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# Public Law: Public Utilities

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cipality brought a declaratory action to have this lease declared null and void. Three distinct grounds of invalidity were urged by the city: (1) the lease was not advertised and adjudicated to the highest bidder, as required by law; (2) the consideration for the lease was not serious; and (3) the legislative act authorizing the city to execute such a lease was unconstitutional, as violating the constitutional prohibition[33] against the loan, pledge, or grant of public property. In the trial court, exceptions of no cause of action and estoppel filed by defendant were overruled; and after a trial, judgment was rendered holding the lease null and void.

This judgment was reversed on appeal. As the statute authorizing the lease required no advertisement and adjudication to the highest bidder, and specifically authorized the lease to defendant, the general requirements of law were held inapplicable. The agreements made by the lessee to keep the buildings repaired and insured, and to assume responsibility for all injuries sustained therein, were held to provide the serious consideration required for the validity of the contract. The Supreme Court held the third contention of the municipality equally without merit, by pointing out that the leasing of governmental property was not a loan, pledge, or grant within the intendment of the constitutional prohibition.

## PUBLIC UTILITIES

*Melvin G. Dakin**

It has now been some seven years since the Louisiana Public Service Commission promulgated its opinion and order fixing a rate base and a rate of return for Louisiana Power and Light Company:[1] the event was significant because it marked the adoption of a "prudent investment-cost of capital" approach to the determination of the rate base and the rate of return. The opinion provided:

> "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 acqui-

33. La. Const. of 1921, Art. IV, § 12.
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1. 65 PUR (NS) 18 (1946).

sition 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.

"The rate of return to be allowed shall be such a percentage of the rate base which will yield enough money after all reasonable operating expenses, maintenance, taxes, annual retirement or depreciation appropriations and amortization of utility plant acquisition adjustments have been paid or set aside, to pay bond interest and sufficient stock dividends to maintain the credit of the utility, attract new capital, reward good management and to enable the investor to recoup at any time the money he has prudently invested. The rate of return is a question to be determined in each individual case from evidence as to efficiency of the operation of the subject utility, market prices and ratio of earnings to market value of the stocks and bonds of similar enterprises operating under similar conditions, and any other relevant facts."[2]

In *Gulf States Utilities Co. v. Louisiana Public Service Comm.*,[3] the Supreme Court has now given its tacit approval to the use of the commission's "prudent investment-cost of capital" approach to rate making. Paradoxically, perhaps, at the same time it has given an applicant utility substantially (though not all)[4] the relief asked for.

Applicant asked for a 20 per cent increase in rates, an increase alleged to be necessary to assure a return of 6⅓ per cent on its "depreciated rate base." Commission staff calculations indicated that for the year considered the adjusted net

2. Id. at 23.

3. 222 La. 132, 62 So. 2d 250 (1952).

4. The applicant's brief contains a vigorous and well-documented attack on the failure of the commission to give consideration to the present value of the utility property in its rate order, quoting the court's statement in Southern Bell Telephone Company v. Louisiana Public Service Commission, 187 La. 137, 174 So. 180 (1937), that rates and charges which reduced the net return to the point where they did not represent just and adequate compensation on the present fair value of the property were illegal and must be set aside. The attack evoked no more than a passing reference in the court's opinion to the *Hope* case (Federal Power Commiss. v. Hope Natural Gas Company, 320 U.S. 591 [1944]) and a reference to the adoption by the commission of the "prudent investment" theory. Thus the court accepted, apparently without question, the right of the commission to abandon "fair value" as a criterion.

operating income represented a return of 5.1 per cent on net or depreciated rate base. The staff also calculated that for the entire operations of the company net operating revenues covered interest charges and preferred dividends and left a return of 12.4 per cent on the common stock equity. A financial and market expert for the applicant testified that a return of 10 per cent on the common stock equity would be necessary to attract additional common stock capital. On the basis of these and other considerations, the commission denied the application for a rate increase. Applicant's suit in the district court was dismissed on the ground that it had failed to sustain the burden of proof necessary to rebut the presumption that rates fixed by the commission would yield a reasonable return to the applicant and were not confiscatory. On appeal, the Supreme Court reversed the district court, annulled the order of the commission, and granted the 20 per cent increase in rates requested by the applicant.

The court summarized the commission's position in the *Louisiana Power and Light Company* case as substantially "that the rate of return to be allowed was not to be a fixed static percentage of the plant investment but that the rate in each individual case would be determined from evidence as to the efficiency of the operation and other factors." Despite this commission disclaimer that it was tying itself to a "fixed static" percentage return, the court found that the commission had allowed a rate of return of 6 per cent (or slightly more) on invested capital in some 29 cases decided since adoption of its "prudent investment" approach. The proposition to which this history of commission action is deemed to lead is that "if 6% is and has been considered by the Commission to be a just and equitable rate of return, it would seem that refusal to grant an applicant a rate increase which would enable it to earn 6% would be inequitable and unjust in the absence of exceptional circumstances."[5] Among the "exceptional circumstances" or "other factors" in the case which impressed the commission, but failed to impress the court, was, of course, the fact that allowance of a 6 per cent return on prudently invested capital would mean a 12.4 per cent return on the applicant's common stock equity. The frailty in the commission's "exceptional circumstances" was that, in calculating a return in excess of 10 per cent on the common

5. 222 La. 132, 142, 62 So. 2d 250, 253 (1952).

stock equity, there were included earnings from an industrial steam-electric operation over which it was found not to have jurisdiction.[6] Eliminating these earnings, as required by the court's decision, left an amount for the common stock presumably less than 10 per cent, although it is not clear that this was so from either the commission's or the court's opinion. Had the commission demonstrated that with these earnings eliminated there would still be in excess of 10 per cent for the common equity, the court, I believe, would have accepted the conclusion that an increase in rates at this time was not appropriate. In other words, if the commission had demonstrated that the applicant, with an overall return of less than 6 per cent, could pay bond interest and preferred dividends and have remaining earnings representing in excess of 10 per cent on the common stock equity, the case for an increase in rates would have rested squarely on the sufficiency or insufficiency of that excess to attract additional needed capital at current "cost of money" rates.

In this regard, it is difficult to see how the commission can fully utilize its "prudent investment" approach to the problems of rate-making without utilizing the corollary "cost of capital" analysis beyond the point which it did in this case. Thus, after noting that the return (including the industrial steam-electric earnings) would represent 12.4 per cent on the common stock equity, the opinion comment is that this analysis was based on company-wide operations in Louisiana and Texas and that "it is impossible to allocate the capital structure of the company to any specific part of its operations."[7] It seems apparent, however, that the analysis for the Louisiana commission and courts will be inadequate if the return on Louisiana operations is not allocated among the respective segments of applicant's capitalization so as to demonstrate what that return means in earnings for an allocated "Louisiana" common stock equity. Unless the analysis is carried this far, the commission will always find itself in the position it is on this appeal, that is, of being unable to demonstrate successfully that failure to permit a 6 per cent return to an applicant is not necessarily discriminatory even though it has allowed a 6 per cent return

6. The settlement of this dispute has important consequences in imposing a continuing supervision of allocated facilities upon the commission. This question and the jurisdictional question alluded to have been discussed in an earlier issue of this REVIEW, Note, 13 LOUISIANA LAW REVIEW 617 (1953).

7. Thirty-Second Annual Report of the Louisiana Public Service Commission, Order No. 5931 (Feb. 15, 1952).

to other seemingly similar applicants in the state. A demonstration that present rates which represent less than an overall return of 6 per cent but nonetheless represent in excess of 10 per cent earnings[8] on the common stock equity allocated to the Louisiana operations might well support refusal to permit an increase to 6 per cent. Less than 6 per cent return overall would then not be "inequitable and unjust" because of the presence of such "exceptional circumstances." The results of such an analysis could quite plausibly be among the "other relevant facts" which the commission has said it would consider in arriving at "reasonable and just" rates.[9]

It is interesting to note the relatively greater interest by utilities generally in bringing in more of their invested capital at the common stock level of the capital structure. Given acceptance of the notion by regulatory bodies that common stock money is generally entitled to earn 10 per cent or more as against earnings of say 2½ per cent to 5 per cent to be allotted to bonds and preferred stock, it is apparent that a capital structure with 50 per cent common stock and surplus will require a higher overall return to assure 10 per cent to common stock equity than will a capital structure of only 25 per cent common stock and surplus.[10] The development is not without its paradoxical

8. Applicant's expert witness assumed 10% return on the common stock equity as the current "bare bones" cost of common capital. The commission has indicated that the ratio of earnings to market prices of the stock and the ratio of earnings to market value of stocks of similar enterprises operating under similar conditions will be relevant facts in the determination of the rate of return to be allowed. The cost of common stock capital could therefore be either more or less than 10% depending on the way in which the market appraised the applicant's risk characteristics.

9. Another criterion which the commission has indicated it would use, namely "efficiency of operation" might perhaps better have been cast in the opposite terms of "lack of efficiency of operation," at least where it is to be brought into play in the consideration of an application for an increase in rates. Thus conceivably the commission's investigations might lead it to conclude that in a given case an application for an increase should be refused, even though the alleged rate of return was less than 6% on prudently invested capital, because the operation was being conducted with such lack of efficiency that a portion of the revenues which should have come through to the common stock equity was being dissipated in unnecessary expenses. Judgments of this kind would, of course, entail utilization by the commission of model expense analyses compiled from industry experience against which to measure the performance of any given utility operation. For a recent experience of the California Public Utilities Commission in attempting to regulate contracts for services between a subsidiary operating company and its parent which were alleged to result in arbitrary exactions, see Pacific Tel. & Tel. Co. v. Public Utilities Commission of California, 34 Cal. 2d 822, 215 P. 2d 441 (1950).

10. In an era of less sophisticated regulation, the touchstone of a "fair return on fair (reproduction cost new) value" made possible a more reward-

aspects, since it sometimes places utilities commissions in the position of having to resist the influx of too much venture capital into the industry because of its relatively greater costliness,[11] whereas such an influx, from the standpoint of financial regulation generally, has been regarded as a healthy development.[12]

# Civil Code and Related Subjects

## LEASE

*J. Denson Smith**

Only two cases reached the court for the adjudication of problems involving ordinary leases. The question of whether a verbal lease of a filling station to a lessee "as long as he wanted it, provided he ran it right" was within the purview of Louisiana Civil Code Article 2685 as one entered into "without fixing its duration" was answered in the affirmative in *Herring v. Breedlove.*[1] The lessee's suit for damages was dismissed. In another case, *Probst v. Nobles*[2] the court held that a reduction of rent ordered by the housing expediter did not have the effect of terminating the lease. This conclusion was supported by the proposition that when the parties entered into the lease contract they were chargeable with knowledge of the provisions of the Housing and Rent Act then in force. The fixing of the rent by the housing expediter was therefore contemplated by them as a matter of law. The case was remanded for a determination of the question as to whether the lease contract had been violated by sub-leasing.

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ing "trading on the equity" operation. Thus, if "fair value" as determined on a "reproduction cost new" basis was substantially in excess of total invested capital, and if senior charges were at an average rate substantially less than 6% on senior invested capital, net operating revenues representing 6% on such excessive fair value could mean returns for the common stock equity very considerably in excess of 10% thereon. The decision in the *Hope* case collapsed many such structures.

11. For a development of this problem, see New England Tel. & Tel. Co. v. Department of Public Utilities, 97 N.E. 2d 509 (Mass. 1951).

12. For a statement of policy on this matter by the Securities & Exchange Commission, see In the Matter of El Paso Electric Co., 8 S.E.C. 366, 383 (1941).

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2. 66 So. 2d 609 (La. 1953).

1. 222 La. 1088, 64 So. 2d 441 (1953).