

# THE CONSTITUTIONAL LIMITS ON RATEMAKING: A REPLY TO FRANK DARR

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## I. INTRODUCTION

Professor Darr's recent article, *The Constitutional Limits On Ratemaking: A Response to William Pond*,<sup>1</sup> mounts a broad challenge to my 1989 essay<sup>2</sup> addressing the fundamental principles that govern public utility ratemaking. In order to avoid a revival of the confusion which has characterized this field, this reply shows that Professor Darr is in error and that the principles relied on in my paper, as articulated in such landmark cases as *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*<sup>3</sup> and *Federal Power Comm'n v. Hope Natural Gas Co.*<sup>4</sup>, have been reaffirmed, and placed beyond argument, by the 1989 decision in *Duquesne Light Co. v. Barasch*.<sup>5</sup>

These principles, reflected in an unbroken line of Supreme Court decisions for over one hundred years, establish that public utilities have a constitutional right to be given an opportunity to earn the reasonable cost of furnishing the service and that the prescription of rates which are insufficient for that purpose constitutes confiscation in violation of the Fifth and Fourteenth Amendments.<sup>6</sup>

In spite of this overwhelming judicial authority, Professor Darr argues that the setting of utility rates is not different from price fixing under the general police power, and is subject to the same legal principles. He states flatly "that the source of state authority to fix prices is the same whether one is addressing a utility or a milk producer."<sup>7</sup> The numerous errors in Professor Darr's article and the complete lack of substance in his conclusions call for a reply.

Professor Darr argues that my article contains two mistakes, one con-

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1. Darr, *The Constitutional Limits on Ratemaking: A Response to William Pond*, 11 ENERGY L.J. 53 (1990) [hereinafter Darr]. Professor Darr entitles his article: "A Response to William Pond." Even a cursory glance at my article shows that my name is Walter Pond.

2. Pond, *The Law Governing the Fixing of Public Utility Rates: A Response to Recent Judicial and Academic Misconceptions*, 41 ADMIN. L. REV. 1 (1989).

3. 262 U.S. 679 (1923).

4. 320 U.S. 591 (1944).

5. 488 U.S. 299 (1989).

6. Railroad Comm'n Cases, 116 U.S. 307 (1886); *Reagan v. Farmers' Loan & Trust Co.*, 154 U.S. 362 (1894); *Covington & Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578 (1896); *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923); *United Rys. & Elec. Co. v. West*, 280 U.S. 234 (1930); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989).

7. Darr, *supra* note 1, at 54.

cerning the basis of state authority, the other concerning the scope of the *Hope Natural Gas* test. He is wrong on both points.

## II. THE BASIS OF STATE AUTHORITY

Professor Darr seems unable to understand the difference between price control under the state's police power and the fixing of rates for individual utility companies. Under the former, a price is established for a specific product or service which is binding on all who furnish the product or service, regardless of its economic impact on individual vendors. If they cannot successfully operate under the established price, their only remedy is to discontinue selling the product or service. But since 1886, the Supreme Court has consistently held that this type of price control cannot be applied to public utility services, in view of the unique obligation of the utilities to furnish adequate service on demand. Thus, the price fixing authority of the state in the public utility field is subject to the requirement that the rates must be just and reasonable as applied to individual utility companies and their constitutionality must be tested by the application of eminent domain principles.

Chief Justice Rehnquist reaffirmed this century-old rule in the *Duquesne Light* case in three sentences:

The Constitution protects the utility from the net effect of the rate order on its property.<sup>8</sup>

[T]he Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory . . . .<sup>9</sup>

If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments.<sup>10</sup>

It is thus clear that the basis of state authority to fix utility rates rests on entirely different principles from that applicable to the authority to control prices in the non-utility field under the police power.

The only support relied on by Professor Darr for his argument is the concurring opinion of Justices Black, Douglas and Murphy in *Federal Power Comm'n v. Natural Gas Pipeline Co.*<sup>11</sup> It is true that the three justices argued that rate regulation of public utilities should be subject to the standard of judicial review applicable to non-utility economic regulation. But Professor Darr is in error when he speaks of this concurring opinion as if it were the opinion of the Court. While concurring in the result, the three justices actually dissented from the legal principles expressed in the opinion of the Court. Professor Darr never acknowledges the following statement of the concurring opinion: "[I]nsofar as the Court assumes that . . . the due process clause of the Fifth Amendment grants it power to invalidate an order as unconstitutional because it finds the charges to be unreasonable, we are unable to join in the opinion just announced."<sup>12</sup> Thus, Professor Darr is wrong when he states that

8. *Duquesne*, 488 U.S. at 314.

9. *Id.* at 307.

10. *Id.* at 308.

11. 315 U.S. 575 (1942).

12. *Id.* at 599 (Black, Douglas & Murphy, J.J., concurring).

the *Natural Gas Pipeline* case "was a rejection of the judicial interference resulting from the application of the due process and commerce clauses to assert substantive review."<sup>13</sup> "Quite simply, the Court rejected a distinction between price fixing and price and entry regulation."<sup>14</sup> Far from supporting his argument, the decision is directly opposed to it.

In a vague and inherently contradictory way, Professor Darr seeks to find some support for his views in the *Permian Basin Area Rate Cases*.<sup>15</sup> There the Supreme Court approved, with significant safeguards, the fixing of area wide rates for producers of natural gas. Professor Darr concedes that the case supports the conclusions stated in my article. He says:

[T]he Court seemed to recognize implicitly a floor to avoid a taking. If the rate is too low, then the producer could withdraw service. This discussion then would seem to support Pond's contention that there is a distinction between price regulation in which the investment can be removed and that in which the investment cannot.<sup>16</sup>

In light of this, it is incomprehensible that Professor Darr nevertheless claims to find support for his views in the *Permian Basin* case because "the right to recover costs to the investor for legitimate service to some extent, . . . would be lost during the period in which the commission considered the rate increase or request for abandonment."<sup>17</sup> Professor Darr fails to recognize that this is unavoidably true in every rate case, and that the so-called "regulatory lag" in no way affects the legal principles which the commission must apply.

### III. THE SCOPE OF THE *HOPE* TEST

Professor Darr returns to the practice of claiming support for his position from Justice Douglas' opinion in the case of *Hope Natural Gas*,<sup>18</sup> by giving it a distorted and completely untenable interpretation. His basic assertion is that the *Hope Natural Gas* case changed the law governing the constitutional protection of public utilities. It is clear, however, that the Court merely abandoned the requirement of a fair value rate base and gave to regulatory agencies discretion as to the method they used in reaching the constitutionally acquired end result, which it did not modify in any way.

Seldom has the meaning of a Supreme Court decision been so clearly established by its author as Justice Douglas' opinion in *Hope Natural Gas*. Thus, clear proof of the meaning of *Hope Natural Gas* arises from a comparison of the opinion in that case with Justice Douglas' opinion in *Bowles v. Willingham*<sup>19</sup> upholding war-time rent control. Both cases were argued and decided within a few weeks of each other.

In the *Hope Natural Gas* case, both the Commission and the Court of Appeals had held that the constitutional standard for rate orders established

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13. Darr, *supra* note 1, at 55.

14. *Id.*

15. 390 U.S. 747 (1968).

16. Darr, *supra* note 1, at 56.

17. *Id.* at 57.

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

19. 321 U.S. 503 (1944).

in the *Bluefield* case<sup>20</sup> was controlling.<sup>21</sup> Justice Douglas, in his opinion, restated the *Bluefield* test in express terms as follows: "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."<sup>22</sup> Justice Douglas then carefully examined the record to determine the economic impact of the rates at issue and found that these rates would "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed. . . ."<sup>23</sup> On this basis, the rate order of the Commission was upheld.

In spite of this, Professor Darr claims that the *Hope Natural Gas* case does not stand for the proposition that the investor must receive the *Bluefield* level of return, because there is no express citation to *Bluefield* in the *Hope Natural Gas* decision.<sup>24</sup> This is a naive argument. The *Bluefield* case was then, and is today, a binding precedent which establishes a specific constitutional protection for public utility companies.<sup>25</sup> It was not necessary for Justice Douglas to cite the case by name to make its rule applicable; on the other hand, if he wanted to abandon the *Bluefield* standard, it would have been necessary to overrule *Bluefield*.

Justice Douglas' treatment of this rate case should be compared with his treatment of the fixing of maximum rents under war-time rent control regulation in *Bowles v. Willingham*,<sup>26</sup> decided only a few weeks after the *Hope Natural Gas* case. This was a case of price control under the police power, or, in this particular case, the war power. No consideration of the effect of the rent control regulation on particular persons or companies was required so long as the maximum rents were generally fair and equitable. In upholding the rent control regulation, Justice Douglas expressly distinguished it from public utility ratemaking, saying:

We are not dealing here with a situation which involves a 'taking' of property . . . By Section 4(d) of the Act it is provided that 'nothing in this Act shall be construed to require any person to sell any commodity or to offer any accommodations for rent.' There is no requirement that the apartments in question be used for purposes which bring them under the Act.<sup>27</sup>

The comparison of these two opinions by Justice Douglas put into sharp

20. 262 U.S. 679 (1923).

21. *Cities of Cleveland and Akron v. Hope Natural Gas Co.*, 44 P.U.R. (N.S.) 1, 32 (1942); *Hope Natural Gas Co. v. FPC*, 134 F.2d 287, 308-09 (4th Cir. 1943), *cert. granted* 319 U.S. 735 (1943).

22. *Hope Natural Gas*, 320 U.S. at 603. Professor Darr apparently seeks to minimize the effect of this clear statement by asserting that Justice Douglas "parrots the language of *Bluefield*." Darr, *supra* note 1, at 58. To parrot is "to repeat without understanding." THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1413 (2d ed. 1987). The suggestion that Justice Douglas did not understand what he was saying is, of course, preposterous.

23. *Hope Natural Gas*, 320 U.S. at 605.

24. Darr, *supra* note 1, at 58.

25. It is cited by the Supreme Court with approval in the *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 (1989).

26. 321 U.S. 503 (1944).

27. *Id.* at 517.

relief the difference between public utility ratemaking and price-fixing in the exercise of general police powers and completely refutes Professor Darr's assertion that "state authority to fix prices is the same whether one is addressing a utility or a milk producer."<sup>28</sup>

But Justice Douglas has done more to establish the meaning of the *Hope Natural Gas* case than the two contrasting 1944 opinions. He has given an express and detailed explanation of the *Hope Natural Gas* case in his dissenting opinion in the *Permian Basin Area Rate Cases*. Justice Douglas dissented, saying:

What the Court does today cannot be reconciled with . . . *FPC v. Hope Natural Gas Co.* . . . .<sup>29</sup>

It was urged in the separate opinion of Mr. Justice Jackson in *Hope* that a system of regulation be authorized which would center not on the producer but on the product 'which would be regulated with an eye to average or typical producing conditions in the field (citation omitted).' But the Court rejected that approach . . . .<sup>30</sup>

Justice Douglas stated succinctly why *Permian Basin* could not be reconciled with *Hope Natural Gas* when he said, "The 'result reached' as to any producer is not known; [t]he 'impact of the rate order' on any producer is not known; [t]he 'total effect' of the rate order on a single producer is not known."<sup>31</sup>

In view of the foregoing it is clear that the decision in *Hope Natural Gas* requires that the "end result" of a rate order must be just and reasonable as to the specific public utility company and its investors and must meet the financial integrity and attraction of capital tests as stated in *Bluefield* and restated by Justice Douglas in *Hope Natural Gas*.

With the meaning of the *Hope Natural Gas* case so clearly established, it is hard to understand how Professor Darr can seriously advance the untenable proposition that "[s]ince at least the *Hope* decision . . . ratemaking and price fixing have been based on the same theory of state police power."<sup>32</sup> This is even more inexplicable since Professor Darr concedes that "In the *Duquesne* decision, the Court again returned to the eminent domain analogy for a limitation to price and entry regulation . . . the decision reflected a decidedly stronger notion of protection of the investor interest and clear reference to the *Bluefield* standard."<sup>33</sup>

The fact of the matter is that the *Duquesne* case affirms in every respect the conclusions reached in my article.

#### IV. CONCLUSION

I hope it is not too optimistic to believe that we may now finally be spared further attempts to use the decision in the *Hope Natural Gas* case as support

28. Darr, *supra* note 1, at 54.

29. *Permian Basin Area Rate Cases*, 390 U.S. at 829 (Douglas, J., dissenting).

30. *Id.* at 831 (emphasis added).

31. *Id.* at 830.

32. Darr, *supra* note 1, at 57.

33. *Id.* at 60.

for a doctrine of utility rate regulation which was clearly rejected by the Court.