

June 2014

Rate Making and Judicial Review (An Address)

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RATE MAKING AND JUDICIAL REVIEW*

PERHAPS the most engrossing topic of discussion in the last few months, is the subject of fixing rates to be charged by public utilities. There has been so much confusion and apparent misunderstanding on the subject, that it might be of interest to discuss with you, a body of lawyers, some aspects of rate making and regulation in so far as the federal courts are concerned.

"The legal theories and the technique of procedure for ascertainment of what is a case of confiscation of a business devoted to a public use or service, should be of interest to any group of lawyers. It is the duty of lawyers to advise the public of the ways of the law, and surely you should make use of this opportunity to correct some very wrong impressions created by the public press on this phase of our constitutional protection.

"Article 3 of the Constitution of the United States provides that the judicial power of the United States shall be vested in one Supreme Court and in such inferior courts as Congress may, from time to time, ordain or establish. Section 2 of that article provides that the judicial power shall extend to all cases in law and in equity arising under the Constitution, the laws of the United States, &c. And the Fourteenth Amendment forbids any state to make or enforce any laws which shall deprive any person of life, liberty or property without due process of law or deny to any person within its jurisdiction, the equal protection of the law. It is the deprivation of property, without due process of law, that warrants the public utilities to make contest against any state regulatory bodies created by statute when the rates fixed by those bodies constitute a confiscation of property.

"As long as there is a district court of the United States or a circuit court of appeals, both of which have been ordained and established, the injunctive power of either or both will survive and may be used by any utility in protection of its property where an attempt is made to fix rates which, if enforced, would amount to confiscation of property. It is difficult for any student of the law, certainly impossible for a constitutional lawyer, to conceive of any way that Congress may take from the federal courts their power and duty to protect property about to be confiscated by regulation of any state or municipality.

"The law has placed safeguards about the constitutional protection given property. In rate making controversies or whenever the constitution is brought into question in a case in the district court, the law requires the judge presiding to call to his assistance two other judges, one of whom must be a Supreme Court justice or a circuit

* Address delivered before the Unity Club, Brooklyn, N. Y., on March 4th by Hon. Martin T. Manton, Judge of the United States Circuit Court of Appeals (2nd Circuit).

judge and so there is formed the so-called 'statutory court,' to which we have heard frequent reference. This is provided for by the U. S. Civil Code, Sec. 266.¹ The law provides a direct appeal, as a matter of right, to the Supreme Court from any decision rendered by the so-called 'statutory court.' The Supreme Court has established very definite rules for the judicial process, once it is put into operation, in confiscation cases.

"Rate making and, more strictly speaking, rate regulation by public authority in the United States, was established more than half a century ago. On March 1, 1877, in *Munn v. Illinois*,² the Supreme Court for the first time decided that private property devoted to public use is subject to public regulation and it was more than 200 years prior to that time that Lord Chief Justice Hale of England pointed out in a treatise, *DePortibus Maris*, that when private property is affected by public interest, it ceases to be private property only.

"The efficient and impartial enforcement of the rights of a state or municipality and its inhabitants, in order to obtain adequate service at fair uniform rates, is just as essential, as if indeed it is not more necessary, than providing the necessary power and authority in the first instance, to insure such service for itself and its citizens. The strict persistent enforcement of the law and the franchise or contract rights available to the municipality and the rights of its inhabitants under indeterminate permits and commission regulation, is generally found necessary to secure satisfactory service at a fair uniform rate. The underlying principle is that business of certain kinds holds such a peculiar relation to public interest, that there is superintroduced upon it the right of public regulation.

"The law has long been established providing a fair return on a rate based on capital invested in property devoted to and used in public service. The rate of return must be fair. The right to regulate rates is based fundamentally upon the exercise of the police power of the state. That is the power of government which is inherent in every sovereignty. It is the power to govern men and things, and while it is exercised for the common good, the police power of a state is not unlimited. Its use is always subject to judicial review and when exercised in an arbitrary or oppressive manner, it is without due process of law and such action may be annulled as violative of the rights protected by the constitution. Therefore, it is observable that in granting this protection of the national constitution, the ques-

¹ "No interlocutory injunction suspending or restraining the enforcement, operation or execution of any statute of a state by restraining the * * * enforcement of an order made by an administrative board or commission * * * shall be issued or granted * * * unless the application for the same shall be presented to a justice of the Supreme Court of the United States, or to a circuit or district judge, and shall be heard and determined by three judges, of whom at least one shall be a justice of the Supreme Court or a circuit judge and the other two may be either circuit or district judges, and unless a majority of said three judges shall concur in granting such application." Section 266 of the Judicial Code (28 U. S. C. A., Sec. 380).

² 94 U. S. 113.

tions involved are essentially questions of federal law and particularly of injunctive relief, both of which are primarily subjects for interpretation and construction by the national courts.

"Rates for public utilities must be calculated on a rate base which is the fair value of the property devoted to the public service, used and useful, and such fair value is determined by giving to all relevant matters such weight as may be right and just in each case. The leading case on this subject was considered by the Supreme Court in 1898.³ There the public was asking that the rate base be measured by reproduction cost and the railroad companies were asking that they be allowed to earn on a rate base measured by the outstanding securities on their property which outstanding securities they claimed represented their original investment thereon. The Court laid down the so-called 'fair value rule' saying that reproduction costs would be unjust to the railroad because it would not reflect honest investment prudently made, but it held that the basis of calculation as to the reasonableness of rates to be charged must be the fair value of the property being used by it for the convenience of the public and that in order to estimate such value, the original cost of construction, the amounts expended in public improvements, the amount and value of its bonds and stocks, the present as compared with the original cost of construction, the probable earning capacity of the property under the rates prescribed by statute, and the sum required to meet the operating expenses, were all matters for consideration to be given just and equitable weight under the circumstances. The Court announced the rule that the company was entitled to a fair return on the value of the property which it employed for public convenience and put forth the doctrine that the public is entitled to demand, on the other hand, that no more be exacted from it for the use of a public utility than the services rendered by it are reasonably worth.

"While many rate cases have gone to the Supreme Court since that decision, an examination of them will find that this pioneer case has been departed from very little. New considerations, of course, were necessary to consider and it is as to these that the Court has formulated additional rules for the guidance of the public utilities commissions and the courts. A study of these cases convincingly shows that the Court does not concern itself primarily with the question whether a particular method of valuation has been followed but with the question whether, upon the entire record before it, it appears that a just measure for the rates under consideration has been adopted. The Court considers each case in the light of its own particular facts and adopts no exclusive yard stick for the determination of the rate base except that which is controlled by equity.

"The Public Service Commission is not a court; it is a fact-finding body charged with the duty of administering the law. There is always a rate which is just and reasonable as between the public utility and the public, and it is this rate which the commission should

³ Smyth v. Ames, 169 U. S. 466, 18 Sup. Ct. Rep. 418 (1898).

strive to ascertain and order. Rates fixed by it must not be so low as to cross the line of confiscation and ordinarily they should not closely approach that line. On the other hand, they should not be so high as to be unjust and unreasonable. Rate orders to stand the test of the court's power to review, must find support in the evidence introduced at the hearing. They can not be arbitrary or unsupported by evidence. They must follow and not disregard both the law and the evidence; they must be reasonable and not capricious and they must prescribe rates which are non-confiscatory. They must not interfere with sound business judgment and good management on the part of the owners of the utility property.

"The rate making power being an exercise of the police powers of the state, is a legislative power. Therefore, it is through the rate-making function exercised directly by the legislature that a regulatory body is created to whom the power of making rates is delegated by the legislature. Thus it is that the police power of the state is exercised by the legislature through its agency, the regulatory body. But its action is limited by the Constitution of the United States and the Constitution of the state where it functions. Of course, the regulatory body is further limited in the use of legislative power delegated to it by the requirement enjoined on it in the legislative enactment creating it. Therefore, a regulatory rate order is of the same force as the legislative enactment and is subject to the same limitations.

"The Fourteenth Amendment of the Federal Constitution, through the due process and equal protection clauses, provides two important limitations of state legislative power. It is because of these that all legislative enactments and likewise all regulatory rate orders which are foreign to or infringe upon these two clauses or either of them, are void and may be annulled by an injunction in the federal courts. Moreover, all legislative enactments and all regulatory rate orders which transcend the limitations of the state constitution and all rate orders which fail to meet the requirements enjoined in the enactment creating the regulatory body, are void. A regulatory body or commission is not clothed with the general power of management incident to ownership and it is not empowered to substitute its judgment for that of the directors of the company in the matters of operation. But in rate making, in determining the rate base, it is also not empowered to substitute in whole or in part, any other type or construction of plant for that under investigation.

"The Commission has no power to make findings and issue orders except upon compliance with the course of procedure and the rules and decision prescribed in the state regulatory law under which it functions. The Commission's right to act depends upon compliance with requirements of the statute as to notice and hearings. It must grant a full hearing which must be adequate and fair and its findings must rest upon the evidence introduced and the evidence must show the existing or proposed rates to be unreasonable in order that they may be changed up or down, and failure on the part of the

Commission to make reasonable compliance with those statutory requirements, invalidates the order. The Commission has no power to lessen the value of utility property or to make deductions from its value on the assumption that customers through the payment for service are making contributions to depreciation or other expenses or to the capital of the company nor because of some assumed relation existing between the utility company and its customers, for that does not exist.

"These principles find support in the Supreme Court decisions and make it clear that the Commission has no power to prescribe confiscatory returns or an inadequate rate of return. For this would be a violation of the due process clause and the limitation of legislative power. One thing is certain and it is that the Commission engaged in fixing public utility service rates must give heed to the decisions of the United States Supreme Court in relation to rate making and conduct such investigation or inquiry and authorize such rate orders as under the decisions of that Court, the utility company and the public are entitled to have made.

"In recent years, the state which is the depository of the sovereign will and power of the people, has exercised its rights to enter the business of furnishing public utility services. When it does, the public is entitled to the same protection as in the case of private ownership. At other times, instead of doing so and instead of exercising its right of government ownership, it sometimes provides for the creation of public service corporations and it grants to them the right to furnish utility service at a profit. It endows upon them certain powers and clothes their business with valuable rights and privileges. These are creatures of the state. They live and exist upon the hypothesis that they will be a public benefit and confer benefits upon the public. They are not organized for the purpose of speculating in other properties, stocks or bonds. They perform a function of the state. Their very existence and their only powers, rights and privileges are derived solely from the state. They too are subject to regulation. In the private enterprise, the owner demands the highest profit obtainable and gets all he can. His investment is in the perilous field of competition. He must create his own market, procure his customers, advertise his business, assume all risks and receive no help from the state and having received no such grants from the state, no valued rights or privileges, he is not obliged to ask only fair profits on the sale of his product to the public. His profit is limited only by the laws of competition.

"In the public service business, an owner is entitled only to what is fair and reasonable profit on the service he furnishes the public. The corporation is performing a function of the state. The business is permitted to be established for the benefit of the public as well as for the pecuniary gain of the stockholders. The investment is protected against competition and clothed with the privileges of a monopoly. The market is established, the customers have no choice for they must use the service rendered. The corporation is given the

right of eminent domain. It is allowed the free use of the municipality's streets; it is exempt from payment of franchise taxes; it has a uniform charge placed on the service and it is relieved from furnishing gratuitous service. It is protected from all grafting politicians and is clothed with the right of emergency relief in time of distress. Such rights and privileges granted to the public service corporations are of great value and are to be compensated for along with other benefits conferred upon the public service corporations. These are economic reasons which form the basis of the decisions of the Supreme Court granting protection on the one hand and affording profit, and on the other hand restraining oppression and arbitrary and excessive charges.

"Municipalities such as cities have often intervened in cases which primarily are between the public service corporation, the utility corporation and the regulatory body of the state. While such intervention has uniformly been permitted, the Supreme Court recently in the New York Telephone case ⁴ laid down the rule that the relation between the company and its customers is not that of partners, agents and principals or trustees and beneficiary. In Fall River Gas Co.⁵ it was said that the relation between a public service corporation and the public was not a partnership, but rather that of independent contracting parties. In the New York Telephone case, the Supreme Court pointed out that customers pay for service, not for the property used to render it; that the payments were not contribution to depreciation or operating expense or to capital of the company; that by paying the bills for service, the customers did not acquire any interest, legal or equitable, in property used for their convenience or in the funds of the company; that property paid for out of moneys received for service belonged to the company, just as does that purchased out of proceeds of its stocks and bonds.

"But in a case where the inhabitants of a municipality are directly interested, the responsibility of protecting not only its own rights, but the rights of its inhabitants, rests upon the municipality. With a proprietary or business power to care for its own force and with a governmental or legislative power to care for the rights and welfare of its inhabitants, it has been considered proper to admit municipalities into such litigations where regulatory laws or where rate orders are being considered. Therefore petitions to intervene by municipalities have been uniformly granted. The public utility corporations have a special interest for municipalities. They furnish electricity of dependable constancy; street cars run on the public streets and telephone service are necessary requirements for not only the city but its inhabitants in the promotion of health, convenience and general welfare. The responsibility of a municipality in exercising its legal right of participating in rate making cases where it and its inhabitants are affected by the rates, is commensurate both to the value of the service and the costs of the services to the user.

⁴ 271 U. S. 23, 46 Sup. Ct. Rep. 363 (1925).

⁵ 214 Mass. 529, 102 N. E. 475 (1913).

"The principle that the rate base is a fair value of the used and useful property at the time rates are fixed has been universally established and recognized. That contemplates the time when the order fixing the rate is made by the utility board. Prices of labor and material and valuations of property devoted to the service fluctuate and change with the upward or downward trend of the prices.

"Some utilities are not content with a fair return upon their investment, not even with a fair return upon the fair value of their properties. They seek to narrow the fair value rule laid down in the *Smyth v. Ames* case. They urge that dominance be given to reproduction costs, estimates of physical property, and then augment those estimates with a long list of financial intangibles. The courts have been quick to stamp with disapproval such items on the list of intangibles. The rate-making case is always a contest between engineers, accountants and lawyers; a contest of wits in various directions.

"But with all the efforts made to change it, *Smyth v. Ames* represents the rule today as it did in 1898, that fair value means under all the facts and circumstances surrounding the particular case what is both fair to the utilities and to the public. The 14th Amendment in protecting the property of utilities devoted to public services, does not always protect the utilities' actual investment in the property.

"In making rates, the Commission and the courts always make sure that the rates are to be for the use of the property; its present fair value recognized and it must be only such as is presently devoted to the public service. The comparison, that is, the value fixed in the appraisal, must be only of that property which is an instrument of public service and that valuation must be a reasonable value. The Supreme Court has pointed out that the ability or sagacity of the owners of property need not be considered as an enhancement of its value. Many relevant matters are weighed in the judicial determination of fair value. The judgment must be based upon a reasonable basis; it can not be arbitrary or unjust. There is no particular rule or formula. Courts do not give dominance to any method of valuation or to any relevant matters under all circumstances. It is concerned only in arriving at a rate base which is substantially fair and just, both to the utility and to the public. Some matters considered are the original cost of construction, the amount expended in permanent improvements, the amount of market value of bonds and stocks, the present as compared with the original cost of construction; the probable earning capacity of property under particular rates prescribed by the statute; the sum required to meet operating expenses; appreciation and depreciation; going value; the financial history of the company; the enhancement of costs and book values are all subjects of consideration. Going value is to be added to the plant as a whole over the sum of the values of its component parts which is attached to it because it is in active and useful operation and earning a return. Good will in the ordinary sense of that term which means an element of value arising from a well known business favor-

ably regarded by its customers, is not included in the valuation for rate making. Going value does not include good will. The concrete measure of going value is generally the cost of attaching and developing the business over and above the cost of the construction of the plant. Franchises to do business are not valuable in order to enhance the value of the rate base. Working capital is a proper matter to be considered in determining the rate base. Depreciation must be considered as well as depreciation reserve.

"What is a fair return depends upon the facts and circumstances surrounding the utility at the time of the inquiry. Some of these are the risks and hazards in the business. The location where the business is conducted; the rate usually realized upon equally stable investments in the community; the legal rate of interest; the money market and business conditions generally; the financial connections of the utilities and the management and operative experience of the utility. The rate of return has varied from as low as 6% to as high as 8%, depending upon these factors. The courts can not prescribe rates; they do not do so either in the state or federal courts. Rate making is a function of the legislative branch of the government. The federal courts but review rates to ascertain if the rate fixed is confiscatory, and to be confiscatory means that if in force, they are regarded as deprivation of the property of the utility without due process of law. The trial courts exercise independent judgment in reaching their conclusions; they are not bound to accept the testimony before the utilities board. Usually a master is appointed who hears the questions of valuation and other material evidence entering into the subject to determine whether the rate of return is inadequate and therefore confiscatory.

"The Supreme Court on a review which is an absolute right of either party, has complete freedom in reviewing each case. The trial of a rate order case is an equity proceeding and an appeal is a proper remedy of review.

"With these precautions to guarantee constitutional protection, both the utility and the public can rest with the security that justice will be done in any controverted matter that reaches the federal courts.

"The right of review of orders of a utility board in the state court, by way of certiorari or other procedure, is not in conflict with the right of protection afforded through the federal courts. It is only misunderstanding and an ill-advised aroused public feeling that causes unwarranted and unfortunate statements as to the 'assumed jurisdiction' and 'misrepresentation of power by the federal courts.'

"If the lawyers who understand the principles of rate making and the review by courts would spread the information to the public and particularly to the newspapers, much would be done in standing by the Constitution which has been so protected over a long period of years the rights of a citizen in guaranteeing protection of life, liberty and property."