

# ENERGY LAW JOURNAL

Volume 12, No. 2

1991

## COMMENT: SHEDDING LIGHT ON *DUQUESNE*

*Honorable Richard D. Cudahy\**

*Duquesne Light Co. v. Barasch*<sup>1</sup> represents the first return of the Supreme Court to the constitutional law of state rate-making since the 1930s.<sup>2</sup> The Court attempts, I think with some success, to fit *Duquesne* into the *Hope Natural Gas*<sup>3</sup> "end result" mode. Messrs. Kolbe and Tye in an insightful article in the *Yale Journal on Regulation*<sup>4</sup> have focused on footnote 7 of the *Duquesne* opinion.<sup>5</sup> That footnote suggests that the utilities' loss "from prudent but ultimately unsuccessful investments" under Pennsylvania's modification of the pure prudent investment rule might be offset by an adjustment of the risk premium element of the rate of return on equity. This leads us into fascinating discussions of asymmetric risk and of ways of calculating regulatory risk premiums to accommodate it. I think Kolbe and Tye may be on to something. But before looking more closely at their insights, I believe it important to put the regulatory context into perspective. Actually, I think the perspectives of the *Duquesne* opinion are generally appropriate, although some of the details are debatable.

First of all, I am skeptical of the thesis that a regulatory contract has been reached and that regulators in the 1980s casually cast away the rule book and scrambled the expectation of investors. I do not think it was so much the rules that changed; rather, it was the circumstances to which the rules had to be applied that were profoundly altered. We have witnessed what was, at least in its origins, a nuclear construction crisis; it was a regulatory crisis only in the sense that regulation was nonplussed (or possibly stunned) by unprecedented capital demands in an inflationary environment.<sup>6</sup> Nuclear plants, for example,

---

\* Judge, United States Court of Appeals for the Seventh Circuit.

1. 488 U.S. 299 (1989).

2. See, in that genre, *West Ohio Gas Co. v. Public Utils. Comm'n of Ohio*, 294 U.S. 63 (1935).

3. *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

4. A. Lawrence Kolbe & William B. Tye, *The Duquesne Opinion: How Much "Hope" is There for Investors in Regulated Firms?*, 8 *YALE J. ON REG.* 113 (1991).

5. 488 U.S. at 310-12 n.7.

6. A recent apparent exception is the disallowance of a substantial amount of Southwest Gas Corporation's costs incurred in a pipe replacement program. Southwest requested a \$42.1 million rate increase, but the Arizona Corporation Commission approved only \$7.8 million in relief. "The rationale for

represented huge and unpredictable chunks of investment abruptly thrust into the investment stream. This has been dubbed "lumpy" investment. Never before in the history of the electric utility industry had a totally new technology of uncertain costs and apparently of uncertain performance occupied such an overwhelming position in utility financing requirements.

Second, there is nothing new about the used and useful concept as a requirement for inclusion of property in rate base. The rule was conceived as an elementary protection for ratepayers against being saddled with additions which did not provide service. The Pennsylvania statute at issue in the *Duquesne* case contains language which the Pennsylvania Supreme Court held to carry "used and useful" beyond the rate base with the language "otherwise included in the rates charged . . ." This is unfortunate because ten-year amortization has nothing to do with rate base but is a means of burying "mistakes" (or other no-longer-useful investments) over a long enough period to make the burden on ratepayers bearable. Many, many "mistakes" have been buried by regulators on a ten-year amortization basis over the years, but with the coming of nuclear and other expensive technology the bodies may have become too big for the graves.

I think that Kolbe and Tye are probably correct in pointing out the potential difficulties of substituting a rate of return adjustment for ten-year amortization of unproductive costs. Market adjustments in the cost of capital may deal with some of these problems, as some have suggested. But I believe that the allowance of ten-year amortization would be better regulation. Nevertheless, I certainly do not think this view should be the basis of elevating the matter to a thesis of constitutional law. For purposes of constitutional law, the question is whether there has been a taking of property. The question is not whether the regulatory tools were all used to the greatest advantage. I think the *Duquesne* Court is correct in its computation of the impact on allowed return of the denial of ten-year amortization.<sup>7</sup> That seems to me to be the relevant question and leads to the inescapable conclusion that the impact of this disallowance was not "constitutionally objectionable." There is no suggestion that earnings or dividends will be substantially affected or that working capital will be substantially impaired. And, although I disagree with the disallowance of ten-year amortization of these costs as a matter of regulatory policy, I certainly think a plausible argument can be made on its behalf. The disallowance is merely an extension, having a certain internal logic, of the used and useful doctrine in a new dimension. The disallowance proves to me that the life of regulation should *not* be logic; it ought to be experience.

The used and useful doctrine, far from being unique to Pennsylvania, is the basis, among other things, of the rule against including construction work in progress in rate base for current rate-making purposes. Instead, as we all

---

this disallowance essentially entails 'imprudent' spending regarding the cost of the \$120 million ACC-approved acquisition of Phoenix gas distribution properties from Arizona Public Service Co. in 1984, plus the \$100 million spent since then replacing defective pipe." *Southwest Gas Senior Debt Remains on S & P Watch*, Business Wire, July 20, 1990, available in LEXIS, Nexis Library, B Wire File.

7. It is arguable that the disallowance should have been related to the common shareholders' portion rather than to total rate base and total allowed return, but this is not a major issue.

know, orthodox regulatory accounting requires that the allowance for funds used during construction be capitalized and added as an increment to rate base at the time when the plant in question goes into service. Therefore, the cost of carrying all this construction capital during the long construction period has been added to the value of the rate base upon which rates may be calculated. Future ratepayers, who receive the service delivered from the completed plant, bear these costs rather than current ratepayers who do not receive the service. Presumably charging these costs to current ratepayers would violate the used and useful principle.

While I served on the Wisconsin Commission in the middle 1970s, in a period of high inflation, heavy prospective investment and bloated load forecasts, we were faced with the construction work in progress problem. The accounting and finance staff headed by the astute Fred Huebner took the lead in bringing this question before the Commission and pointing out alternative solutions. Not only was there a serious cash flow problem for the utilities, but there were indications that consumers paid more over the long run by capitalizing interest during construction than by expensing it and covering it from current revenues. In 1974 we adopted the practice, not of including construction work in rate base, but of adjusting the allowed rate of return so that required revenues would produce the *equivalent* of a return on construction work in progress up to a limit of ten percent of rate base. If the construction work exceeded ten percent of rate base, interest during construction on the excess would be capitalized, as in the past, at a relatively conservative rate. This approach generated additional dollars of current revenue to aid in financing the utility's construction enterprise but did not directly violate the used and useful principle by putting construction work in the rate base. There seem to be no asymmetries involved in this sort of creative accounting, but it is not entirely unlike the adjustment suggested by the Supreme Court at the end of its footnote 7, proposing adjustment of the "risk premium element" of the rate of return on equity to offset the loss from disallowances of prudent but ultimately unsuccessful investments.

I recently came across an opinion I wrote concurring in a rate order of March 8, 1974, trying to explore whether a new approach to construction work in progress would be a compulsory loan from consumers repayable to them in future reduced rates or merely an imposition on current customers of capital costs which their demands were creating. Whatever the analysis, the ten percent rule boosted revenues and illustrated, once again, the probity of the *Hope Natural Gas* injunction to look to the bottom line. Incidentally, I am happy to say that my 1974 opinion indicated some skepticism about whether the then-current and scary forecasts of demands would really come true.

In *Duquesne* the Court went to some lengths to relate the issue of disallowance of ten-year amortization to the "fair value" approach to valuation and to the original or historical cost method. There seems to be some assumption in both the *Duquesne* opinion and in the Kolbe and Tye critique that the used and useful concept is more compatible with a fair-value rate base approach than with a prudent investment approach. I understand the logic of this observation ("good" investments have fair value and "bad" ones don't).

But again experience prevails, and I believe the used and useful principle has been applied generally in original cost, prudent investment jurisdictions as much as in fair value jurisdictions.

As I have indicated, I believe the used and useful concept is a consumer protection notion that has never been fully integrated with public utility financing theory; and there are historical factors which help to explain some of the confusion. My impression is that the word "prudent" as in "prudent investment rate base" was intended in Justice Brandeis's time to exclude extravagant expenditures like gold-plated pipes or marble-floored headquarters buildings. Extravagance was particularly frowned upon if the contractor furnishing equipment or services to the regulated utility was a sister subsidiary of the same holding company or a company organized by the utility president's son. "Prudent" was also meant to eliminate inflated cost figures on the books, watered stock, or shady accounting. I doubt that when the word "prudent" was first used in this connection, it was thought to extend to a "prudent" choice of generating technology or a "prudent" load forecast. Nowadays (and for a long time), of course, the word has been applied to the latter sorts of management decisions so that there has been an increasingly routine search undertaken for "imprudent" plant expenditures. This brings us to the present day phenomenon of potentially serviceable plant not involving extravagance or fraud which is held to be "imprudent" because no one will need it for the next ten years. Or we have the situation as in *Duquesne* of "prudent" expenditures which will result in nothing of value to be included in the rate base.

There seems to be a feeling, perhaps reflected in the writings of Kolbe and Tye, that anything which is properly authorized by a state regulatory commission is by definition "prudent" and therefore ought to find its way into the rate base. In the pre-nuclear era, regulatory commissions relied almost totally upon company load forecasts and company choices of plant technology. Since loads grew regularly at a rate of seven percent or so a year, and power was generated by burning fuel under a boiler or building a dam—neither of which normally lead to anything "imprudent"—there was rarely much disjuncture between what was authorized and what found its way to the rate base. At least any deviations were pretty minuscule.

I think the coming of the nuclear era (together with fuel-cost inflation and other woes) changed all that. In an age of multibillion dollar plants with fifteen-year lead times it became a bit unrealistic to think that rubber stamp regulatory approvals would continue to bind no matter what costs or performance disasters lay ahead. I believe, however, that these new problems came with inflation and a new, profoundly revolutionary technology and were not simply the product of bad faith on the part of the regulators. Gradually an expectation developed that state regulatory authority would independently evaluate load forecasts and technologies. We have been, I think, evolving some new rules and procedures, like long-range advance planning laws, which we hope can accommodate the new kinds of problems. Regulatory growing pains may have resulted in what some would call a heightened regulatory risk.

But I do not see how the rules could be kept from adjusting to the new engineering, economic and political realities.

After all, one can hardly blame the ratepayers for complaining about paying for multibillion dollar facilities which may never be of use to them. They are unlikely to be impressed with the argument that since their utility is regulated on a prudent investment basis, they should pay for facilities which once were rubber stamped by a commission but which now, for one reason or another, seem to be totally useless. The old regulatory procedures were simply not designed to deal with this magnitude of problem. So let us keep developing rules and procedures which will work rather than bitterly blaming the regulators for the difficulties inherent in applying traditional rules to radically changed circumstances.

This brings me back to the question of the regulatory contract. There may indeed be such a contract, but it is not a purely bilateral one involving the state and the utility investors. The consumers of electricity are also a party. I have become a bit impatient with arguments that regulators have breached their obligation to investors by failing to do something which may be totally incomprehensible to the consumers of electricity. Both the utilities and their regulators think they know what is best for the consumer and are upset that consumers do not accept their better judgment. But it is axiomatic that the system must be understandable to the consumers as well to the providers of service and their overseers.

I think the sort of thing that the Wisconsin Commission did in the 1970s, following Fred Huebner's lead, in adjusting rate of return to, in effect, account for construction work in progress is the kind of thing that regulators must do in striking a proper balance between financing needs and fairness to consumers. I am certain that regulatory agencies are no less anxious than investors to keep the system as stable and predictable as possible. Believe me, regulators are not thrilled to put plants on the books for two billion dollars that were authorized for five hundred million or less. Therefore, although I think Kolbe and Tye have identified and creatively analyzed some of the problems with what seems to me to be a regulatory glitch but not a constitutional mistake, I am not convinced that regulation has gone berserk. Regulators are all painfully aware that utilities have to raise capital. The people raising the capital and the investors, on the other hand, have to be aware that regulators must deal with the third party to the contract, the consumer, who, above all, wants service for his money. The system will be under severe stress as long as we must deal with infirm technologies, infirm load forecasts, and other problems of the real world. No regulator can make those problems go away.

I have two final thoughts: first, is it entirely unfair to reward utility managements that seem correct *ex post* as well as *ex ante*? In the real world, being right about the extent of load growth and being right about the cost and difficulty of nuclear construction is extremely valuable from the viewpoint of utility customers. And, of course, such foresight (or luck) would be richly rewarded in unregulated industry. But I agree that, as a financing fact, utilities cannot be forced to "eat" everything which turns out to be a mistake. So isn't it an incentive to sound thinking *ex ante* to provide only ten-year amorti-

zation (return *of* capital) rather than return *on* capital for projects that do not come to fruition? In other words, prior approval, although a defense against loss, should not be quite so highly rewarded as ultimate success.

Second, it is interesting how ideas in regulation as in other fields go full circle. For instance *Smyth v. Ames*,<sup>8</sup> which the Supreme Court cites and discusses in *Duquesne*, established fair value as a constitutional requirement for rate base. Yet *Smyth v. Ames* was a pro-consumer decision, where the reproduction cost of the regulated railroad was lower than its original cost because of the long deflation in the latter part of the nineteenth century. Despite the pro-consumer slant in that case, however, the industry subsequently favored fair value on the assumption that it would generally be higher than original cost. The extensive and expensive and arguably unreliable reproduction cost studies required to establish fair value eventually led to its demise in favor of prudent investment, original cost.<sup>9</sup> At that point original cost was argued to be in the consumers' interest. Now, in the era of junked or abandoned plants, according to the Supreme Court, fair value might again favor the consumer because whatever did not make it into a useful plant could be disregarded in return calculations.

These are a few observations of an ex-regulator—now far removed from the battlefields. As I see it, as in other fields, logic is fascinating and important, but experience must eventually call the tune.

---

8. 169 U.S. 466 (1897).

9. See *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 289 (1923) (Brandeis, J., dissenting).