicate that production for the year 1940 is the proper guide for future depletion expense and we will allow $624,440 as the average cost of depletion in our determination of the cost of service. (Depletion expense is computed on the unit-of-production, hence it varies with the actual production of gas.)

The record shows that Hope Company's annual depreciation expense has remained relatively stable, the proper amounts for 1939 and 1940 being as follows:[27]

	1939	1940
Production Plant	$351,811	$349,676
Transmission Plant	460,267	460,245
General Plant	25,725	25,676
Total Depreciation Expense	$837,803	$835,597

The Commission finds that the annual depletion and depreciation allowance required for future operating expenses is $1,460,037.

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[27] Determined by applying the following straight-line depreciation rates to the average depreciable investment for the year:

	Rate
Production Plant:	
Structures	4.17%
Field Line Material, Meas. & Reg. Station Equipment	2.22%
Gas Well Equipment	2.22%
Transmission Plant:	
Main Lines, Rights-of-Way and Meas. & Reg. Station Equipment	1.56%
Structures	2.50%
Compressor Station Equipment	2.56%
General Plant:	
Structures	2.17%
Office Furniture & Equip.	4.00%
Other Equipment	3.57%
Communication Equipment	3.85%

Exploration and Development Costs

Section 14(b) of the Natural Gas Act authorizes the Commission to determine the "propriety and reasonableness of the inclusion in operating expenses, capital, or surplus of all delay rentals or other forms of rental or compensation for unoperated lands and leases." Delay rentals paid periodically on natural gas lands to reserve the gas rights for a future supply of gas are included in exploration and development costs. The other costs included are those associated with the drilling of non-productive wells, the abandonment of non-productive leases and the abandonment of projects on which preliminary expenditures were made to determine the gas prospects of available acreage.

The Hope Company, like other companies in the natural gas industry, has followed the conservative practice of charging all exploration and development costs to operating expenses. Exploration and development costs are necessary to replenish the Company's gas supply in order to maintain continued gas service. The Commission has included Hope's gas producing acreage and its useful unoperated acreage at cost in the rate base. The annual depletion allowance is based upon the actual legitimate cost of gas producing leases so there is no margin in that annual allowance to cover exploration and development costs. In fairness to the investors and the rate payers the Commission will make an allowance for delay rentals related to the unoperated acreage and the other exploration and development costs in operating expenses. Hope incorrectly stated the cost of abandoned and surrendered leases in 1939 and 1940 and we find that the cost of leases abandoned should be included in exploration and development costs in the respective amounts of $45,164 for 1939 and $12,422 for 1940. The Company's exploration and development costs were $500,344 in 1939 and $407,920 in 1940. In view of the Company's extensive program for drilling

540917 O - 43 - 9

wells in the next few years and its recent experience with respect to exploration and development costs, the Commission finds that the proper and reasonable future annual allowance for such costs is $600,000 for rate-making purposes.

Reclassification and Rate Case Expenses

The Hope Company presented evidence to show that it has spent $675,000 in making reclassification studies in order to comply with the recent Systems of Accounts prescribed by the West Virginia Commission and the Federal Power Commission. The Company also showed expenditures totaling $825,000 as its expenses in this rate case. A contention is made by the Company that it should be allowed an interest rate of 8% on the "unamortized balance" of its reclassification and rate case expenses. In fact, however, the Company has charged all these costs to operating expenses as they were incurred during the years 1938-1941 and the rate payers have already paid enough to reimburse the Company. The Company's interstate wholesale rates have been excessive for several years and the unusually large amount of rate case expenses would ordinarily prompt the Commission to disallow any such expenses to be amortized in the future under the rates the Commission will prescribe because it results in a duplication of charges. But in view of the Supreme Court's statement that even where rates in effect are excessive the utility should be allowed its reasonable expenses for presenting its side to the Commission, the Commission concludes that the rate case expenses and the reclassification expenses, totaling $1,500,000 should be spread over a 10-year period beginning January 1, 1939, by the inclusion of $150,000 annually in operating expenses.[28] The Company has charged rate case and property reclassification

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[28] *Driscoll v. Edison Light & Power Co.*, 307 U. S. 104, 120-121.

expenses to operating expenses as incurred in the amounts of $543,121 for 1939 and $624,041 for 1940. Those amounts will be eliminated from operating expenses for rate-making, and the allowance of $150,000 annually for ten years will be made instead.

Affiliate's Excess Profits From Processing Hope Company's Gas

Hope Construction & Refining Company, an affiliate, extracts gasoline and other by-products from the natural gas of Hope Natural Gas Company. The extraction of gasoline and butane is profitable and is necessary to make the natural gas marketable and transportable. The process of extracting gasoline and butane reduces the heating value of the natural gas and consumes a certain volume of Hope's natural gas, thus imposing a burden upon the gas business.[29] Much of the gasoline extracted from Hope's natural gas has been sold to the Standard Oil Company at about one-half the price received from sales to others. It is significant that the Hope Natural Gas Company processed its own gas before 1920. The natural gas customers are entitled to be credited with a share of the profit from the processing of Hope's gas, even as they would pay the deficit if that essential processing were not profitable. It is agreed that it is proper to make a credit for a portion of the profits realized by Hope Construction & Refining Company from the processing of Hope's gas, but there is a dispute over the amount of the credit. The Commission concludes that the credit proposed by the Company, being a royalty of ¼ of the gross earnings from the gasoline and butane extracted, is not supported by sufficient evidence. The excess profits of the affiliated company above the cost of processing Hope's gas and a fair rate of return on its investment is the proper credit to Hope Natural Gas

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[29] *Re Hope Natural Gas Co.*, P. U. R. 1921E 418, 428-430.

Company. See *United Fuel Gas Co. v. Comm'n,* 278 U. S. 300, 319-321; *Dayton Power & Light Co. v. Comm'n,* 292 U. S. 290, 295. The cost of processing Hope's gas includes all of the affiliated company's related operating expenses, including depreciation expense, taxes, and a liberal 6½% rate of return on the net investment, plus working capital, devoted to the processing function. The affiliated company's extraction plants are usually located near Hope's compressor stations. The Commission finds that Hope should have received payments of $117,641 in 1939 and $119,592 in 1940 for the steam and boiler fuel which it furnished its affiliate at the extraction plants, and that the gas vapors which are returned to Hope after processing belong to Hope as part of its natural gas. From the record we find that Hope Construction & Refining Company had the following average net investment and required working capital devoted to processing Hope's natural gas:

	1939	1940
Gross Investment	$1,716,145	$1,696,510
Depreciation Reserve Requirement	1,208,739	1,260,312
Net Investment	507,406	436,198
Working Capital	80,000	80,000
Average Net Investment	$ 587,406	$ 516,198

The Commission finds that Hope's affiliate has earnings from the processing of gas in excess of a fair return and that these excess profits are applicable as reductions of Hope's operating expenses. For 1939 and 1940 these excess profits are determined as follows:

	1939	1940
Gasoline and Butane Revenues	$791,451	$770,028
Related Operating Expenses	518,394	551,370
Net Processing Income	273,057	218,658
Return at 6½% on Net Investment Plus Working Capital	38,181	33,553
Excess Profits	$234,876	$185,105

In prescribing future rates the affiliate's excess profits for 1940 will be employed as a conservative measure of Hope's portion of the profits from the gasoline and butane extracted from its gas.

Other Adjustments to Operating Expenses

Hope furnishes management services to several affiliated companies at cost, and credits the proceeds to miscellaneous gas revenues thereby permitting the cost of those services to others to remain in its operating expenses. The Commission, therefore, finds that operating expenses should be reduced $192,415 for 1939 and $109,194 for 1940 for the cost of services billed to others in order to reflect actual net operating expenses.

Hope furnishes natural gas to Hope Construction & Refining Company for use in repressuring oil wells. The gas is returned to Hope's system at reduced pressures. An amount of 2½¢ per m.c.f. is regarded as the cost of recompressing the natural gas returned to the Hope Company. Hope records these transactions as sales and purchases of natural gas and that practice overstates both revenues and expenses. The Commission finds that operating expenses and revenues should be reduced $72,388 for 1939 and $73,644 for 1940 to eliminate duplication of cost in production and transmission expenses.

The Company has eliminated the property and expenses relating to the transportation of coke-oven gas used as fuel at its Hastings Compressor Station and in its figures has substituted the cost of an equivalent amount of natural gas priced at 22¢ per m.c.f. The Commission agrees with the Company and finds that $295,158 for 1939 and $333,036 for 1940 should be eliminated from operating expenses, and that $107,758 for 1939 and $126,000 for 1940 should be included in operating expenses to reflect the equivalent cost of natural gas for the quantity of coke-oven gas used as fuel in the Hastings Station.

Hope furnishes steam from its compressor stations without charge to Hope Construction & Refining Company

for use in the extraction plants, with the exception of the steam furnished from Goff Compressor Station, and does not record this transaction on its books. The necessary adjustment for this free steam has been made by the Commission. The Company credits revenue instead of expenses with the value of steam furnished by its Goff Station, thereby overstating both gas service revenues and the cost of compressing natural gas. The Commission, therefore, finds that operating expenses should be reduced $4,404 for 1939 and $6,000 for 1940 to state the actual cost of operation.

Hope bills the Peoples Natural Gas Company at the rate of 38.5¢ per m.c.f. for the natural gas sold and includes the gross amount of the billings in revenues. The Peoples Company must compress that gas to transport it to market, so Hope refunds 3¢ per m.c.f. to Peoples under the provision of the sales contract and includes this amount in its operating expenses as a cost of compressing gas. This accounting practice followed by Hope overstates the actual revenues and overstates the actual operating expenses. The Commission finds that the cost of compressing gas has been stated incorrectly and that operating expenses should be reduced $115,923 for 1939 and $292,158 for 1940.

Certain donations were included by the Company in Administrative and General Expenses. The Commission finds that donations amounting to $5,183 for 1939 and $3,496 for 1940 are not allowable costs for purposes of rate-making and should be deducted from operating expenses.

The Company has included $10,926 for the settlement of a claim for damages and $16,318 to meet a deficiency in its insurance plan for employees in general expenses for the year 1939. These expenses are applicable to prior years' operations and therefore not allowable for 1939.

Hope recorded the salvage received from an experimental liquefying gas plant as revenues in the amount of $23,896. That amount should have been applied as a

reduction of the cost of the experiment, which cost was charged to 1940 operating expenses. Therefore, the Commission finds that 1940 operating expenses should be reduced $23,896.

State and Miscellaneous Federal Taxes

The Company has included in taxes for the years 1939 and 1940 certain amounts which should not have been included, and has failed to include certain other amounts which should have been included. The following table shows the amounts:

Taxes Not Applicable	**1939**	**1940**
Taxes applicable to prior years	$23,349	$17,099
W. Va. taxes billed others	10,768	41,334
Taxes not applicable to gas operations	2,741	3,218
	36,858	61,651
Taxes Applicable		
Underaccrual of taxes	16,548	313
Net Tax Adjustment	$20,310	$61,338

The Company has over-accrued Federal Income taxes on its books and the Commission has made a deduction of $33,479 for 1939 and $16,480 for 1940 to reflect the taxes actually paid which were $191,521 for 1939 and tentatively reported to be $912,313 for 1940.

Specific Distribution Expenses

The Commission finds that certain amounts included in depreciation, administrative and general expenses, and taxes are specific distribution costs, as follows:

	1939	**1940**
Depreciation	$ 82,000	$ 89,345
Taxes	126,981	141,640
Administrative and General	17,237	13,231
Total	$226,218	$244,216

Operating Expenses Summary

The total of the Commission's adjustments to operating expenses per books results in a reduction of $1,186,002 for the year 1939 and a reduction of $1,199,958 for the year 1940, and they are summarized as follows:

	1939	1940
Decreases in Operating Expenses:		
Excess Profits on Gasoline and Butane	$ 234,876	$ 185,103
Steam Furnished H. C. & R. Co.	117,640	119,592
" " " —Goff Station	4,404	6,000
Refund to the Peoples Nat. Gas Co. for compressing gas	115,923	292,158
Gas used in repressuring oil wells	72,388	73,644
Management Fees and Expenses	192,415	109,194
Excess Cost of Coke-oven gas	187,400	207,036
Donations	5,183	3,496
Salvage from Liquefying Gas Experiment	—	23,896
Taxes	20,310	61,338
Income Tax	33,479	16,480
Reclassification and Rate Case Expenses	543,121	624,041
Expenses applicable to Reserve Gas Co.	125	—
Expenses applicable to prior years	27,244	—
Total Decreases	1,554,508	1,721,978

	1939	1940
Increases in Operating Expenses:		
Abandoned Leases	$ 45,164	$ 12,422
Adm. & General Expenses Capitalized in error	79,439	138,018
Depletion and Depreciation	93,903	221,580
Reclassification and Rate Case Expenses	150,000	150,000
Total Increases	368,506	522,020
Total Adjustments	$1,186,002	$1,199,958

The functional classification of operating expenses per books and after the application of the foregoing adjustments follows:

Operating Expenses	1939		1940	
	Per Books	Allowed	Per Books	Allowed
Interstate Operating Expenses:				
Natural Gas Production	$ 1,439,971	$ 1,186,578	$ 1,427,594	$ 1,227,930
Gas Purchased	7,746,854	7,675,105	8,605,981	8,533,779
Transmission Expenses	1,906,993	1,481,833	2,437,381	1,818,335
Administrative and General Expense	1,593,814	1,069,090	1,653,623	1,187,336
Depletion	18,400	392,500	18,384	624,440
Depreciation	1,200,000	837,803	1,309,418	835,597
Amortization (other)	6,369	6,369	5,996	5,996
Exploration and Development Costs	455,179	500,334	395,498	407,920
Taxes: State and Miscl. Federal	1,211,732	1,053,117	1,348,005	1,133,862
Federal Income Tax (before tax saving)	225,000	191,521	928,793	912,313
Total Interstate	15,804,312	14,394,259	18,130,673	16,687,508
Specific Distribution Expenses:				
Distribution	201,929	201,775	215,128	215,128
Customers' Acctg., Coll. and Sales Exp.	166,180	164,167	161,917	160,908
Administrative and General		17,237		13,231
Depreciation		82,000		89,345
Taxes		126,981		141,640
Total Distribution	368,109	592,160	377,045	620,252
Total Operating Expenses	$16,172,421	$14,986,419	$18,507,718	$17,307,760

Future Operating Expenses

The operating expenses as determined for the purpose of estimating the future cost of interstate service are based primarily on the actual operating cost for the year 1940, the latest available data in the record. That year reflects an increase of $2,300,000 over the operating expenses of 1939 and is the best guide to present and future costs.

The Commission finds that the following adjustments to 1940 costs are reasonable and proper for the purpose of estimating future operating expenses for rate fixing:

Increase in wages not reflected in 1940 operating costs		$202,172
Increase in West Virginia property taxes not reflected in 1940 operating costs		81,751
Decrease due to the following non-recurring costs which were included in administrative and general expenses for 1940:		
Cost of moving Company office from Pittsburgh, Pa. to Clarksburg, W. Va.	$41,750	
Experimental liquefying gas plant	8,492	
Pennsylvania State income tax	4,601	
Decrease		54,843
Increase in Exploration and Development costs to allow an average amount of $600,000 annually in the future costs		192,080
Total net increase over 1940 operating expenses		$421,160

Federal Income Tax

In accord with practice, Hope's income tax return for 1940 was prepared on a tentative basis. The evidence in the record shows that the net taxable income was approximately $3,801,304 for 1940 and was $1,160,733 for 1939, that the tax rate was 24% for 1940 and 16.5% for 1939, and that the income tax was approximately $912,313 for 1940 and was $191,524 for 1939.

The Company does not report operating revenue deductions for tax purposes the same as it records them on its books.[30] Adjustments for rate-making and accounting purposes do not affect operating expenses for tax purposes, because that amount is determined by the administration of the federal Revenue Acts. The complete effect of all Commission adjustments is shown by any increase or decrease in revenues which results from a rate order. In order to determine a reasonable allowance for income taxes it is

[30] The net income per books in 1940 was $5,234,175 after book income taxes of $928,793 or $6,162,968 before income taxes. The net taxable income for that year was $3,801,304 showing that Hope claimed $2,361,664 for tax deductions not reflected in operating expenses on its books.

necessary only to apply the proper tax rate to the net taxable income applicable to the test year and to give effect to any tax saving or increase by reason of a change in revenue due to a rate order.

A combined normal and surtax rate of 40% is being discussed in Congress. We will use that rate for the purpose of computing the future income tax allowance. Based on 1940 net taxable income of $3,801,304 the income tax would be $1,520,522 at a 40% tax rate.

Each dollar of the indicated reduction in gross revenues will result in a reduction of forty cents in income taxes. The following computation shows the indicated reduction in rates and the amount of income taxes by applying the rate of return found to be fair and which is discussed in the subsequent section:

	Before Income Tax Saving	After Income Tax Saving
Operating Revenues from Interstate Sales	$19,296,755	$15,686,898
Deductions:		
Interstate Operating Expenses (Excluding income taxes)	16,196,355	16,196,355
Other Gas Revenues	(83,275)	(83,275)
Allocation of costs to local West Va. Sales[31]	(2,694,075)	(2,694,075)
Federal Income Tax at 40%	1,520,522	76,579
Net Operating Revenue from Interstate Sales	$ 4,357,228	$ 2,191,314
Return at 6½% on Interstate Rate Base of $33,712,526	2,191,314	
Excess Earnings before Income Tax Saving	2,165,914	
Income Tax Saving	1,443,943	
Excess Earnings after Income Tax Saving	$ 3,609,857	

[31] Computed as follows:

West Virginia Operating Revenues		$3,435,675
Specific Distribution Expenses	$ 620,252	
Return at 6½% on Distribution Property	121,348	741,600
Allocation of costs to W. Va. Sales		$2,694,075

The Commission finds that the amount of $76,579 is an adequate allowance for Federal Income taxes for the future.[32]

The operating expenses allowed for the future are shown by the functional classification in the following tabulation:

	1940	Adjustments For Future Operating Changes	As Adjusted For Future
Interstate Operating Expenses:			
Natural Gas Production	$ 1,227,930	$ 202,172	$ 1,430,102
Gas Purchased	8,533,779		8,533,779
Transmission Expenses	1,818,335		1,818,335
Administrative and General Expense	1,187,336	(50,242)	1,137,094
Depletion	624,440		624,440
Depreciation	835,597		835,597
Amortization (other)	5,996		5,996
Exploration and Development Costs	407,920	192,080	600,000
Taxes—State and Miscl. Federal	1,133,862	77,150	1,211,012
Federal Income Tax	912,313	(835,734)	76,579
Total Interstate	16,687,508	(414,574)	16,272,934
Specific Distribution Expenses:			
Distribution	215,128		215,128
Customers' Acctg., Coll. & Sales Promotion	160,908		160,908
Adm. and Gen. Expense	13,231		13,231
Depreciation	89,345		89,345
Taxes	141,640		141,640
Total Distribution	620,252		620,252
Total Operating Expenses	$17,307,760	$(414,574)	$16,893,186

[32] Computed as follows:

Net Taxable income for 1940	$3,801,304
Reduction in revenues	3,609,857
Revised Net taxable income	191,447
Tax Rate	40%
Allowance for Income Tax	$ 76,579

RATE OF RETURN

Many factors enter into the determination of what constitutes a fair rate of return in each rate case. The Supreme Court has stated the principal factors in *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm.*, 262 U. S. 679, 692-3. They are that the return of a public utility shall be equal to that generally being made at the same time and in the same region on investments in other enterprises attended by corresponding risks and, that the return should be sufficient to assure confidence in the financial soundness of the utility and to maintain its credit and enable it to attract the capital necessary for the proper discharge of its public duties.

The record contains an abundance of evidence on the subject of rate of return. The information includes investors' appraisal of the natural gas industry, comparative risk data, interest rates and yields on securities of natural gas and electric utilities, statistics showing the growth and stability of the natural gas industry, the trend of the cost of money and its current cost, commodity price indices, industrial production, employment, and payroll indices, federal reserve bank rediscount rates, national income payments and other economic data, idle money statistics, the financial history of the Hope Company and the facts about recent financing by its parent Standard Oil Company. That evidence reveals unmistakably that, compared to industrial and railroad enterprises, the utility business has relatively greater stability. Moreover, it shows also that interest rates generally are now lower than they have ever been in this century; it discloses that the yields on better issues of natural gas company bonds sold in the last year or two are close to 3%.

The Company's contention that it should be allowed a rate of return not less than 8% is unreasonable. The record shows that the Hope Company is a seasoned enterprise whose risks have been minimized by (1) ample past and present provisions for depletion and depreciation with con-

current high profits; (2) protected established markets, through affiliated distribution companies, in populous and industrialized areas; and (3) available supplies of gas locally to meet requirements, except on certain peak days in the winter, which it is feasible to supplement in the future with gas from other sources. During the forty-two years of its history, to 1941, Hope has earned on its owners' equity an annual average profit of 12% and, in addition, has built up through annual provisions charged to expense, depletion and depreciation reserves far in excess of requirements. Hope faces no hardship with respect to increased taxes, operating expenses, and inflation, greater than those faced by similar enterprises. The Company's efficient management, established markets, financial record, affiliations, and its prospective business place it in a strong position to attract capital upon favorable terms when it is required.

In making the findings on rate of return, the national and international situations have commanded our attention and entered our deliberations. The Commission is aware of the increased demands made upon Hope for gas due to the war program. Considering these matters, the underlying factors, and all of the evidence in the record, the Commission finds that 6½% is the fair rate of return for the Hope Natural Gas Company. This rate of return being for the future, has been set only after endeavoring to weigh all known and predictable elements; in setting it we have made allowance for presently unforeseeable contingencies. Our views on the subject of rate of return are consonant with recent decisions by the Supreme Court and other courts and commissions involving natural gas companies.[33]

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[33] *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. ....; *Peoples Gas Light & Coke Co. v. Slattery*, 373 Ill. 31, 25 N. E. (2d) 482, 500-501, 31 P. U. R. (N. S.) 193, 217-218, App. Dis. 309 U. S. 634; *East Ohio Gas Co. v. Cleveland*, 27 P. U. R. (N. S.) 387, 412, Aff. 137 O. S. 225, 28 N. E. (2d) 599, 612, 35 P. U. R. (N. S.) 158, 174-175; *Re Montana-Dakota Utilities Co.*, 32 P. U. R. (N. S.) 121, 128; See *Re Canadian River Gas Co. et al.*, F. P. C. Op. 73.

LAWFULNESS OF PAST RATES

In 1938 the Cities of Cleveland and Akron, Ohio, filed complaints with the Federal Power Commission alleging that the rate which Hope charged East Ohio Gas Company was unjust, unreasonable and unlawful. These complaints were registered before Hope filed its five interstate wholesale rate schedules which are involved in these proceedings. The acceptance of a rate schedule for filing does not mean that the Commission approves it, and does not establish the justness or reasonableness of the rate. *Re Home Gas Co.*, 39 P. U. R. (N. S.) 102, 109. On October 14, 1938, this Commission instituted an investigation of the reasonableness of all of Hope's interstate rates. If it had been possible to adduce the volume of evidence required for the disposition of such a complex matter within a few months, the Commission would have prescribed the reasonable interstate wholesale rates for 1939 and subsequent years. The City of Cleveland raised the issue of the lawfulness of the rate charged by Hope to the East Ohio Gas Company and asked this Commission, as an aid to State regulation, to make a separate determination of the reasonable rates since June 30, 1939. Originally the City of Cleveland requested this Commission to find the lawful Hope-East Ohio rates since June 21, 1938, but it now represents that the subject is idle for rates prior to June 30, 1939, because those rates which Cleveland consumers were obligated to pay East Ohio have been settled. The Commission does not have the authority to fix rates for the past and to award reparations. But Congress did empower and instruct the Commission in Section 5(a) of the Natural Gas Act to fix future rates, and as a step in that process we must necessarily consider the reasonableness of past and existing rates. When the issue is raised and the public interest will be served, we consider as a necessary part of that duty the power to examine the entire rate problem involved and to determine what rates were lawful in the past. Also, Section 14(a) of the Act authorizes the Commission to investigate any facts

which it finds necessary in order to determine whether Hope has violated any provision of the Natural Gas Act. Furthermore, the Commission has power to perform any act, pursuant to Section 16, which is necessary or appropriate to carry out the provisions of the Act. Under Section 4(a) of the Act any interstate wholesale rate that is not just and reasonable is unlawful. *Federal Power Commission v. Natural Gas Pipeline Co.,* 315 U. S. ..... Hope's rate collected from East Ohio Gas Company was lawful after June 21, 1938, the effective date of the Act, only to the extent that it was just and reasonable. The City of Cleveland states that the Ohio Commission is investigating the reasonableness of the East Ohio Gas Company's bonded retail rates in Cleveland for the period since June 30, 1939, and that the lawfulness of Hope's rate is an important factor in the case. 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.[34]

In response to the request of the City of Cleveland, the Commission will make the appropriate findings of fact as to the lawfulness of the rates charged East Ohio by Hope since June 30, 1939. The Interstate Commerce Commission has furnished precedents for the performance of this public duty.[35] Congress intended that this Commission cooperate with State Commissions and municipalities, and the provisions of Sections 5(b) and 17 are special evidence of such intent.

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[34] Sections 1, 2, 4 and 5(a). See *Missouri v. Kansas Natural Gas Co.,* 265 U. S. 298, 308; *Illinois Natural Gas Co. v. Central Illinois Public Service Co.,* 314 U. S. 498, 506; *Kentucky Nat. Gas Corp. v. P. S. C.,* 28 F. Supp. 509, 513, aff. 119 Fed. (2d) 417.

[35] *W. A. Barrows Porcelain Enamel Co. v. Cushman Motor Delivery Co.,* 11 M. C. C. 365, 366; *Dixie Mercerizing Co. v. ET & WNC Motor Transp. Co.,* 21 M. C. C. 491, 492. See: *United States v. Morgan,* 307 U. S. 183, 313 U. S. 409; *Lima Tel. Co. v. P. U. C.,* 98 O. S. 110, 120 N. E. 330.

REASONABLE EARNINGS AND RATES FOR THE FUTURE

Future reasonable earnings and rates must be fixed with consideration of a forecast of operating revenues and expenses. The most recent experience of the Company is the best guide for prognostications. The President of the Company predicted a great increase in sales for 1941 over 1940. Comparative income figures for the first quarters of 1940 and 1941 show an increase of $592,000 in net operating income or about 20%. The increasing demands for natural gas in the industrialized areas of Hope's markets are common knowledge. It seems certain that 1940 will be the lowest year, on an earnings basis, of the 1940-1944 period. Upon a consideration of all the relevant facts in the record and the future prospects, the Commission finds that 1940 is a conservative "average" year and should be used in rate-making in these proceedings. This is a conservative basis because allowance will be made for all probable future increases in the rate base and operating expenses while the operating revenues for the relatively low year of 1940 are employed as the test in fixing rates for the future.

Applying the 6½% rate of return to the rate base for the future of $33,712,526, produces $2,191,314 as the amount of annual return which the Company is entitled to earn in the future. Hope's income available for return is not less than $5,801,171, so the excess of $3,609,857 is the sum by which existing revenues must be reduced.

Hope's gas sales revenues are classified between intrastate sales and interstate sales for purposes of determining the sales and rates subject to the jurisdiction of this Commission.

Hope's entire properties are located within the State of West Virginia and production, transmission, compressing and general facilities are used jointly for intrastate or local sales and interstate or export sales. Therefore, a classification or allocation is necessary to deter-

540917 O - 43 - 10

mine operating expenses and return applicable to the interstate business. Certain direct costs pertaining to distribution property and sales in West Virginia are easily segregated from the joint costs. The allocation of the remaining joint costs is made in accordance with the following facts and principles which are undisputed in the record and accepted by all parties to these proceedings.

The Company's local retail business in West Virginia is incidental to its major business of exporting gas from West Virginia. In determining the allocation of joint expenses to the local West Virginia business, this fact was given consideration, with the result that a smaller amount of expenses was allocated to that business than would have resulted by the application of one of the customary allocation methods. Briefly, the amount of joint expenses (including return) allocated to the local business was that amount which, together with the specific local expenses, would give the Company a 6½% return on the net investment in property used exclusively in the local business. As indicated above, a more orthodox allocation probably would have resulted in assigning a larger share of the joint costs to the West Virginia sales and a greater amount of the excess profit, although the amount would not be material, to the interstate sales. The method used was proposed by representatives of the Company and was not controverted.

The following schedule (Col. (c)) shows the excess of future net operating revenue over 6½% return on the interstate rate base, and Columns (d) and (e) show the prescribed rates and revenues after giving effect to the rate reduction:

Net Operating Income Available For Return

Rate Base for Interstate Sales $33,712,526

	M.c.f.	Before Reduction	After Reduction	
			Prescribed Rates M.c.f.—cents	Amount
(a)	(b)	(c)	(d)	(e)
Operating Revenues from Interstate Sales:				
East Ohio Gas Company	40,376,091	$14,726,736	29.50	$11,910,947
Peoples Natural Gas Company	9,738,612	3,457,207	28.50	2,775,504
River Gas Company	388,750	136,063	35.00	136,063
Fayette County Gas Company	859,106	270,618	28.50	244,845
Manufacturers Light and Heat Company	2,241,684	706,131	28.50	638,880
Total Interstate Revenues	53,604,243	$19,296,755		$15,706,239
Deductions:				
Operating Expenses		16,272,934		16,272,934
Other Gas Revenues		(83,275)		(83,275)
Allocation of Costs to Local West Virginia Sales		(2,694,075)		(2,694,075)
Total Deductions from Interstate Revenues		13,495,584		13,495,584
Net Operating Income from Interstate Sales		5,801,171		2,210,655
6½% Return on Interstate Rate Base		2,191,314		2,191,314
Excess of Future Net Operating Income over 6½% Return on Interstate Rate Base		$ 3,609,857		$ 19,341[36]

The Company's intrastate rates are under the jurisdiction of the Public Service Commission of West Virginia. The West Virginia Commission and the State of West Virginia are interveners in these proceedings and no objection was made by them to the method used herein for the allocation of cost to local operations in West Virginia.

The evidence on the cost of service allocated among the five customer companies and the conditions of service for the respective companies disclose that no reduction in rates is applicable to the affiliated River Gas Company.

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[36] It is not considered necessary to refine average rates per m.c.f. more than the prescribed rates shown above and the result is the margin of $19,341.

Among other reasons for this determination, is the fact that the River Gas Company is a small company and has a poor load factor. Accordingly, the total amount of the reduction in interstate rates is applicable to the East Ohio Gas Company, Peoples Natural Gas Company, Fayette County Gas Company and the Manufacturers Light and Heat Company. The present average rates per m.c.f. are 36.5¢ for East Ohio Gas Company, 35.5¢ for the Peoples Natural Gas Company, 35¢ for the River Gas Company, and 31.5¢ for Fayette County Gas Company and the Manufacturers Light and Heat Company.

The conditions and characteristics of service, required by the contracts, are similar for the East Ohio Gas Company and the Peoples Natural Gas Company with respect to obligations and priorities by classes of consumers, but there is a great difference with regard to delivery pressures. Hope Company delivers gas to the East Ohio Company at sufficiently high pressures so that no additional compression is required by the East Ohio Company for delivery of the gas to the ultimate consumers. On the other hand, Hope delivers gas to the Peoples Natural Gas Company, at various pressures, into that company's Brave Compressor Station and the Peoples Company must compress the gas for transportation to the ultimate consumers. From the evidence we conclude that the differential of one cent between the average price per m.c.f. for gas sold to the East Ohio and the Peoples Companies is reasonable, and it reflects the difference in the cost, conditions and characteristics of service.

Considering the cost of rendering service to the Fayette County Gas Company and the Manufacturers Light and Heat Company, and the conditions and characteristics of service to those companies, the fact that Hope knows precisely what deliveries it must make to them from day to day and the fact that those two companies buy less than 6% of the total gas sold by Hope, the Commission

finds that the rate for these companies should not be different from the rate paid by the Peoples Natural Gas Company. In the absence of compelling reasons to the contrary, it is good and desirable practice to fix rates that are uniform. Applying this principle in these proceedings the Commission will prescribe uniform rates for the Peoples Natural Gas Company, Fayette County Gas Company and the Manufacturers Light and Heat Company.

After considering all the evidence with respect to Hope's interstate wholesale rates and the proper average rates per m.c.f. for the five customer companies at the respective points of delivery, the Commission finds the following rates to be just and reasonable:

	Average Rate Per M.c.f.—Cents
East Ohio Gas Company	29.5
Peoples Natural Gas Company	28.5
Fayette County Gas Company	28.5
Manufacturers Light and Heat Company	28.5
River Gas Company	35.0

In passing, it might be noted that the over-all rate of return for 1940 would have been 8% if the new rates had been in effect that year and if the earnings from the distribution property had remained unchanged. This rate of return is reduced to 6½%, because of estimated increase in expenses and increase in rate base which we have allowed for the future.

Appropriate findings and order will be entered in accordance with this Opinion.

LELAND OLDS, *Chairman*
CLAUDE L. DRAPER, *Commissioner*
BASIL MANLY, *Commissioner*
CLYDE L. SEAVEY, *Commissioner*

Dated at Washington, D. C.
this 26th day of May, 1942.

LEON M. FUQUAY,
Secretary.

September 15, 1942, brief on behalf of the petitioner is filed.

Same day, supplement to brief on behalf of the petitioner is filed.

September 21, 1942, motion of respondent, City of Akron, to dismiss Part B of the Petition for Review is filed.

NOTE.—The motion to dismiss is in the words and figures following, to-wit:

United States Circuit Court of Appeals

FOR THE FOURTH CIRCUIT

No. 4979

OCTOBER TERM, 1942

HOPE NATURAL GAS COMPANY,
Petitioner,

vs.

FEDERAL POWER COMMISSION,
CITY OF CLEVELAND,
CITY OF AKRON,
PENNSYLVANIA PUBLIC UTILITY COMMISSION,
Respondents.

MOTION OF RESPONDENT, THE CITY OF AKRON, TO DISMISS PART B OF PETITION FOR REVIEW.

A. F. O'Neil,
Director of Law of The City of Akron,
304 Municipal Building,
Akron, Ohio,

Clyde B. Macdonald,
Assistant Director of Law,
304 Municipal Building,
Akron, Ohio,

Attorneys for Respondent, The City of Akron.

September 21, 1942

United States Circuit Court of Appeals
FOR THE FOURTH CIRCUIT

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OCTOBER TERM, 1942

HOPE NATURAL GAS COMPANY,
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vs.

FEDERAL POWER COMMISSION,
CITY OF CLEVELAND,
CITY OF AKRON,
PENNSYLVANIA PUBLIC UTILITY COMMISSION,
Respondents.

MOTION OF RESPONDENT, THE CITY OF AKRON, TO DISMISS PART B OF PETITION FOR REVIEW.

The City of Akron, a respondent in the above entitled cause, moves this Honorable Court to dismiss Part B of the Petition for Review filed herein on the ground that the Court has no jurisdiction under Section 19 (b) of the Natural Gas Act (52 Stat. 831; 15 U.S.C.A. 717r (b)) to review the "Findings as to Lawfulness of Past Rates" entered by respondent, Federal Power Commission, on May 26, 1942. These "findings" do not constitute an

"order" within the meaning of Section 19 (b) of the Natural Gas Act.

A. F. O'NEIL,
Director of Law of The City of Akron,

CLYDE B. MACDONALD,
Assistant Director of Law,
Attorneys for Respondent,
The City of Akron.

NOTICE OF MOTION.

Please take notice that this Motion of Respondent, The City of Akron, to Dismiss Part B of Petition for Review will be brought on for hearing before this Honorable Court on the 5th day of October, 1942, or as soon thereafter as the Court may hear the same in the Post Office Building in the City of Richmond, Virginia.

A. F. O'NEIL,
Director of Law of The City of Akron,

CLYDE B. MACDONALD,
Assistant Director of Law,
Attorneys for Respondent,
The City of Akron.

PROOF OF SERVICE.

STATE OF OHIO,
SUMMIT COUNTY, SS.

Clyde B. Macdonald, attorney for respondent, The City of Akron, being first duly sworn, deposes and says that on the 19th day of September, 1942, he duly served

a copy of the within motion and brief in support thereof upon counsel for petitioner, Hope Natural Gas Company, by depositing the same on such date in the United States Post Office at Akron, Ohio, in a sealed envelope, with postage prepaid, addressed to William B. Cockley, Attorney for Hope Natural Gas Company, at his post office address, 1759 Union Commerce Building, Cleveland, Ohio; that on the 19th day of September, 1942, he duly served a copy of the within motion and brief in support hereof upon counsel for respondent, Federal Power Commission, by depositing the same on such date in the United States Post Office at Akron, Ohio, in a sealed envelope, with postage prepaid, addressed to Richard J. Connor, General Counsel, Federal Power Commission, Washington, D. C.; that on the 19th day of September, 1942, he duly served a copy of the within motion and brief in support thereof upon counsel for respondent, City of Cleveland, by depositing the same on such date in the United States Post Office at Akron, Ohio, in a sealed envelope, with postage prepaid, addressed to Thomas A. Burke, Jr., Director of Law, 204 City Hall, Cleveland, Ohio; that on the 19th day of September, 1942, he duly served a copy of the within motion and brief in support thereof upon counsel for respondent, Pennsylvania Public Utility Commission by depositing the same on such date in the United States Post Office at Akron, Ohio, in a sealed envelope, with postage prepaid, addressed to Claude T. Reno, Attorney General, Pennsylvania Public Utility Commission, Harrisburgh, Pennsylvania.

CLYDE B. MACDONALD,

Sworn to before me and subscribed in my presence this 19th day of September, 1942.

H. GLADYS SOURS,
Notary Public

[NOTARIAL SEAL]

My commission expires April 5, 1943.

United States Circuit Court of Appeals

FOR THE FOURTH CIRCUIT

No. 4979

OCTOBER TERM, 1942

HOPE NATURAL GAS COMPANY,
Petitioner,

vs.

FEDERAL POWER COMMISSION,
CITY OF CLEVELAND,
CITY OF AKRON,
PENNSYLVANIA PUBLIC UTILITY COMMISSION,
Respondents.

ADOPTION BY THE RESPONDENT CITY OF AKRON, OF THE BRIEF OF RESPONDENT CITY OF CLEVELAND IN SUPPORT OF MOTION TO DISMISS PART B OF PETITION FOR REVIEW.

The respondent, The City of Akron, affirms and adopts in full the brief of the respondent City of Cleveland in support of its motion to dismiss Part B of the Petition for Review, together with the Statement of Facts, Argu-

ment, and Appendix and respectfully prays that said brief in support of the motion of the respondent City of Cleveland to dismiss Part B of the Petition for Review be considered in connection with and as part of the motion herein made by the respondent The City of Akron.

A. F. O'NEIL,
Director of Law of The City of Akron,
304 Municipal Building,
Akron, Ohio,

CLYDE B. MACDONALD,
Assistant Director of Law,
304 Municipal Building,
Akron, Ohio,

Attorneys for Respondent,
The City of Akron.

September 22, 1942, motion of respondent, City of Cleveland, to enlarge time for filing brief is filed.

Same day, motion of respondent, City of Akron, to enlarge time for filing brief is filed.

Same day, motion of respondent, Federal Power Commission, to enlarge time for filing brief is filed.

Same day, joinder of respondent, Pennsylvania Public Utility Commission, in motions to enlarge time for filing briefs is filed.

September 23, 1942, application of respondent, Pennsylvania Public Utility Commission, for extension of time for filing brief is filed.

September 24, 1942, order granting special permission to respondent, Federal Power Commission, to file a brief in excess of 50 printed pages but not exceeding 150 printed pages is filed.

Same day, order granting special permission to respondent, Pennsylvania Public Utility Commission, to file a brief in excess of 50 printed pages but not exceeding 100 printed pages is filed.

Same day, order extending time to October 15, 1942, for the filing of the briefs of the respective respondents is filed.

September 30, 1942, brief on behalf of the petitioner on the motions to dismiss Part B of the Petition to Review is filed.

October 5, 1942, motion of respondents to extend the time for filing respondents' briefs from October 15, 1942, and to continue the case for oral argument to the November term, is filed in Open Court.

Argument on motions

October 5, 1942 (October term, 1942), cause came on to be heard on the motion of respondents to extend the time for filing respondents' briefs and to continue; and on the motions of the respondents to dismiss Part B of the Petition for Review, before Parker, Soper and Dobie, Circuit Judges, and was argued by counsel and submitted.

540917 O - 43 - 11

Order continuing hearing on motions to dismiss part B of the petition for review; continuing case to the November term, and as to briefs. Filed and entered October 5, 1942

(Style of Court and Title Omitted)

This cause came on to be heard on the motions of the respondents City of Cleveland and City of Akron to dismiss Part B of the Petition for Review:

For reasons appearing to the court,

It is ordered, by this Court, that the hearing on the motions to dismiss Part B of the Petition for Review be continued to the hearing on the merits; that this cause be, and it is hereby, continued to the November term of this Court, to be placed at the foot of the argument docket for that term; that the briefs on behalf of the respondents be filed on or before October 31, 1942, and that the reply brief, if any, on behalf of the petitioner, be filed not later than three days prior to the argument of the cause.

JOHN J. PARKER,
Senior Circuit Judge.

OCTOBER 5th, 1942.

October 31, 1942, brief on behalf of respondent, Federal Power Commission, is filed.

Same day, volumes I and II of appendix to briefs on behalf of respondents are filed.

Same day, brief on behalf of respondents other than Federal Power Commission is filed.

November 11, 1942, application of petitioner for special permission to file a reply brief exceeding 50 printed pages is filed.

November 16, 1942, reply brief on behalf of the petitioner is filed.

Argument of cause

November 18, 1942 (November term, 1942), cause came on to be heard before Parker, Soper, and Dobie, Circuit Judges, and was argued by counsel and submitted.

United States Circuit Court of Appeals, Fourth Circuit

No. 4979

HOPE NATURAL GAS COMPANY, PETITIONER

versus

FEDERAL POWER COMMISSION, CITY OF CLEVELAND, CITY OF AKRON, AND PENNSYLVANIA PUBLIC UTILITY COMMISSION, RESPONDENTS

On Petition for Review of Orders of the Federal Power Commission

(Argued November 18, 1942. Decided February 16, 1943)

Opinion

Filed February 16, 1943

Before PARKER, SOPER and DOBIE, Circuit Judges

William B. Cockley (Walter J. Milde, Theodore R. Colborn, William A. Dougherty, Kemble White and Anthony F. McCue on brief) for Petitioner, and Milford Springer, Counsel for the Federal Power Commission, and Spencer W. Reeder, Assistant Director of Law in Charge of Utility Controversies for the City of Cleveland, (Charles V. Shannon, Louis W. McKernan and Howell Purdue, of counsel for the Federal Power Commission; Thomas A. Burke, Jr., Director of Law for the City of Cleveland; Robert E. May; Alexander W. Parker and Joseph M. Winston, Jr., Attorneys for City of Cleveland; A. F. O'Neil, Director of Law, and Clyde B. Macdonald, Assistant Director of Law for the City of Akron, Attorneys for City of Akron; Claude T. Reno, Attorney General of the State of Pennsylvania; Harry M. Showalter, Counsel, and Samuel Graff Miller, Assistant Counsel, Attorneys for Pennsylvania Public Utility Commission, on brief) for Respondents.

PARKER, Circuit Judge: This is a petition by the Hope Natural Gas Company, hereafter referred to as "Hope", to review an order of the Federal Power Commission under the provisions of sec. 19 (b) of the Natural Gas Act of June 21, 1938, 52 Stat. 831, 15 USCA 717 r (b). Hope, a subsidiary corporation of the Standard Oil Company of New Jersey, was organized under the laws of West Virginia in the year 1898 and since that time has been engaged in the production, transportation and sale of natural gas. 80% of its sales are in interstate commerce and are subject to the

jurisdiction of the Commission, but its interstate rates had not been regulated prior to this proceeding. In 1938 the cities of Cleveland and Akron, Ohio, filed complaints with the Commission alleging that the rates charged by Hope to the East Ohio Gas Company were unreasonable. The Pennsylvania Public Utility Commission filed complaints that the rates charged to the Peoples Natural Gas Company, the Fayette County Gas Company and the Manufacturers Light and Heat Company were also unreasonable. The Commission then instituted an investigation, on its own motion, into the reasonableness of all of Hope's interstate wholesale rates; and all of the proceedings relating to these rates were consolidated for hearing before the Commission.

On May 26, 1942, the Commission filed its opinion, findings and order holding that the rates charged since June 30, 1939 were unreasonable and establishing reduced rates for the future, the reduction ordered being approximately 20% in the rates charged the East Ohio Gas Company and the Peoples Natural Gas Company, both Standard Oil affiliates, to which by far the larger part of its sales were made. The rates to these companies were reduced from 36.5 and 35.5 cts. per m. c. f. to 29.5 and 28.5 cts. per m. c. f. respectively. Rates to two other companies, Fayette and Manufacturers, representing a small volume of the total sales, were reduced from 31.5 cts. to 28.5 cts.

The reductions in rates were ordered on the basis of findings made as to the value of Hope's property used in connection with its interstate business, the estimated operating expenses of the business and a rate of return upon investment of 6½%. Hope complains of the findings with respect to all of these matters but particularly with respect to the valuation of the property adopted as the rate base. The valuation adopted by the Commission as the rate base was arrived at by taking the cost of the property as shown by the books of the company, corrected for bookkeeping errors but without allowance for price increases or consideration of capital items theretofore charged to expenses, and deducting therefrom accrued depreciation based upon the estimated useful life of the property employed without reference to evidence as to its present condition based upon tests and observation. This method was applied to property taken over from other companies as well as to property originally purchased by Hope. The corrected book cost of the property was found to be $51,957,416, and depreciation was found to be $22,328,016 as of December 31, 1940, leaving a net investment of $29,629,400. To this was added $1,392,021 for net capital additions up until the effective date of the order, $566,105 for useful unoperated acreage and $2,125,000 for working capital. This gave a rate base of $33,712,526.

Hope introduced evidence to the effect that prior to 1923 labor costs in well drilling as well as the portion of the overhead expense of the company allocable thereto had been treated as expense in its bookkeeping entries, instead of being charged to capital account; that these items were a legitimate part of the cost of the property and present expenditures of like character were required to be so treated in the system of accounting prescribed by the Commission; that the items representing such expenditures prior to 1923 should be considered by the Commission as a part of the legitimate cost of the property notwithstanding they had been charged to expense; and that, when they were so considered, the cost of the property was shown to be $69,735,000, instead of $51,957,416.

It was shown that the property used by Hope in its interstate business had been constructed over a forty year period during which there had been great fluctuations in prices and that prices at the time of hearing were at a far higher level than they were during the years preceding the first world war. The Public Utilities Commission of Ohio had found the reproduction cost new of the property, as of June 30, 1937, to be $100,257,000 and its present value after depreciation to be $66,166,382.* Hope introduced an estimate of cost of reproduction new amounting to $97,340,000 and a statement showing that the application of price trends to original cost would result in a figure of $105,101,000. This price trend statement showed that for property placed in public service between 1891 and 1916 at an original cost of $25,249,550 the price trends gave a figure of $52,451,675, whereas for property placed in service between 1917 and 1938 at a cost of $45,303,889 the trended value was only $53,788,551. Hope contended that the allowance for depreciation should have been based on the actual condition of the property as determined by observation with allowance for obsolescence; and that the depreciation allowance resulting was 34.51%. Applying this rate of depreciation to the estimate of the cost of reproduction new of its property, it arrived at a rate base as of December 31, 1938, of $66,360,000.

The Commission found that Hope's estimates of reproduction cost and trended original cost were without probative value and disregarded them, as it did also Hope's evidence as to the observed condition of the property. No consideration was given to the change in price levels which was shown by the estimates and which, even in their absence, might have been noticed as matters of general and common knowledge.

*East Ohio Gas Co. v. City of Cleveland, 27 P. U. R. (N. S.) 387, 417. See also table 6 appended to report of Commission in that case but not published in Public Utilities Reports.

The vital questions in the case relate to the determination of the rate base; and, in view of the low rate of return allowed and the consequent lack of margin to take care of error in the base, the rates allowed must be condemned as unreasonable and confiscatory because of the following errors with respect to the valuation of the property constituting the base: (1) the Commission did not find the present fair value of the property and took no account of the change of price levels in determining the rate base; (2) the Commission ignored items of well drilling costs and overhead, aggregating in excess of $17,000,000, which entered into the original cost of the property, basing this action on the fact that, under the system of accounting that prevailed at the time, these items had been charged on the company's books to expense; and (3) the Commission ignored evidence as to the present condition of the property and computed accrued depreciation theoretically on the straight-line service-life method. We shall discuss these matters separately in the order named.

PRESENT VALUE

The report of the Commission shows, not only that it gave no consideration to rise in price levels in determining the amount of the rate base, but also that it made no attempt to ascertain the present fair value of the property involved. It adopted as the rate base the original cost of the property as shown by the company's books, adjusted to correct bookkeeping errors and depreciated as above indicated. It took the view that this depreciated book cost could properly be taken as the base without reference to whether it did or did not represent the present fair value of the property, saying: "With the decline in favor of 'fair value' as the only mode of public utility rate regulation, its keystone, reproduction cost, crumbles. Bona fide investment figures now become all important in the regulation of rates."

Much is to be said in favor of the prudent investment theory of determining the rate base. It is simple; it is expeditious; and it avoids the necessity of resorting to unsatisfactory estimates of the cost of reconstructing a system that no one would now reconstruct. Where there has been no great change in price levels, prudent investment cost can be taken, subject to appropriate depreciation, as representing the present fair value of the property for rate making purposes. And even where there have been changes in price levels, it can be thus taken, we think, if such basis has been established by legislative authority prior to the dedication of the property to public use or if statutory provision has been made for valuation of the property on the basis of present fair value and the use of prudent investment cost in the future, and the property

has been so valued. See Bauer & Gold, "Public Utility Valuation for Purposes of Rate Control" (1934) pp. 424 et seq. In the absence of such legislation and valuation, however, such depreciated original cost cannot be taken as the rate base where there has been a change in the level of prices and the investment in the utility has been made while the "fair value" theory was prevailing. As is well said in Bauer & Gold, supra, pp. 424 and 425:

"If the rights and obligations of future investors are exactly set forth, and if systematic provisions are made for enforcement, they would doubtless be held subject to the conditions. If they furnish capital under a policy explicitly enunciated, they can have no grounds for claiming that they are deprived of 'due process.' For all future dealing, legislatures are probably free to establish any policy that seems desirable from the public standpoint. They are probably not required to continue the indefinite basis of dealing with all future investments merely because no definite policies and standards were established in the past.

"The situation, however, is different with regard to properties constructed or installed in the past. As to these, the funds were contributed under the general law of the land, without exact limitations upon the return. Except for the undefined rule that they were entitled to fair return on fair value, they were not placed under precise and systematic control. If prices increased after the date of investment, the companies have been entitled to have the advance recognized in new valuations. This right probably cannot be abrogated on grounds of public policy unless a proper equivalent is provided. While the right itself is vague and variable, it nevertheless exists and presumably cannot be modified except through replacement by a definite substitute that is fair and reasonable."

And the same authors, in dealing with the method of establishing a fixed rate base "through outright adoption of investment as rate base, starting with existing book value of the properties on the basis of present accounting methods", point out as an objection to it that fluctuation in prices may not be ignored. At pp. 432 and 433 they say:

"Besides doubts as to reliability of present book figures, the proposal also raises the question as to how the shift in price level should now be treated in the light of fallen prices. Under the law of the land there is no doubt but that the public is entitled to have fair value determined according to present and prospective prices. If 'fair value' does not rest exclusively upon reproduction cost levels, it certainly must be determined nevertheless largely with consideration to the price changes that have taken place. Properties installed during the pre-1929 era back to about

1914, would have to be repriced on the basis of the new level. Furthermore, the public is entitled also to have considered the advances in technology which resulted in reduced unit cost of construction. These adjustments would be entirely ignored in outright adoption of book value as the starting point of a fixed rate base.

"These are matters of important consideration in planning and establishing the new policy of control. For the future, the purpose is, of course, to eliminate the factor of price fluctuations from consideration in the rate base. In the past, however, under present law, this has been the dominant element in valuation and primarily responsible for the unsatisfactory conditions of regulation. *But if a fixed rate base is to be established, the question should not be ignored as to how the price changes that have taken place should be provided for in the adoption of initial rate base.*" [Italics supplied.]

There is nothing in the Natural Gas Act which justifies the thought that Congress was providing therein for the exclusive use of the prudent investment theory of property valuation. No "fixed rate base" as advocated by Bauer & Gold is referred to, and no provision is made for initial valuation of properties with addition of subsequent investment costs as the base. On the contrary, the usual general provision for "just and reasonable" rates is made in sec. 4 (a) of the Act; and, as we shall point out hereafter, it is well settled in existing law that, to be considered "just and reasonable", rates must be such as to yield a fair return upon the fair value of the property used in rendering the service. In sec. 6 (a) provision is made for the Commission to ascertain the actual legitimate cost of the property and 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*" [Italics supplied.]

The pertinent sections of the Natural Gas Act, 52 Stat. 821, 15 USCA 717c (a) 717d (a), 717e (a) (b), are as follows:

"Sec. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful."

"SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged,

or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall 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: Provided, however, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates."

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

"(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction."

It was clearly the intention of Congress that under these sections the Commission might investigate and ascertain cost and depreciation of properties of natural gas companies, irrespective of whether a rate inquiry was involved or not, and that, where rate making was involved, the investigation might extend to other facts which bear on cost or depreciation and the fair value of the property. Instead of prescribing a change in the method of determining the rate base, it is clear that the statute contemplates that the base should be determined in accordance with existing legal rules; and it is basic in these rules that the present fair value of the property be ascertained so that rates may be established which will afford a fair return upon fair value and so will not be confiscatory in the constitutional sense. This we understand to be the construction given the Act in the recent case of Federal Power Commission v. Natural Gas Pipeline Co., 315 U. S. 575, 585, 586, where the Court, speaking through Mr. Chief Justice Stone, said:

"By long standing usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense. Los Angeles Gas Co. v. Railroad Commission, 289 U. S. 287, 305; Railroad Commission v. Pacific Gas Co.,

supra, 394, 395; Denver Stock Yard Co. v. United States, 304 U. S. 470, 475. Assuming that there is a zone of reasonableness within which the Commission is free to fix a rate varying in amount and higher than a confiscatory rate, see Banton v. Belt Line Ry. Corp., 268 U. S. 413, 422, 423; Columbus Gas Co. v. Commission, 292 U. S. 398, 414; Denver Stock Yard Co. v. United States, supra, 483, the Commission is also free under sec. 5 (a) to decrease any rate which is not the 'lowest reasonable rate.' *It follows that the Congressional standard prescribed by this statute coincides with that of the Constitution*, and that the courts are without authority under the statute to set aside as too low any 'reasonable rate' adopted by the Commission which is consistent with constitutional requirements.

"The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances." [Italics supplied.]

The conception that, not to be confiscatory, rates must yield a fair return upon the present fair value of the property has long been well settled by Supreme Court decisions. Munn v. Illinois, 94 U. S. 113, established the principle that rates of public utilities were subject to regulation by the state. Mr. Chief Justice Waite, who wrote the opinion in that case, laid down the limitation, however, in Stone v. Farmers Loan & Trust Co., 116 U. S. 307, 331, that the power could not be exercised to confiscate the property invested in the utility, saying, "From what has thus been said, it is not to be inferred that this power of limitation or regulation is itself without limit. This power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation. Under pretense of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property without reward; neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law." Regulation of rates of public utilities differs from ordinary price fixing such as was involved in Nebbia v. New York, 291 U. S. 502, in that, in the case of a public utility, property has been dedicated to the use of the public and the state can require its continued operation, whereas in the case of ordinary property subject to price regulation the owner is not required to sell. By dedicating his property to public use the owner impliedly consents to regulation of its rates by the state; but this consent is conditioned upon his property's not being taken from him under the guise of regulation, i. e. that the rates fixed allow him a fair return

upon its fair value. The rule is thus stated in the Minnesota Rate Cases, 230 U. S. 352, 434:

"The basis of calculation is the 'fair value of the property' used for the convenience of the public. Smyth v. Ames, supra (p. 546). Or, as it was put in San Diego Land & Town Co. v. National City, supra (p. 757), 'What the company is entitled to demand, in order that it may have just compensation, is a fair return upon the reasonable value of the property at the time it is being used for the public.'"

In Los Angeles Gas Co. v. R. R. Com'n, 289 U. S. 287, 305, cited with approval by Mr. Chief Justice Stone in Federal Power Commission v. Natural Gas Pipeline Co., supra, Mr. Chief Justice Hughes laid down the criterion in the following language:

"As the property remains in the ownership of the complainant, the question is whether the complainant has been deprived of a fair return for the service rendered to the public in the use of the property. This Court has repeatedly held that the basis of calculation is the fair value of the property, that is, that what the complainant is entitled to demand, in order that it may have 'just compensation,' is '*a fair return upon the reasonable value of the property at the time it is being used for the public.*' In determining that basis, the criteria at hand for ascertaining market value, or what is called exchange value, are not commonly available. The property is not ordinarily the subject of barter and sale and, when rates themselves are in dispute, earnings produced by rates do not afford a standard for decision. The value of the property, or rate base, must be determined under these inescapable limitations. And mindful of its distinctive function in the enforcement of constitutional rights, the Court has refused to be bound by any artificial rule or formula which changed conditions might upset. We have said that the judicial ascertainment of value for the purpose of deciding whether rates are confiscatory 'is not a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts.' Minnesota Rate Cases, 230 U. S. 352, 434; Georgia Railway & Power Co. v. Railroad Commission, 262 U. S. 625, 630; Bluefield Water Works Co. v. Public Service Commission, 262 U. S. 679, 690." [Italics supplied.]

Under this rule, in the absence of some such statutory provision as indicated at the beginning of this discussion, the determination of fair present value as the rate base is inescapable if there is to be a "fair return upon fair value". What has declined in favor is not, as the Commission thought, the "doctrine" of fair value, but the cumbersome and misleading reproduction cost theory as a means of determining it. Property has no value except present

value. Past value exists only in memory or in history, future value only in estimate or expectation. It is the property presently existing which belongs to the utility and is used by the public. It is that property which is depreciated through use and which is gradually being sold through depreciation to the public. And it is the value of that property as used which must be considered in fixing rates that will reimburse the company for its partial sale through use and provide an adequate return upon investment. If a piece of property which cost $10,000 originally but can only be replaced at a cost of $20,000, and is worth $20,000 to the company in carrying on its business, be treated as being worth only $10,000 for the purpose of depreciation and return, the company is deprived of property by the rate in exactly the same way as a merchant who is required to sell for $5 a pair of $10 shoes. It must not be forgotten that it is the property owned by the utility, and not the cash invested by stockholders in its stock, that is devoted to public use; that this property is worn out in furnishing the service which the public receives and which the utility is bound to render; and that, unless the utility receives a rate sufficient to make necessary replacements at current prices with a fair return upon the present fair value of its investment, its property is being taken from it and given to its customers.

The task of arriving at fair present value is a difficult one and necessarily involves exercise of judgment of a high order. The problem is easily over-simplified by those seeking to maintain a thesis. In times of falling prices, those representing the utilities emphasize the importance of original investment cost, while those seeking lower rates point out the folly of fixing rates on the basis of a value which no longer exists and demand that reproduction cost be taken as the criterion. In periods of rising prices, the position of the advocates is reversed. To fix value on original investment cost without reference to change in price levels may easily lead to absurdly high or low valuations, with an undue burden on the public in the case of falling prices and with such confiscation of the property of the utility in the case of rising prices as may result in its ruin. It is idle to argue that the utility should not complain if it recoups through its rates the original investment in its equipment. The law requires that the business of the utility go on. Its equipment must be replaced as it is worn out. And, if the rates allowed are not sufficient to make replacements at current prices, bankruptcy is inevitable. On the other hand, estimates of reproduction cost do not provide a satisfactory method of arriving at value. Aside from the temptation of expert witnesses to overestimate costs in a theoretical reproduction, the fact is that nobody could or would build the utility again as it has

grown up through the years. While reproduction cost may be considered, therefore, it is not ordinarily, standing alone, a fair criterion of valuation.

The duty of the Commission to determine the present fair value of the property and to give consideration to all factors entering into that value is thus stated by Mr. Chief Justice Hughes in the case of Los Angeles Gas Co. v. R. R. Com'n, supra, 289 U. S. at 306:

"The actual cost of the property—the investment the owners have made—is a relevant fact. Smith v. Ames, 169 U. S. 466, 547. But while cost must be considered, the Court has held that it is not an exclusive or final test. The public have not underwritten the investment. The property, on any admissible standard of present value, may be worth more or less than it actually cost. The time and circumstances of the outlay, and the effect of altered conditions demand consideration. Even when cost is revised so as to reflect what may be deemed to have been invested prudently and in good faith, the investment may embrace property no longer used and useful for the public. This is strikingly illustrated in the present case, where the Company has a large gas manufacturing plant which, in view of the supply of natural gas, has not been used for several years and is not likely to be used for many years to come, if at all. But no one would question that the reasonable cost of an efficient public utility system 'is good evidence of its value at the time of construction.' We have said that 'such actual cost will continue fairly well to measure the amount to be attributed to the physical elements of the property so long as there is no change in the level of applicable prices.' McCardle v. Indianapolis Water Co., 272 U. S. 400, 411. And when such a change in the price level has occurred, actual experience in the construction and development of the property, especially experience in a recent period, may be an important check upon extravagant estimates.

"This Court has further declared that, in order to determine present value, the cost of reproducing the property is a relevant fact which should have appropriate consideration. Southwestern Bell Telephone Co. v. Public Service Commission, 262 U. S. 276, 287, 288; Bluefield Water Works v. Public Service Commission, supra; Standard Oil Co. v. Southern Pacific Co. 268 U. S. 146, 156; McCardle v. Indianapolis Water Co., supra, p. 410. In Southwestern Bell Telephone Company v. Public Service Commission, supra, this Court said that 'it is impossible to ascertain what will amount to a fair return upon properties devoted to public service without giving consideration to the cost of labor, supplies, etc., at the time the investigation is made. An honest and intelligent forecast of probable future values, made upon a view of all the relevant circumstances, is essential. If the highly important element of

present costs is wholly disregarded such a forecast becomes impossible.' See St. Louis & O'Fallon Railway Co. v. United States, 279 U. S. 461, 485. But again, the Court has not decided that the cost of reproduction furnishes an exclusive test. See Smyth v. Ames, supra; Minnesota Rate Cases, supra; Georgia Railway & Power Co. v. Railroad Commission, supra. We have emphasized the danger in resting conclusions upon estimates of a conjectural character. We said, in Minnesota Rate cases, supra, p. 452,—'The cost-of-reproduction method is of service in ascertaining the present value of the plant, when it is reasonably applied and when the cost of reproducing the property may be ascertained with a proper degree of certainty. But it does not justify the acceptance of results which depend upon mere conjecture. It is fundamental that the judicial power to declare legislative action invalid upon constitutional grounds is to be exercised only in clear cases. The constitutional invalidity must be manifest and if it rests upon disputed questions of fact, the invalidating facts must be proved. And this is true of asserted value as of other facts.' The weight to be given to actual cost, to historical cost, and to cost of reproduction new, is to be determined in the light of the facts of the particular case. McCardle v. Indianapolis Water Co., supra."

In the pending case, original investment cost cannot be taken alone as a measure of the present fair value of the property because of the great changes in the prices of labor and materials which have occurred over the more than forty years during which the investments in the property have been made. These changes are matters of general and common knowledge and are shown by many publications, statistical reports and other documents readily available. That such changes have occurred is shown also by the evidence offered before the Commission. It is true that the statements of reproduction cost and trended original cost fail to allow for the increased productivity of labor and fail to take account of other pertinent factors; and the Commission, we think, was justified in refusing to accept the conclusions therein contained. But this does not mean that the Commission could ignore the change in price levels which was clearly established and was matter of general and common knowledge otherwise. The Commission's staff prepared statements showing that the conclusions of Hope's reproduction cost and trended cost statements should not be accepted. They could doubtless have furnished estimates as to the proper effect to be accorded price trends in the correct valuation of the property. At all events, the Commission should have given consideration to the matter; and, if of opinion that investment cost was a true measure of the present value of the property notwithstanding increase in prices, it should have found this as a fact.

It could not absolutely ignore the fact of increased price levels in determination of present fair value. This is clearly laid down by Mr. Chief Justice Hughes in Los Angeles Gas Co. v. R. R. Com'n, supra, and is firmly established by repeated decisions of the Supreme Court.

In the recent case of McCart v. Indianapolis Water Co., 302 U. S. 419, the Supreme Court affirmed a holding of the Circuit Court of Appeals that a decision of a district court should be reversed and the case remanded for a redetermination of value because of an upward trend in prices of which the Circuit Court of Appeals took judicial notice and which the District Court had not taken into account.

In West v. C. & P. Tel. Co., 295 U. S. 662, the Supreme Court, in condemning the use of certain price trend indices in connection with cost as establishing present value, said:

"The established principle is that as the due process clauses (Amendments V and XIV) safeguard private property against a taking for public use without just compensation, neither Nation nor State may require the use of privately owned property without just compensation. When the property itself is taken by the exertion of the power of eminent domain, just compensation is its value at the time of the taking. So, where by legislation prescribing rates or charges the use of the property is taken, just compensation assured by these constitutional provisions is a reasonable rate of return upon that value. To an extent value must be a matter of sound judgment, involving fact data. To substitute for such factors as historical cost and cost of production, a 'translator' of dollar value obtained by the use of price trend indices, serves only to confuse the problem and to increase its difficulty, and may well lead to results anything but accurate and fair. This is not to suggest that price trends are to be disregarded; quite the contrary is true. *And evidence of such trends is to be considered with all other relevant factors.* St. Louis & O'Fallon Ry. Co. v. United States, 279 U. S. 461, 485; Clark's Ferry Bridge Co. v. Public Service Comm'n, 291 U. S. 227, 236." [Italics supplied.]

In that case, the District Court, departing from the method employed by the Maryland Commission, adopted as the rate base cost less depreciation reserve. This method the court likewise condemned, saying:

"The opinion in essence consists of the conclusion, that, all the circumstances considered, it will be fair to appraise the property at cost less depreciation reserve. This rough and ready approximation of value is as arbitary as that of the Commission, for it is unsupported by findings based upon evidence."

In McCardle v. Indianapolis Water Co., 272 U. S. 400, 411, the Court, in condemning a valuation which did not take account of a change in the level of prices, said:

"Undoubtedly, the reasonable cost of a system of waterworks, well-planned and efficient for the public service, is good evidence of its value at the time of construction. And such actual cost will continue fairly well to measure the amount to be attributed to the physical elements of the property so long as there is no change in the level of applicable prices. And, as indicated by the report of the commission, it is true that, if the tendency or trend of prices is not definitely upward or downward and it does not appear probable that there will be a substantial change of prices, then the present value of lands plus the present cost of constructing the plant, less depreciation, if any, is a fair measure of the value of the physical elements of the property. The validity of the rates in question depends on property value January 1, 1924, and for a reasonable time following. While the values of such properties do not vary with frequent minor fluctuations in the prices of material and labor required to produce them, they are affected by and generally follow the relatively permanent levels and trends of such prices."

In Southwestern Bell Tel. Co. v. Public Service Commission, 262 U. S. 276, 287, the Court said:

"Obviously, the Commission undertook to value the property without according any weight to the greatly enhanced costs of material, labor, supplies, etc., over those prevailing in 1913, 1914 and 1916. As matter of common knowledge, these increases were large. Competent witnesses estimated them as 45 to 50 per centum.

* * * * *

"It is impossible to ascertain what will amount to a fair return upon properties devoted to public service without giving consideration to the cost of labor, supplies, etc., at the time the investigation is made. An honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances, is essential. If the highly important element of present costs is wholly disregarded such a forecast becomes impossible. Estimates for tomorrow cannot ignore prices of today."

In Bluefield Water Works & Imp. Co. v. Public Service Com., 262 U. S. 679, 689, the Court said:

"The record clearly shows that the commission in arriving at its final figure did not accord proper, if any, weight to the greatly enhanced costs of construction in 1920 over those prevailing about 1915 and before the war, as established by uncontradicted

evidence; and the company's detailed estimated cost of reproduction new, less depreciation, at 1920 prices, appears to have been wholly disregarded. This was erroneous."

See also Driscoll v. Edison Lt. & Power Co., 307 U. S. 104, 118–119.

The case of R. R. Commission v. Pacific Gas & Electric Company, 302 U. S. 388 is not to the contrary; for it appears in that case that the Commission there received and considered evidence of cost of reproduction and other evidence bearing upon the value of the property. Here no consideration whatever was given to change in price levels and its effect on value, and investment cost less depreciation is frankly taken as the rate base without any pretense that it represents value. As stated above, we find no fault in the action of the Commission in rejecting the estimates of reproduction cost and trended value; and we have considered whether we might not sustain the rate base on the theory that, upon the rejection of these estimates, the only evidence of value before the Commission was the evidence of investment cost. This, however, would be to close our eyes to the rise in price levels which are so great and far reaching that we must take judicial notice of them, and which are shown by the evidence to that effect included in the estimates. It would be to close our eyes also to the fact that the Commission has proceeded upon an erroneous theory of law in arriving at the rate base.

And there is nothing to the contrary in Federal Power Commission v. Natural Gas Pipeline Co., supra. It is true that in that case the court said that the Constitution "does not bind rate making bodies to the service of any single formula or combination of formulas"; but substantially the same thing had been said long before in the Minnesota Rate cases. See 230 U. S. at 434. It had been repeated by Mr. Chief Justice Hughes in the opinion in Los Angeles Gas Co. v. R. R. Com'n, supra, and appears in the opinions in a number of other cases. The concurring opinion does interpret the opinion of the court as holding that the Commission may now adopt prudent investment as a rate base and reject all other formulas. We think, however, in view of the expression in the majority opinion quoted above, to the effect that the rate must be one which is not confiscatory, that, in judging whether the rate is confiscatory or not, historical cost under the prudent investment theory can be adopted as the rate base without reference to other matters affecting value only where it can reasonably be found to represent present fair value. Rate making bodies may make pragmatic adjustments "within the ambit of their statutory authority," but the ambit of their authority does not extend to action which is confiscatory in char-

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acter. Original cost or historical cost as shown by the books is evidence of value in all cases and can be adopted as representing present fair value where under all the circumstances of the case it is not unreasonable to do so. But, in the light of the cases cited above, it is unreasonable to adopt it as representing such value when, as in the case at bar, there has been a great change in price levels.

To sum up on this branch of the case: The Natural Gas Act makes no provision for a "fixed rate base" or the exclusive use of prudent investment in determining the base. Not to be confiscatory, rates must allow a fair return upon the present fair value of the property. To determine this fair return upon present fair value, the Commission must find what the present fair value of the property is. The Commission is not confined to any one formula or group of formulas in determining present fair value, but must determine it in the light of all the circumstances of the case. Prudent investment cost with proper allowance for depreciation may in some cases provide, without consideration of anything else, a proper measure of present fair value, but not where following investment there has been a decided change in price levels. Such a change in price levels is shown by the evidence in this case and besides is a matter of such general and common knowledge that the court must take judicial notice of it. The adoption by the Commission of investment cost less depreciation as the rate base, therefore, is arbitrary and unreasonable, does not conform to statutory requirements and is violative of the due process clause of the 5th Amendment to the Constitution.

EXCLUSION OF WELL DRILLING COSTS

Prior to 1923 Hope and the companies from which it acquired properties charged on their books to expense the labor cost directly involved in drilling new wells and the portion of overhead expense properly allocable thereto. The items so charged amounted to approximately $17,000,000, which, of course, does not take account of depreciation or depletion. Under the system of uniform accounts now prescribed by the Commission, such items are charged, as they should be, to capital investment; and such items since 1923 have been so charged by Hope because of a requirement to that effect in the West Virginia law. In valuing Hope's property, however, the Commission refused to consider in the valuation these items aggregating $17,000,000 (reduced by depletion and depreciation to around $4,000,000), because they had originally been charged on the books to expense, although they clearly represented investment in existing property.

If present fair value be taken as the criterion in determining the rate base, in accordance with our holding as to the legal and constitutional requirements in the premises, there can be no question but that the present fair value of these wells and all elements that have entered into that value must be given consideration, whatever be the method of accounting that Hope may have followed in entering the investment on its books. And, even if the prudent investment theory be adopted for determining the rate base, we see no valid reason for excluding these items from the investment. The wells are existing property used by the utility in its service to the public. The items entered into their cost just as truly as if they had been charged to capital account. No question is raised as to the investment being prudent; and the method of accounting employed with respect to the items cannot change the fact that they represent investment by the company in property which it uses in rendering the service for which rates are prescribed. "Original cost," says Mr. Justice Brandeis in a note to his celebrated dissenting opinion in Southwestern Bell Telephone Co. v. Public Service Commission, 262 U. S. 276, 295, "is the amount actually paid to establish the utility." In this note, which shows very clearly that under the prudent investment theory, historical cost, which is prudent investment, must take account of what the property would have cost on the basis of what normally should have been paid for it. He says:

"Original cost is the amount actually paid to establish the utility. The amount is ascertained, where possible, by inspection of books and vouchers, and by other direct evidence. If this class of evidence is not complete, it may be necessary to supplement it by evidence as to what was probably paid for some items, by showing prices prevailing for work and materials at the time the same were supplied. But the evidence of these prices is merely circumstantial, or corroborative, evidence of the amount actually paid. In determining actual cost, whatever the evidence, there is no attempt to determine whether the expenditure was wise or foolish, or whether it was useful or wasteful. Historical cost, on the other hand, is the amount which normally should have been paid for all the property which is usefully devoted to the public service. It is, in effect, what is termed the prudent investment. In enterprises efficiently launched and developed, historical cost and original cost would practically coincide both in items included and in amounts paid. That is, the subjects of expenditure would coincide; and the cost at prices prevailing at the time of installation would substantially coincide with the actual cost."

The question arose before the Interstate Commerce Commission in connection with the valuation of the New York, Philadelphia

and Norfolk R. Co., 97 I. C. C. 273, 279, where the Commission said:

"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 included 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."

It is argued that the items charged to expense entered into the rates paid by the customers of the company, and that the company may not treat as capital investment the expenditures for property thus paid for by its customers. The answer, of course, is that the customers paid for gas, not for the construction of wells, and that neither the cost of the wells nor the company's ownership thereof is affected by the fact that it may have paid for them with the proceeds of rates that were unreasonably high. A very similar question was before the Supreme Court in Board of Commissioners v. New York Tel. Co., 217 U. S. 23. In that case the company had charged to annual expense an excessive amount for depreciation, which is not different in principle from charging items to expense that should be charged to capital, since in both cases charge to expense is increased and the charge to capital account decreased by the error. In denying a contention that the depreciation reserve thus accumulated, which had been invested in the business, should be used to make up a deficiency

in any year when earnings should be less than a reasonable return, the court said:

"Constitutional protection against confiscation does not depend on the source of the money used to purchase the property. It is enough that it is used to render the service. San Joaquim Co. v. Stanislaus County, 233 U. S. 454, 459; Gas Light Co. v. Cedar Rapids, 144 Ia. 426, 434, affirmed 223 U. S. 655; Consolidated Gas Co. v. New York, 157 F. 849, 858, affirmed 212 U. S. 19; Ames v. Union Pacific Railway Co., 64 F. 165, 176. The customers are entitled to demand service and the company must comply. The company is entitled to just compensation and, to have the service, the customers must pay for it. The relation between the company and its customers is not that of partners, agent and principal, or trustee and beneficiary. Cf. Fall River Gas Works v. Gas & Electric Light Com'rs, 214 Mass. 529, 538. The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory. Galveston Electric Co. v. Galveston, 258 U. S. 388, 395; Georgia Ry. v. R. R. Comm., 262 U. S. 625, 632. And the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations. Profits of the past cannot be used to sustain confiscatory rates for the future. Newton v. Consolidated Gas Co., 258 U. S. 165, 175; Galveston Electric Co. v. Galveston, supra 396; Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission, 292 F. 139, 147. City of Minneapolis v. Hand, 285 F. 818, 823; Georgia Ry. & Power Co. v. Railroad Commission, 278 F. 242, 247, affirmed 262 U. S. 625; Chicago Rys. Co. v. Illinois Commerce Commission, 277 F. 970, 980; Garden City v. Telephone Company, 236 F. 693, 696.

"Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses, or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company, just as does that purchased out of proceeds of its bonds and stock."

See also Smith v. Illinois Bell Tel. Co., 282 U. S. 133, 158, and Lindheimer v. Illinois Tel. Co., 292 U. S. 151.

A question arises as to whether the decision in the Board of Commissioners v. New York Telephone Company, supra, is not in conflict with what was said in Railroad Commission v. Cumberland Tel & Tel. Co., 212 U. S. 414, quoted from and relied on in the brief of the Commission. If there were such conflict, it would be our duty to follow the decision in the New York Telephone case, as it is the latest expression of the Supreme Court on the matter. But rightly understood, there is no conflict in the decisions. In the Cumberland case the court said, "We are not considering a case where there are surplus earnings after providing for a depreciation fund, and the surplus is invested in extensions and additions."

We have considered the cases of which Natural Gas Co. v. Public Service Commission, 95 W. Va. 557, 121 S. E. 716, may be taken as typical, to the effect that, when a company has had its rates fixed by a public service commission on the basis that certain items represent expense of doing business, it may not thereafter treat the same items as representing capital investment. Without questioning the soundness of these decisions, we think that they have no application here. This is the first proceeding for fixing the interstate rates of the company. A proceeding in West Virginia in the year 1921 fixed intrastate rates; but these related to the comparatively small portion of the company's business done in West Virginia and had no relation to interstate sales. It does not appear, moreover, to what extent, if any, the well drilling costs here under consideration were relied upon as expense of operating in the fixing of those rates, or that the rates charged were higher than they would have been if the costs had been charged to capital and the depreciation thereon charged to expense. It is suggested that the local rates of the East Ohio Gas Co. were based upon the interstate charges of Hope; but there were no proceedings before a utility commission for fixing those rates prior to the time that Hope ceased charging the well drilling items to expense, and it does not appear to what extent, if any, the rates of East Ohio as fixed by municipal ordinances and court proceedings were affected by Hope's expensing of these items.

It should be kept in mind that what the Commission must determine is the value of the company's property, whether the method used be the prudent investment method or some other. If the property were being condemned, no one would suggest that items which went into the cost of producing it should not be considered as a part of its cost, whatever method of accounting it had employed. If it were being sold on the basis of cost, no court would exclude such items from consideration. And there is as little ground for excluding them from consideration in a proceed-

ing like this, where value is being determined as a basis for rates which must compensate the company for the gradual sale of its property through use as well as provide a return upon its investment. Certainly if the company had charged to capital investment items which should have been charged to expense, there would be no excuse for not eliminating them in the valuation of the property; and there is as little excuse for not considering as capital investment items erroneously charged to expense. Bookkeeping which does not reflect realities must not be allowed to obscure the real nature of the inquiry.

DEPRECIATION

It is elementary that, whatever method be adopted for arriving at the valuation of the property, account must be taken of accrued depreciation. The Commission computed accrued depreciation by applying the straight-line service-life method to its properties, i. e. by finding a rate of depreciation based on the average service life of property, multiplying this by the years the property had been in use, and applying this percentage to the book cost of the property. The unit of production method was applied to "plant costs associated with gas supply".* Hope offered evidence of the present condition of the property, but this was condemned by the Commission as unreliable, and no consideration was given to present condition, other than that arrived at by applying the straight-line service-life formula as the measure of depreciation.

Hope contends that the application of the Commission's formula to book cost results in consequences which are inequitable and absurd in the light of existing facts. Thus, it points out that its well equipment having a book cost at the end of 1938 of $7,610,510 was depreciated to $3,222,807, or 42.4% of its cost, whereas the salvage value of such equipment over the past 10 year period has been 65.2%. Field line equipment having a book cost of $7,934,169 was depreciated to $4,088,602, or 51.5%, although the gross salvage value of such material has been 56.7%. Counsel for the Commission challenge the use of the term "salvage value" in connection with this property; but, without going into this controversy, it is sufficient to say that the Commission's method results in a depreciated value which is less than that which the company has accorded similar property under its system of accounting when removed from its wells or lines and held for further use. Other instances of absurd and inequitable consequences resulting from

*Hope complains also that, in the case of property acquired from other companies which had been taken over by Hope, the Commission deducted the depreciation reserve of those companies from book cost, even though it exceeded straight-line service-life depreciation accrued at the time. In the view that we take of the broader question, however, it is not necessary to go into this.

the application of the Commission's formula to book cost are called to our attention; but it is unnecessary to go into them here.

Many of the consequences complained of will be eliminated when the present value of the property is considered in the light of changed price levels and the depreciation percentage is applied to the higher valuations resulting. We think, however, that the Commission may not close its eyes to the actual present condition of the property in determining present value and compute depreciation on the basis of mere formulas, as it has done in this case. The formulas which it has used are undoubtedly important matters for it to take into consideration; but its duty, under the law, is to determine the present fair value of the property, and this cannot be done without consideration being given to its actual physical condition. The point was directly involved in McCardle v. Indianapolis Water Co. 272 U. S. 411, 416. In that case deduction for depreciation based on the sort of formulas used here without consideration of the actual condition of the property was disapproved by the Supreme Court, the Court saying:

"There is deducted approximately 25 per cent of estimate cost new to cover accrued depreciation. The deduction was not based on an inspection of the property. It was the result of a 'straight line' calculation based on age and the estimated or assumed useful life of perishable elements. The commission's report indicates that the property is well-planned, well-maintained and efficient. Its chief engineer inspected it, and estimated its condition by giving effect to results of the examination and to the age of the property. He deducted about six per cent to cover depreciation. Mr. Hagenah made an estimate of existing depreciation based on actual inspection and a consideration of the probable future life as indicated by the conditions found. He deducted less than six per cent. Mr. Elmes testified that he made an inspection and estimate of all the actual depreciation. He estimated $443,044 would be required to restore the property as of appraisal date to its condition when first installed and put in practical operation. He deducted that amount. The testimony of competent valuation engineers who examined the property and made estimates in respect of its condition is to be preferred to mere calculations based on averages and assumed probabilities. The deduction made in the city's estimate cannot be approved."

This was but a restatement of the doctrine laid down in Pacific Gas & Electric Co. v. San Francisco 265 U. S. 403, 406, where the court said:

"Appellant objects to the application of this method and insists that depreciation should have been ascertained upon full consideration of the definite testimony given by competent ex-

perts who examined the structural units, spoke concerning observed conditions and made estimates therefrom. As these examinations were made subsequent to the alleged depreciation for the definite purpose of ascertaining existing facts, we think the criticism is not without merit. Facts shown by reliable evidence were preferable to averages based upon assumed probabilities. When a plant has been conducted with unusual skill the owner may justly claim the consequent benefits. The problem was to ascertain the probable result of the specified rate if applied under well-known past conditions, not to forecast the probable outcome of a proposed rate under unknown future conditions."

See also B. & O. R. Co. v. United States 298 U. S. 349, 378, where it is said "* * * that opinion of experts unsupported by adequate actual tests may not safely be substituted for concrete data."

In dealing with this subject, Bauer & Gold, after analyzing the broad concept of depreciation contained in the case of Knoxville v. Knoxville Water Co., 212 U. S. 1, go on to say (Public Utility Valuation for Purposes of Rate Control pp. 218–219):

"The Court doubtless intended to deal comprehensively with depreciation in the Knoxville case. It declared that due current provisions may be made as an operating cost and that all actual depreciation due to expired service life shall be deducted in the determination of fair value. The amount of deduction, however, was left as a matter of proof to be determined through evidence. Its determination, just as the establishment of reproduction cost new, depends upon affirmative proof. The same applies to every phase of valuation. No item can be included or deducted without valid basis of fact. Determination of reproduction cost new, or the primary valuation however determined, is one process; deduction for depreciation is a second. Each must be based upon facts. Neither can be taken out of the air nor based upon hypothetical or theoretical calculations and analyses."

And as bearing upon the necessity of inspection and the weight to be accorded evidence based thereon, it is said at page 220 of this comprehensive and well-considered work:

"Emphasis has been laid upon inspection as against calculation by formula in relation to expired life. The decisions, however, have not rejected the conception that depreciation consists of expired life. They have merely relied upon results of inspection as against abstract calculations of expired life that have not been checked against the realities as determined through physical inspection. While life tables may be important as general guidance, in a particular property or unit the economic life may be much greater or much less than the average presented in a life table. As a calculation based on life tables, expired life

of a unit may be 50%, but in reality it may be only 10% because of special conditions relating to the particular item. Conversely, however, theoretical calculation may show expired life of only 10%, while actual depreciation may be 50%.

"The differences in operating and maintenance conditions are so great between utility properties that inspection is necessary to determine reasonably the ratio of expired to total economic life of the different units. The object of examination is determination of this ratio. This may involve estimates as to remaining and relative expired life. But it would be judgment based upon actual inspection rather than upon mere theoretical calculations without regard to the actualities of the property."

Included in accrued depreciation by the Commission were items of $2,107,261 based upon the cost of future abandonment of gas wells and $722,757 upon the cost of future abandonment of other property. Contention is made that, in addition to the error of disregarding the present physical condition of the property in computing depreciation, there was error in adding to depreciation this accrued portion of the cost of future abandonment of property. We cannot agree with this contention. Prior to 1939, the cost of abandonment it is true, had been charged to expense as it occurred. Under the Commission's system of accounting, however, the company was required to set up a depreciation reserve to provide for future abandonment; and in computing depreciation here, the portion of the depreciation reserve already accrued was added. The principle applied was manifestly correct. The future cost of abandonment constituted a charge against the property, which would have to be met whatever system of accounting was followed; and as the property was used, account should have been taken of this item as well as of investment already made. The cost of abandonment is not a matter which concerns only the last year of use and can therefore be considred an expense of that year. It is a matter which affects the entire cost of the property and must be taken into consideration throughout its entire useful life.

If a well, for example, had cost $10,000 and abandonment cost will amount to $1,000, the $1,000 as well as the $10,000 must be taken into account in fixing rates and depreciation as the well is used; and, assuming a life of 20 years, it is clear that at the end of 10 years the value consumed through use is not merely $5,000, or half the original investment, but $5,500, or half the total cost including the cost of abandonment. A purchaser at the end of ten years would not be justified in paying more than $4,500 for the well, because the abandonment cost of $1,000 would fall on him, and the use of the well for the remaining ten year period would only be worth a total of $5,500 from which the abandonment cost

would have to be paid. (In the illustration, no account is taken, as it should be, of the fact that the abandonment cost is to be incurred in the future and that the present worth of the sums required for abandonment, and not the principal sum, is the amount properly to be considered.) In arriving at the present value of the property, therefore, deduction must be made for the accrued portion of future abandonment cost allocable to the property as well as for depreciation in the investment already made in it, otherwise an inflated valuation will result. In computing the accrued portion, allowance must be made, having in mind the interest bearing quality of money, for the fact that the expenditure is to be made in the future. This is a matter of accounting which it is not necessary to elaborate here. The point is that, in arriving at the present value of the property, it is proper to include in depreciation the accrued portion of future abandonment cost properly computed.

OTHER MATTERS AFFECTING THE RATE BASE

Capital additions since 1940. The Commission accepted Hope's estimate of fixed capital expenditures for the years 1941, 1942, and 1943, amounting to $8,956,500. It deducted expenditures in expectation of new or increased business amounting to $1,270,000 and gross property retirements of $2,700,000, making an estimated net change in plant of $4,986,500. From this it deducted estimated net change in depletion and depreciation reserve after elimination of retirement losses chargeable against reserve, and found an estimated increase in net actual legitimate cost over the three year period of $2,784,042. This was divided by two, as the rate order became effective at approximately the middle point of the three year period, or July 15, 1942. The capital addition thus arrived at was $1,392,021. We find no error in this method. Hope complains of the refusal of the Commission to allow the estimated expenditure of $1,270,000 in expectation of new or increased business; but this was purely a matter of estimate, and we cannot say that the action of the Commission with respect thereto was erroneous or arbitrary.

Working capital. The Commission allowed $2,125,000 for working capital. Of this amount $1,228,599 was for material and supplies and is not subject to dispute. $896,401 was for cash working capital. This was arrived at by using 45 days as the lag in the receipt of revenues, and on this basis dividing by eight (as 45 days is the eighth part of a year) annual operating expenses, exclusive of gas purchases, taxes, and depreciation expenses. Since the gas which Hope purchases is paid for by its customers before it pays the producers for that gas, and since taxes are paid

long after the revenues to which they relate have been collected, we cannot say that there was anything erroneous or arbitrary in eliminating all allowance for gas purchases and taxes from this calculation. Had this been done in Hope's estimate, the result would have been $277,820 less than the amount allowed by the Commission. There is manifestly no error in this connection, therefore, of which Hope can reasonably complain.

OPERATING EXPENSES

Annual depreciation allowance. Hope complains because the Commission, in computing annual depreciation as an operating expense, has applied the rate arrived at by the straight-line service-life method above described to the original book cost of the property and, in addition, has excluded from consideration the items of approximately $17,000,000 representing well-drilling costs heretofore charged to expense. It is clear, we think, that annual depreciation must be computed on the basis of the present fair value of the property. The question was before the Supreme Court in United Railways and Electric Co. v. West 280 U. S. 234, 253-254, where the court said:

"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. *It is the settled rule of this Court that the rate base is present value, and it would be wholly illogical to adopt a different rule for depreciation.* As the Supreme Court of Michigan, in Utilities Commission v. Telephone Co. 228 Mich. 658, 666, has aptly said: 'If the rate base is present fair value, then the depreciation base as to depreciable property is the same thing. There is no principle to sustain

a holding that a utility may earn on the present fair value of its property devoted to public service, but that it must accept and the public must pay depreciation on book cost or investment cost regardless of present fair value. We repeat, the purpose of permitting a depreciation charge is to compensate the utility for property consumed in service, and the duty of the commission, guided by experience in rate making, is to spread this charge fairly over the years of the life of the property.'" [Italics supplied.]

While Mr. Justice Butler in a note to his concurring opinion in Lindheimer v. Illinois Telephone Co. 292 U. S. 151, 176, stated that the method of computing depreciation there was not in harmony with the principle of the decision in United Railways v. West, there is nothing to indicate that the court intended to overrule that decision. The question in the Lindheimer case was whether charges to depreciation were not excessive in view of expenditures for current maintenance and the proved condition of the property. The affirmative answer given to that question by the court lends no support to the position that, in computing depreciation, the present value of the property may be ignored and depreciation be computed by applying to original cost the straight-line formula. In so far as the decision may be said to have any bearing at all upon that question, it supports the contrary position.

In Federal Power Commission v. Natural Gas Pipeline Co. 315 U. S. 575, 592, the Supreme Court dealt with an amortization allowance for a "wasting-asset business of limited life." The court said:

"We need not now consider whether, as the Government urges, there can in no circumstances be a constitutional requirement that the amortization base be the reproduction value rather than the actual cost of the property devoted to a regulated business. Cf. United Railways Co. v. West, 280 U. S. 234, 265. It is enough that here the business, by hypothesis, will end in 1954, and that the amortization base, computed at cost and including property already retired, will be completely restored by 1954 by the annual amortization allowances."

Here we are dealing not with a "wasting-asset business of limited life," but with an ordinary public utility which is required by law to continue its service to the public. One of the principal reasons for determining the present fair value of its property is that rates may be fixed which will take account of depreciation based on that value in such way as to permit replacements at current prices so as to maintain the level of efficiency. This purpose will be defeated, if depreciation is allowed on the basis of cost, where cost is less than present fair value. It will be defeated too, if a portion of the property used is excluded from the depreciated

base. The use of the straight-line service-life method of depreciation, like the prudent investment theory of valuation, has the merit of simplicity and ease of application. It can unquestionably be taken into consideration in arriving at depreciation. The Supreme Court has not yet said, however, that it may be used exclusively in cases where, because of change in price levels, cost does not represent fair present value; and the decision in United Railways v. West, supra, which has never been overruled, is squarely to the contrary.

In the present state of the law, it would seem clear that, if the present fair value of the property is found to be either greater or less than the original cost of the property less straight-line service-life depreciation, a proper allowance for the difference should be made in computing annual depreciation chargeable as expense. As pointed out by Mr. Justice Stone in his dissenting opinion in United Railways v. West, supra, however, the question is not a question of law but one of fact for determination by the Commission on all the evidence before it; and, as said in the work on Depreciation by the Staff of the Public Service Commission of Wisconsin (1933) p. 136: "While, as a practical measure, we are convinced that original cost is the proper basis for computing depreciation charges, nevertheless we believe that until the doctrine of the court regarding fair value is changed to prudent investment, it is at least not practical nor plausibly consistent in theory to compute depreciation on any base other than fair value."

And we do not think it proper to ignore, as the Commission did, the element of expense attributable to the depreciation of capital added to rate base after 1940. New property used by the company is subject to depreciation as well as old property; and we see no reason why annual depreciation with respect to the additions made to capital between 1940 and the effective date of the rate order should not have been considered as an element of expense.

Return from gasoline and butane operations of affiliate. Hope Construction and Refining Company, another Standard Oil subsidiary, extracts gasoline and other byproducts from the natural gas produced by Hope. This is in reality a part of Hope's natural gas business, although carried on by an affiliate. The Commission credited to Hope the portion of the profits realized by the affiliate after allowing cost of processing and 6½% return upon net investment. Although this results in crediting to the utility a greater portion of the net profits of the operation of the subsidiary than is ordinarily credited in such cases, we cannot say that the action of the Commission is so arbitrary and unreasonable as to be invalid; and it is well settled that, in the absence of arbitrary action resulting in a confiscatory rate, we may not substitute our judgment of what is right and proper for that of the Commission.

Federal income tax. It is elementary that taxes, including income taxes paid the federal government, are proper elements of expense of operation. The Commission found that $76,579 was a proper amount to allow for federal income tax for the future, although the evidence was that Hope paid $912,313 in federal income tax in 1940. Hope contends that the Commission, in adjudging its 1940 rates to be unreasonable, computed its income tax liability at a figure no greater than that estimated for the future, notwithstanding it had actually paid $912,313 on account of federal income tax in that year. As we have reached the conclusion, as stated more fully hereafter, that the Commission was without power to make findings as to the reasonableness of past rates, except as incidental to fixing rates for the future, we need not determine what allowance should be made for income tax in 1940. So far as rates for the future are concerned, changes in tax laws render irrelevant a discussion of the Commission's figures. In further proceedings to establish rates for Hope, due consideration will doubtless be given to federal income tax liability in estimating necessary expenses of operation, based upon what income tax Hope will be required to pay on income derived from rates found to be reasonable.

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. Texas, 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.

Other matters affecting operating expenses. Hope's contention as to depreciation and return on distribution properties is sufficiently covered by what we have heretofore said about the neces-

sity of ascertaining present fair value. The contention that $165,963 for drilling a dry well should have been charged to expense in 1940 seems well taken; but the matter can have little bearing in future hearings, as the test period will doubtless cover 1941 as well as 1940 and it will be immaterial which year carries the charge. The amortization of rate case expense over a ten year period seems to be reasonable. It is to be hoped that rate controversies will not be matters of annual occurrence. Driscoll v. Edison Light & Power Co., 307 U. S. 104, 121.

RATE OF RETURN

The Commission fixed the rate of return at 6½%. There is no controversy as to the rule applicable in determining the rate. "What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. 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 that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." Bluefield Water Works & Improvement Co. v. Public Service Com'n, 262 U. S. 672, 692.

Under this test we think that the rate of return of 6½% is reasonable. Hope is a well established natural gas company with markets in the industrial regions of Ohio and Pennsylvania protected through its affiliates East Ohio Gas Co. and Peoples Natural Gas Co. As a subsidiary of Standard Oil it has financial advantages that independent utilities do not possess. Cf. Wabash Valley Electric Co. v. Young, 287 U. S. 488, 501. The record shows that profits earned by industrial corporations on invested capital declined from 11.3% in 1929 to 7.5% by 1940. Profits of railroads declined to 3.3% and of utilities to 5.4%. Interest rates are at a low level and rates of return demanded by investors are among the lowest that have ever existed. Securities of natural gas companies were sold at rates between 3% and 6%, with yields on the bulk of bond issues being between 3% and 4½%. Under such circumstances, a finding that 6½% is a reasonable rate of return cannot

be disturbed. A like rate of return was approved by the Supreme Court for natural gas companies in Dayton Power & Light Co. v. Com'n, 292 U. S. 290, 311, and Federal Power Com'n v. Natural Gas Pipeline Co., 315 U. S. 575, 569.

PAST RATES

The Commission, while fixing rates to become effective July 1, 1942, found that the rates charged by Hope from June 30, 1939 to that date were unreasonable and unlawful and that the charges to the East Ohio Gas Company were "unjust, unreasonable, excessive and therefore unlawful to the extent of $830,892 during 1939, $3,215,551 during 1940, and $2,815,789 on an annual basis since 1940." It states that it made this finding because the City of Cleveland had raised the question of the lawfulness of the rate charged the East Ohio Gas Company by Hope and had requested that the Commission find the just and reasonable and lawful rate from June 30, 1939, to the date of the Commission's determination "as an aid to state regulation." With respect to its power to take such action, the Commission said:

"The Commission does not have the authority to fix rates for the past and to award reparations. But Congress did empower and instruct the Commission in section 5 (a) of the Natural Gas Act to fix future rates, and as a step in that process we must necessarily consider the reasonableness of past and existing rates. When the issue is raised and the public interest will be served, we consider as a necessary part of that duty the power to examine the entire rate problem involved and to determine what rates were lawful in the past. Also, section 14 (a) of the Act authorizes the Commission to investigate any facts which it finds necessary in order to determine whether Hope has violated any provision of the Natural Gas Act. Furthermore, the Commission has power to perform any act, pursuant to section 16, which is necessary or appropriate to carry out the provisions of the Act. Under section 4 (a) of the Act any interstate wholesale rate that is not just and reasonable is unlawful. Federal Power Commission v. Natural Gas Pipeline Co., 315 U. S. 575. Hope's rate collected from East Ohio Gas Company was lawful after June 21, 1938, the effective date of the Act, only to the extent that it was just and reasonable. The City of Cleveland states that the Ohio Commission is investigating the reasonableness of the East Ohio Gas Company's bonded retail rates in Cleveland for the period since June 30, 1939, and that the lawfulness of Hope's rate is an important factor in the case. Since the enactment of the 1938 Natural Gas Act this Commission has had exclusive jurisdiction to determine the lawfulness

540917 O - 43 - 13

of the interstate wholesale rates charged by Hope and other natural gas companies.

"In response to the request of the City of Cleveland, the Commission will make the appropriate findings of fact as to the lawfulness of the rates charged East Ohio by Hope since June 30, 1939. The Interstate Commerce Commission has furnished precedents for the performance of this public duty. Congress intended that this Commission cooperate with State Commissions and municipalities, and the provisions of sections 5 (b) and 17 are special evidence of such intent."

The fundamental difference between quasi-legislative and quasi-judicial power is that the one is concerned primarily with prescribing regulations for the future, the other with determining rights in the light of what has occurred in the past. Cf. Baer Bros. v. Denver & R. G. R. Co. 233 U. S. 479, 486. The Natural Gas Act shows clearly that it was the intention of Congress to give the Commission quasi-legislative power, i. e. regulatory power as to future rates; but there is no indication of any intention to clothe it with judicial or quasi-judicial powers with respect to past charges or practices, such as was vested in the Interstate Commerce Commission by section 9 of the Interstate Commerce Act. 49 USCA 9. 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 commission. 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.

Section 4 (a) of the Natural Gas Act, to which the Commission refers in its opinion, merely provides that rates shall be "just and reasonable" and declares unlawful a rate that is not "just and reasonable". Section 14 (a) provides for nothing except investigations by the Commission to determine whether or not the act is being violated. The only power with respect to fixing rates is that contained in section 5 (a) heretofore quoted, which is confined to prescribing rates for the future. Section 16, to which the Commission refers, merely clothes the Commission with power to perform all acts etc. necessary or appropriate to carry out the provisions of the Act. Certainly no power to make findings as to past rates is contained there. Section 5 (b) authorizes the Commission, upon its own motion or upon request of a state com-

mission, to investigate and determine the cost of production or transportation of natural gas, not to fix past rates or to do the same thing indirectly by determining that amounts collected in the past exceeded reasonable rates. Section 17 does no more than authorize the Commission to refer any matter arising in the administration of the act to a board, members of which are to be nominated by state commissions, and to authorize the Commission to confer with state commissions and hold joint hearings with them in connection with any matter "with respect to which the Commission is authorized to act", and to authorize the Commission, in the administration of the act, to avail itself of the cooperation, services etc. of state commissions.

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. Instead of saying so, however, Congress clearly limited the power of the Commission to that of fixing rates for the future by the following provision of section 5 (a): "The Commission shall 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". [Italics supplied.] It is to be noted that in the passage of the Public Utility Act of 1935, upon which the Natural Gas Act is modeled, provisions giving the Commission power to investigate single rates and issue reparation orders, originally incorporated in the bill, were stricken out, the Senate Committee saying in its report: "They are appropriate sections for a state utility law, but the committee does not consider them applicable to one governing merely wholesale transactions". The Commission may not by administrative interpretation of the act thus clothe itself with a power denied it by Congress. As was said by Mr. Chief Justice Groner in Chenery Corp. v. Securities and Exchange Com'n D. C. App. 128 F. 2d 303, 311:

"In expressing this opinion, we are not saying that the Commission's view is not directed to a desirable end. As to that, opinions of men of experience and probity and judgment will differ widely. But, if the Commission's objective is to be attained, it should be only after the pros and cons have been carefully weighed in their relation, respectively, to the dangers and the benefits, and the scales should be controlled by Congress and not by the Commission. In short, all that we hold is that this vital question of policy is one for the Congress and not for the Commission."

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. The suggestion in the Commission's brief that exercise of power as to past rates is necessary to obviate injustices resulting from delay in rate proceedings lacks force in view of the provision of the statute for the entry of interim orders. Sec. 16. Cf. Federal Power Com'n v. Natural Gas Pipeline Co. 315 U. S. 575, 583.

As a step in the process of fixing rates for the future, it was of course proper for the Commission to make findings with respect to the conditions and rates of the past, and we shall construe the findings as made pursuant to that power, and as subject to review like other findings made in support of the order. When so considered, they are invalidated by the same errors that vitiate the findings upon which the order fixing rates for the future is directly based.

It is argued that we are without power to review the findings as to past rates because no order is based thereon; but, as stated above, they are reviewable because made as a step in the proceeding to fix rates for the future. If, however, they be considered separate and apart from this and it be thought, contrary to our view, that the Commission has power to make such findings as to past rates "as an aid to state regulations", we think, nevertheless, that there can be no question as to their being reviewable under the statute. Such determination in that case would be, in effect, an order of the Commission affecting substantial rights and contractual relationships of a party to a proceeding before it and would be reviewable as such, whatever it might be called. Columbia Broadcasting System v. United States 316 U. S. 407; Rochester Telephone Corp. v. United States 307 U. S. 125. As said by Mr. Chief Justice Stone in the Columbia Broadcasting case, supra, with respect to whether particular action by the Commission constituted a reviewable order: "The particular label placed upon it by the Commission is not necessarily conclusive, for it is the substance of what the Commission has purported to do and has done which is decisive. Powell v. United States 300 U. S. 276, 284–85; A. F. of L. v. Labor Board 308 U. S. 401, 408." And as said by Mr. Justice Frankfurter in his concurring opinion in that case: "If an administrative determination of status has the effect of subjecting a person to legal obligations, whether embodied in statute or previously formulated administrative commands, or otherwise affecting legal

rights, such a determination possesses the elements of a reviewable order." A finding by the Commission which determines that past rates are unlawful in a determined amount, and which is to be given effect by a state regulatory body in determining the reasonableness of rates charged on the basis thereof, certainly affects legal rights; and the power of review under the statute should be coextensive with the power of the Commission to make such determination.

In any view of the matter, therefore, the findings as to past rates are reviewable, and should be set aside for the reasons heretofore given in discussing valuation and depreciation. We are impressed, also, with the thought that the finding as to unreasonableness of these rates cannot be sustained because made on the basis of the utility's experience during the years in question, instead of upon a reasonable estimate of expense based upon experience of a prior period. The reasonableness of a rate must be judged in the light of information available at the time it is charged, not in the light of subsequent developments. It is manifestly impractical to conduct a wholesale natural gas business on the basis of annual changes in rates; and certainly it is unreasonable that rates be condemned retroactively on the basis of facts which could not have been known when they were charged.

For the reasons stated, the order of the Commission will be set aside and the cause will be remanded for further proceedings.

Reversed and Remanded.

DOBIE, Circuit Judge, dissenting:

I regret that I must dissent from the majority opinion. The importance of this case, and the wide interest in the vital questions involved, prompt me to set out, very briefly, the reasons for my dissent.

Under the majority opinion, the decision of the Federal Power Commission is reversed on three principal grounds: (1) The adoption by the Commission of the Prudent Investment Theory in fixing the rate-base; (2) The use by the Commission of the Economic Service Life Method in arriving at depreciation; (3) The refusal by the Commission to allow as capital outlay the well-drilling costs which Hope had previously charged to operating expenses.

(1) The Prudent Investment Theory.

The Commission, in arriving at the proper rate-base, frankly and openly adopted the Prudent Investment Theory and paid no attention to the present value of the properties of Hope. Mr. Justice Brandeis, in his classic concurring opinion (Mr. Justice Holmes joined in the opinion) in State of Missouri ex rel. South-

western Bell Telephone Co. v. Public Service Commission of Missouri, 262 U. S. 276, has set forth, with his customary incisive clarity, the Prudent Investment Theory, together with the reasons for his belief in that theory. To my mind, the arguments he therein advances have never been convincingly refuted.

Nearly twenty years have slipped by since that opinion was handed down. During this period, the pronouncements of the United States Supreme Court in this field have been many, varied and quite confusing. This fact has been pointed out by writers whose names are thrice legion. The recent case (involving the Natural Gas Act, with which we are also concerned) of Federal Power Commission v. Natural Gas Pipeline Co., 315 U. S. 575, however, does call for some comment.

The majority opinion in that case (written by Chief Justice Stone) contains no express discussion of the Prudent Investment Theory and certainly does not in precise terms sanction the use of that theory alone. Interesting, though, in this connection is the oft-quoted statement of Chief Justice Stone (315 U. S. at page 586):

"The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end."

But the concurring opinion of Justices Black, Douglas and Murphy, on the specific point under discussion, is as clear as crystal and as crisp as bacon; for this opinion flatly and squarely upholds the validity of the application of the Prudent Investment Theory, to the exclusion of any other theory (315 U. S. at page 606) in three sentences so free from ambiguity that they cannot be misunderstood:

"As we read the opinion of the Court, the Commission is now freed from the compulsion of admitting evidence on reproduction cost or giving any weight to that element of 'fair value'. The Commission may now adopt, if it chooses, prudent investment as a rate base—the base long advocated by Mr. Justice Brandeis. And for the reasons stated by Mr. Justice Brandeis in the *Southwestern Bell Telephone* case, there *could be no constitutional ob-*

jection if the Commission adhered to that formula and rejected all others." [Italics ours.]

It is difficult for me to believe that the majority of the Supreme Court, believing otherwise, would leave such a statement unchallenged.

A careful study of the Natural Gas Act (particularly the precise wording of Section 6) convinces me that Congress intended to give to the Federal Power Commission a wider latitude and a more extended discretion than had been given to any other federal board or commission under any previous statute in the field of rate making.

Further, I think that the methods adopted by the Commission under the Prudent Investment Theory, in arriving at a rate-base in the instant case, were neither fanciful nor arbitrary. It seems to me, too, that there was substantial evidence to support the opposite findings of the Commission.

Accordingly, I see here no adequate reasons for reversing on this score the decision and findings of the Commission.

(2) The Economic Life Service Method of Computing Depreciation.

In computing depreciation and depletion, the Commission employed the Economic Life Service Method. This formula has long been known to, and has been frequently applied by, economists and accountants. It seems to have been often used in connection with depreciation under the federal income tax. I cannot find in this formula any active germs of constitutional invalidity, as it is applied to the instant case.

The Commission based its determination of existing depletion and depreciation upon actual legitimate cost of the properties of Hope. An apparently competent engineer inspected this property to obtain information that would serve as a guide for estimating the property's service life and the amount of money required annually to reimburse Hope for so much of this property as might be consumed in rendering service to the public.

Incidentally, the amount deducted by the Commission fell short by many millions of dollars of the amount accrued and set up by Hope for depreciation and depletion. In his partially dissenting opinion Commissioner Scott expressed the view that the Commission had been, in fixing the amount for depreciation and depletion, far too lenient with Hope.

Again I feel that there was substantial evidence to sustain the Commission's findings under a formula which was neither unrealistic nor capricious.

(3) Disregard of Drilling Costs Charged by Hope to Operating Expenses.

The Commission refused to allow as capital the amount of drilling cost which Hope had in the past charged to operating expenses. The Commission found (and I think this finding is supported by the evidence) that these costs had been considered by Hope in fixing its rates in previous years and that these costs had already been paid by the consumers. On this ground, the Commission declined to include these costs in arriving at the rate-base.

It was the practice of Hope, prior to 1923, to charge well-drilling costs to operating expenses rather than to capital account. In so doing, Hope seems to have followed the then general procedure of the natural gas industry. It changed this practice under a requirement of the Public Service Commission of West Virginia. The present system of accounting prescribed by the Federal Power Commission also follows the West Virginia practice. It is my considered opinion that the present procedure is the proper one.

It is to be noted that this is not a mere mathematical error in book-keeping, which of course, should be corrected. It is rather an accounting policy. It does not seem to me to be vital whether the decision of the Commission here is based upon technical estoppel, equity or fair dealing. And once more, I think the Commission should be here sustained. Under its present claim, Hope seeks to impeach its books, which were competently kept for a long period of years under the older method. And Hope itself, in a previous rate case before the Public Service Commission of West Virginia, claimed these well-drilling costs as operating expenses, its contention was allowed, and its rates were fixed accordingly.

The holding of the Commission here is sustained by the great weight of authority. In the Commission's brief, these authorities are set out at great length, and include decisions of federal courts, decisions of state courts, and decisions of State Utility Commissions. Quite striking here, I think, is an extract from the majority opinion in the recent Natural Pipe Line case (315 U. S. at pages 590, 591):

"Here the companies, though unregulated, always treated their entire original investment, together with subsequent additions, as capital on which profit was to be earned. They charged the out-of-pocket cost of maintenance of plant, whether used to capacity or not, as operating expenses deductible from earnings before arriving at net profits. *They have thus treated the items now sought to be capitalized in the rate base as operating expenses to be compensated from earnings, as in the case of regulated companies.* * * * *We cannot say that the Commission has deprived the companies of their property by refusing to permit them to earn for the future a fair return and amortization on the costs of maintenance of initial excess capacity—costs which the companies fail to show have not already been recouped from earnings before com-*

puting the substantial 'net profits' earned during the first seven years." [Italics ours.]

For the reasons stated, I think the decision and findings of the Commission should be affirmed.

United States Circuit Court of Appeals, Fourth Circuit

No. 4979

HOPE NATURAL GAS COMPANY, PETITIONER
vs.
FEDERAL POWER COMMISSION, CITY OF CLEVELAND, CITY OF AKRON, AND PENNSYLVANIA PUBLIC UTILITY COMMISSION, RESPONDENTS.

On Petition for Review of Orders of the Federal Power Commission

Decree

Filed and Entered February 16, 1943

This cause came on to be heard upon the petition of the Hope Natural Gas Company to review and set aside certain orders issued against it by the Federal Power Commission on the 26th day of May, 1942, in proceedings before said Federal Power Commission numbered G–100, G–101, G–113 and G–127, entitled "City of Cleveland, Complainant, vs. Hope Natural Gas Company, Defendant"; "City of Akron, Complainant, vs. Hope Natural Gas Company, Defendant"; "In the Matter of Hope Natural Gas Company", and "Pennsylvania Public Utility Commission, Complainant, vs. Hope Natural Gas Company, Defendant", respectively, and upon the transcript of record in said proceedings certified and filed in this Court; and the said cause was argued by counsel.

On consideration whereof, it is ordered, adjudged, and decreed by the United States Circuit Court of Appeals for the Fourth Circuit, that said orders of the Federal Power Commission in said proceedings be, and the same are hereby, set aside; and that this cause be, and the same is hereby, remanded to the said Federal Power Commission for further proceedings in accordance with the opinion of the Court filed herein.

JOHN J. PARKER,
Senior Circuit Judge.

MORRIS A. SOPER,
U. S. Circuit Judge.

I dissent. A. M. DOBIE, *U. S. Circuit Judge.*

[Endorsed:] "Filed and entered February 16, 1943. Claude M. Dean, Clerk, U. S. Circuit Court of Appeals, Fourth Circuit."

March 5, 1943, petition of the respondents for a stay of the mandate is filed.

Order staying mandate pending application for a writ of certiorari

Filed and entered March 8, 1943

(Style of court and title omitted)

Upon the application of the Respondents, by their counsel, and for good cause shown,

It is ordered that the mandate of this Court in the above entitled cause be, and the same is hereby, stayed pending the application of the said Respondents in the Supreme Court of the United States for a writ of certiorari to this Court, unless otherwise ordered by this or the said Supreme Court, and provided said application is filed in the said Supreme Court within 30 days from this date.

JOHN J. PARKER,
Senior Circuit Judge.

MARCH 8TH, 1943.

Clerk's certificate

UNITED STATES OF AMERICA,
Fourth Circuit, ss:

I, Claude M. Dean, Clerk of the United States Circuit Court of Appeals for the Fourth Circuit, do certify that the foregoing four (4) volumes is a true copy of the supplement to brief of petitioner; respondents' appendix, volume I (pleadings, orders, and oral testimony); respondents' appendix, volume II (exhibit book with explanatory statements), and the proceedings in the said Circuit Court of Appeals in the therein entitled cause, as the same remain upon the records and files of the said Circuit Court of Appeals, and constitute and is a true transcript of the record and proceedings in the said Circuit Court of Appeals in said cause, made up in accordance with the directions of the Solicitor General of the United States, for use in the Supreme Court of the United States on an application for a writ of certiorari.

In testimony whereof, I hereto set my hand and affix the seal of the said United States Circuit Court of Appeals for the Fourth Circuit, at Richmond, Virginia, this 13th day of March A. D. 1943.

[SEAL] CLAUDE M. DEAN, *Clerk,*
U. S. Circuit Court of Appeals, Fourth Circuit.

SUPREME COURT OF THE UNITED STATES

No. 34, October Term, 1943

Order allowing certiorari.—Filed May 17, 1943

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

SUPREME COURT OF THE UNITED STATES

No. 35, October Term, 1943

Order allowing certiorari.—Filed May 17, 1943

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.