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Public Utilities - Rate Making - Prudent Investment Theory

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cluded that, "since the servitude in this case has become extinct, it cannot be re-created or established anew except by title."[14] This holding seems to indicate that even an express renunciation of acquired prescription, after ten years non-user, would not effectively revest title in the mineral owner.

Defendants who had purchased a portion of Gleason's rights contended that their reliance on the public records estopped plaintiff from denying their ownership. There is some confusion as to what faith can be placed in the public record when dealing with mineral rights. In *Brown v. Sugar Creek Syndicate*[15] the court said, "The mineral and royalty owners who acquired their rights on the faith of the public records after the . . . agreement was registered are obviously protected."[16] However, in subsequent cases the court has used such language as "[a] third person purchasing, on the faith of the public records, . . . *is only required to ascertain* if the recorded owner . . ." has kept the servitude alive (italics supplied),[17] thus indicating that the records could not be relied upon completely. In the instant case the court held that one who purchases mineral rights must determine whether the rights have prescribed when the records show that the servitude has been in existence more than ten years, even if this entails a search behind the records.

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PUBLIC UTILITIES—RATE MAKING—PRUDENT INVESTMENT THEORY—NON UTILITY FUNCTIONS

Appellant, Gulf States Utilities Company, applied to the Louisiana Public Service Commission for authority to increase its rates for electric service in the State of Louisiana. The com-

they have already been irrevocably divested by operation of law. In order to show a renewal of their servitudes, they must prove Bailey's intention to create new rights. . . . Acceptance of rentals under such circumstances does not resurrect mineral servitudes which have become prescribed, either on the theory of tacit renunciation or estoppel." The court in the *Porter-Wadley* case did not give an opinion as to whether such a renunciation could be made.

14. 62 So. 2d 653, 656 (La. 1952).

15. 195 La. 866, 197 So. 583 (1940). In the *Brown* case there was a conflict as to each alleged owner's share of the mineral estate. There was evidence that some of the rights had prescribed. The interested parties executed a pooling agreement which set forth each owner's respective share. This instrument was notarized and recorded, and other parties bought on the faith of this instrument on the record.

16. 195 La. 866, 892, 197 So. 583, 592 (1940).

17. Braswell v. Columbia County Development Co., 153 La. 691, 694, 96 So. 534, 535 (1923).

mission refused to authorize the increase on the ground that the present earnings of appellant were substantial and were not confiscatory.[1] In computing the earnings, the commission included profits from certain private contracts under which the company supplied steam-electric power for industrial use. The district court accepted this computation of appellant's earnings and sustained the ruling of the commission. *Held*, that earnings from the private operations of appellant should not be used to enhance the rate of return produced by the normal public utility enterprise, and that denial to appellant of an increase sufficient to allow a rate of return corresponding to that return allowed other electric companies was discriminatory. *Gulf States Utilities Company v. Louisiana Public Service Commission*, 62 So. 2d 250 (La. 1952).

For many years the Louisiana Public Service Commission, like other regulatory bodies, was required to follow the "fair value" theory of utility regulation, established by *Smyth v. Ames*,[2] in order to comply with the due process provisions of the Federal Constitution. This theory was based on the premise that the owners of the utility were entitled to a fair return on the current value of the property used and useful in performing public service.[3]

Justice Brandeis introduced a completely different approach to the problem in his concurring opinion in the *Southwestern Bell Telephone Company* case.[4] His "prudent investment" theory suggested that *the owner's investment* was the thing to be protected in rate making, rather than the ever changing *value of the physical property of the utility*.[5] Thus, a rate of return sufficient to protect the owner's investment and attract new capital was the object of regulation, rather than a cumbersome, time-wasting appraisal of the utility property. This prudent investment theory was accepted by the Supreme Court of the United States in 1944,[6] and two years later it was adopted by the Louisiana Public Service Commission.[7]

1. L.P.S.C. Order No. 5931.
2. Smyth v. Ames, 169 U.S. 466, 526 (1898).
3. Id. at 546.
4. Southwestern Bell Telephone Co. v. Public Service Comm., 262 U.S. 276 (1923).
5. Id. at 306.
6. Federal Power Comm. v. Hope Natural Gas Co., 320 U.S. 591 (1944).
7. Louisiana Public Service Comm. v. Louisiana Power & Light Co., 65 P.U.R. (N.S.) 18, 22 (1946).

"Although this commission has in the past followed the 'fair value'

The Louisiana commission modified the theory to some extent by adopting a rather unique method of treating the reserve for depreciation of a company. Normally, the reserve for depreciation is deducted from the gross plant account to arrive at the depreciable property to be included in the rate base along with working capital and other allowed items.[8] To this net base it applied a percentage to arrive at the allowable return for the company. The same result would, of course, be achieved by applying the percentage to the gross rate base and the reserve for depreciation respectively and netting the amounts thus arrived at to get the allowable return. In the *Louisiana Power & Light Company* case,[9] however, the commission applied a lower rate to the reserve for depreciation than to the undepreciated rate base on the assumption that there is a certain time lag before sums retained in the business by virtue of additions to the

theory in rate making proceedings, and although this process has been approved by the Supreme Court of this State, this approval was *required by* the former U.S. Supreme Court jurisprudence of *Federal due process.* Since there are no Louisiana decisions requiring use of the 'fair value' theory in public utility rate making to meet *State requirements of due process*, and since there are no state statutes directing use of the 'fair value' theory, it is the opinion of this Commission that the Supreme Court of Louisiana is free to allow the use of the 'prudent investment' theory in public utility rate making by this Commission. Therefore, being desirous of simplifying the rate making process by eliminating the necessity for and the use of the cumbersome, expensive, time wasting and inconclusive reproduction appraisals and studies used in the past, we herewith adopt the 'prudent investment' theory of rate making for public utilities and set out below our application of this theory.

"The owners of a public utility are entitled to earn and receive a fair rate of return upon the money prudently invested in property used and useful in rendering public service. Money is prudently invested, even though it is in excess of the original cost of the property purchased, if the excess of purchase price over original cost was paid as the result of arm's-length bargaining between non-associated buyer and seller, if the excess was necessary for the integration of the property into a larger and more efficient system, and if the purchase necessitating the excess did or reasonably should have resulted in public benefit by improvement of service to customers or in lowered rates or both better service and lowered rates. This integration cost or excess of purchase price over original cost termed in prescribed system of accounts as 'Utility Plant Acquisition Adjustments' should remain a part of the prudent investment during the life of the physical property to which it was applied, and its extinguishment from the investment when and if required by the Commission, should be accomplished by amortization through annual charges to Operating Revenue Deductions during the life of the property remaining after the date of the purchase which created the excess.

"The rate base to be used in determining a fair return shall be the total original cost of the property in useful service plus the allowable amount of Utility Plant Acquisition Adjustments not amortized through charges to Operating Revenue Deductions plus a reasonable allowance for materials and supplies and for cash working capital, less the amount of capital secured from customers as contributions and construction advances."

8. Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 151, 167 (1934).

9. 65 P.U.R. (N.S.) 18 (1946).

reserve for depreciation account can be reinvested in revenue producing equipment.[10] In recent cases involving electric utilities the commission has applied a 6 per cent rate of return to the undepreciated rate base of a 5⅓ per cent rate to the reserve for depreciation,[11] with a resultant net rate in excess of 6 per cent. The formula was abandoned sub silentio in the *Gulf States* matter.

In the instant case, the Louisiana Supreme Court considered for the first time a utility rate dispute involving application of the prudent investment theory as adopted by the commission. The court reaffirmed the proposition it had set forth in *Morgan's L. & T.R. & S.S. Company v. Railroad Commission*[12] that the primary issue for decision in rate cases is whether the rate fixed is reasonable and just. Thus, this court, like most courts when confronted with a rate problem, restated its position that the end result is more important than the means used to attain that result.

In considering the appeal of Gulf States, the Supreme Court first discussed the question on the basis of the commission's own computations, which included the profit from private sales, and set appellant's rate of return at 5.11 per cent. Even accepting this figure, the court decided that the refusal of the commission to allow a rate increase was "somewhat discriminatory."[13] It based its reasoning upon the fact that in twenty-nine similar cases since the commission adopted the prudent investment theory, it had allowed a rate return of 6 per cent. The court held that "refusal to grant an applicant a rate increase which would enable it to earn 6 per cent would be inequitable and unjust in the absence of exceptional circumstances."[14] Thus, the court seemed to adopt the view that, in the absence of special circumstances, the rate of return of a utility should correspond to the rate allowed other utilities furnishing the same type of service. This will probably mean that in future rate cases the emphasis must be placed upon the exceptional circumstances which will distinguish a particular utility from other members of the homogeneous group into which it would naturally fall.

10. Id. at 25.
11. Gulf States Utilities Co. v. Louisiana Public Service Comm., 62 So. 2d 250, 253 (La. 1952).
12. Morgan's L. & T.R. & S.S. Co. v. Railroad Comm., 127 La. 636, 53 So. 890 (1910).
13. Gulf States Utilities Co. v. Louisiana Public Service Comm., 62 So. 2d 250 (La. 1952).
14. Ibid.

How does this expression of the court affect the prudent investment theory in Louisiana? It may limit its application to some extent. When the commission adopted the theory in 1946, it said that the rate of return of the utility would be based on the "efficiency of operation of the subject utility, market prices, and ratio of earnings to the market value of stocks and bonds of similar enterprises operating under similar conditions, and any other relevant facts."[15] Now the court seems to say that these factors may be used to determine the rate of return, but that here they did not constitute such exceptional circumstances as to warrant a rate different from the rate of return allowed other utilities furnishing similar services.

As a matter of fact, however, the instant case was not decided on the basis of the 5.11 per cent rate of return computed by the commission. The court refused to allow the profit from the private sales of steam-electric power to subsidize the normal utility operations of the company, and, therefore, the court considered the case as one in which the commission had allowed a rate of return of 4.35 per cent.

If income from the private contracts was correctly excluded from the utility income, and the rate of 4.35 per cent was correct, there can be little doubt that the commission's refusal to allow an increase was discriminatory. Therefore, the decisive issue in the instant case was whether or not the profit from the private contracts was properly included in the determination of the actual rate of return of appellant.

The subject of the private contracts is a combination of electrical energy and steam supplied by Gulf States to Standard Oil Company and Ethyl Corporation.[16] The special equipment necessary to supply this energy was included in the rate base in the present case. The power plant from which the energy is supplied is not used exclusively for industrial operations. In fact, it contains other standard generators, and, more important, *all the electric energy produced goes through one control room and can be sold to the industries, or can be sold to the normal utility customers.*[17] This presents a strong indication that the combined operations of appellant might properly have been

15. Louisiana Public Service Comm. v. Louisiana Power & Light Co., 65 P.U.R. (N.S.) 18, 23 (1946).
16. Gulf States Utilities Co. v. Louisiana Public Service Comm., 62 So. 2d 250, 251 (La. 1952).
17. L.P.S.C. Order No. 5931, at 7.

treated as a unit for rate making purposes. Other courts have considered problems similar to the present one, but usually the problems have arisen in a different context. The normal utility operations have more often been making a greater profit than the special activity under consideration.

In *Willcox v. Consolidated Gas Company*,[18] in addition to the rate for gas supplied for general consumption in the city of New York, there was a lower rate for that furnished to the city itself. It was said by the court that the criticism of the "wholesale" rate to the city was met by the fact that the total returns from the sale of gas were adequate. Is there a great difference in principle between the supplying of this gas to New York City and the furnishing of steam-electric power for industrial use in the instant case?

In *Illinois Commerce Commission v. Public Service Company of Northern Illinois*,[19] an electric utility leased some of its most valuable territories to another company for a large proportion of the gross income, and the commission ruled that the income from the leased property should be considered income of the company from its electric properties for the purpose of rate determination. Both of the above mentioned cases deal with situations in which the product furnished under the auxiliary agreement and the basic product of the utility are the same. The question becomes more difficult if the products sold or the services rendered are dissimilar.

The Supreme Court of the United States held that a confiscatory rate which was applied to a particular class of traffic of a railroad could not be justified on the ground that income from other classes of traffic offset the loss.[20] However, the court did point out that in evaluating the reasonableness of a particular rate, the income from the entire intrastate business of the railroad could be considered.[21]

Often, certain types of utilities sell appliances or engage in

18. Willcox v. Consolidated Gas Co., 212 U.S. 19 (1909).

19. Illinois Commerce Comm. v. Public Service Co. of Northern Illinois, 4 P.U.R. (N.S.) 1 (1934).

20. Northern Pacific Railway Co. v. North Dakota, 236 U.S. 585 (1915).

21. Id. at 599. "Frequently, attacks upon state rates have raised the question as to the profitableness of the entire intrastate business under the State's requirements. But the decisions in this class of cases . . . furnish no ground for saying that the State may set apart a commodity or a special class of traffic and impose upon it any rate it pleases, provided only that the return from the entire intrastate business is adequate."

other types of merchandising or jobbing. Generally, commissions consider these activities separate and apart from the normal utility operations for purposes of rate determination.[22] Finally, two types of utilities operated by the same company are considered separately.[23] A review of the above cases seems to indicate that the degree of similarity between the basic product or basic service of the utility and that product or service furnished under the auxiliary agreement has been a substantial criterion for determining whether the two activities should be treated as a unit for rate determination.

It is true that situations such as the one in the instant case are not common. The utility plant must be located close enough to an industrial plant to make the furnishing of this type of steam-electric energy practical. However, similar situations do exist in California and New Jersey, and the commissions of those states treat the private contracts as part of the operations of the utilities, and include them in the determination of their profits.[24]

The Supreme Court of Louisiana refused to take this view, saying, "we think it clear that its steam-electric business is, and was always intended to be, a private enterprise separate and apart from the normal utility service it renders the public."[25]

Clearly this is a controversial subject, with persuasive arguments on both sides of the question. It would seem, however, that the Supreme Court might have attributed greater weight to the judgment of the commission that this was a matter "concerning the service to be given or rendered by the public utilities"[26] and thus have eliminated a very complicated problem. The commission is presumably in a better position to know the complete situation and to appraise it in the light of greater experience. Judicial relief would nonetheless be appropriate here in light of the conclusion reached by the court that a rate of less than 6 per cent would be inequitable and unjust in the absence of exceptional circumstances.[27]

Albert L. Dietz, Jr.

22. Re Rates and Structures, 29 P.U.R. (N.S.) 391, 471. See also Colorado Interstate Gas Co. v. Federal Power Comm., 324 U.S. 581, 597 (1944).

23. Board of Trustees of Waterville v. Waterville G. & E. Co., 1917F, P.U.R. 126 (1917). Where a company owned the gas works and electric plant in the same city, the court refused to treat the two properties as a unit for rate making purposes.

24. L.P.S.C. Order No. 5931, at 6.

25. Gulf States Utilities Co. v. Louisiana Public Service Comm., 62 So. 2d 250, 254 (La. 1952).

26. Ibid.

27. Ibid.