"USED AND USEFUL": AUTOPSY OF A RATEMAKING POLICY

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The "used and useful" principle emerged from the primordial ooze of the public regulation of private enterprise and, in the epoch of "fair value" ratemaking, entered common regulatory parlance. It has become "a bedrock principle of utility regulation."[1] Compared to the particularities of modern ratemaking, such as marginal cost pricing, discounted cash flow analyses, cost classification and allocation techniques, and econometric modeling, it has a certain immutable friendliness and clarity. It seems beyond cavil that "[t]he rate base on which a return may be earned is the amount of property used and useful, at the time of the rate inquiry, in rendering a designated utility service. If the original cost or prudent investment concept is applied, this figure normally may be taken from the utility's books."[2]

Why then should anyone intimate, as does this article, that "used and useful" is moribund? Or, for that matter, that it even requires scholarly exposition? The recent wrangling within the U.S. Court of Appeals for the D.C. Circuit over application of used and useful to a cancelled nuclear plant suggests that the concept is alive, if not well. That court struggled mightily with the principle in three successive *Jersey Central Power & Light Co. v. FERC* decisions[3] which highlight how troublesome its various meanings and applications have become during the era of end result ratemaking. In the process, the court examined used and useful for one of the few times in the ninety-year history of the concept.

This article examines the evolution of the used and useful concept, the confusion it has engendered, and its current applications and misapplications, focusing on the ratemaking practices of the Federal Power Commission (FPC)

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1. Kentucky Utils. Co. v. FERC, 760 F.2d 1321, 1324 n.4 (D.C. Cir. 1985).

2. 1 PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 139-40 (1969).

3. Jersey Central Power & Light Co. v. FERC, 730 F.2d 816 (D.C. Cir. 1984) [hereinafter *Jersey Central I*] (unanimously affirming the Commission's summary denial of Jersey Central Power & Light's (JCP&L) application to recover $397 million prudently invested in a later-abandoned nuclear plant); Jersey Central Power & Light Co. v. FERC, 768 F.2d 1500 (D.C. Cir. 1985) [hereinafter *Jersey Central II*] (remanding the case because of the Commission's failure to explain how its summary application of its used and useful rule affected the overall end result of the rate; later vacated in favor of *en banc* review in Jersey Central Power & Light v. FERC, 776 F.2d 364 (1985)); Jersey Central Power & Light v. FERC, 810 F.2d 1168 (D.C. Cir. 1987) [hereinafter *Jersey Central III*] (vacating and remanding the Commission's order for failure to inquire under FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) (*Hope* or *Hope Natural Gas*), whether a rate that excludes recovery of the investment in the abandoned plant is just and reasonable in light of its effect on the investors in the financially-distressed utility). All majority opinions are by Judge Bork.

and its successor, the Federal Energy Regulatory Commission (FERC), both of which have been scarcely less taciturn than the courts in discussing the idea.

I. USED AND USEFUL BEFORE *HOPE*

Long before regulatory bodies or the courts plumbed the methodological niceties of ratemaking, the idea evolved that the public has certain rights in the private property it used for its own benefit. Going back to the regulation of ferry boats and port facilities under King James I of England, courts distinguished between those goods and services solely within the ambit of private property rights and those "affected with a public interest."[4] In *Munn v. Illinois*,[5] the Supreme Court set out the historic theory underlying public regulation of private property:

> Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use, but, so long as he maintains the use, he must submit to the control.[6]

The issue inherent in such a formulation is how best to distinguish activities clothed in public interest[7] from those within what was jurisprudentially called the *juris privati*. Whether the public use or convenience is construed broadly or narrowly determines largely the protagonist's relative market position as a

4. Lord Hale, *De Jure Maris & Brachiorum Ejusdem*, in 1 HARG. LAW TRACTS 6-8 (1787).

5. Munn v. Illinois, 94 U.S. 113 (1876).

6. *Id.* at 126.

7. Various tests are suggested for determining whether an enterprise operates as a public utility, *i.e.*, in the public interest. Economic tests pertain to natural limitations on the source of supply, the conditions under which a product is supplied (*e.g.*, natural monopoly considerations), the scarcity of advantageous sites, time limitations on the customer, or perhaps conditions that deter competition. *See* M. GLAESER, OUTLINES OF PUBLIC UTILITY ECONOMICS, 172-79 (1931). A further legal distinction is drawn in those cases where a private company operated as an agent of the state, exercising its right of eminent domain. Public control arises from the use of public power. Olcott v. The Supervisors, 83 U.S. 678, 695 (1873). Later, in the regulatory context, Justice Brandeis stated that an investor's "company is the substitute for the State in the performance of a public service . . . ." Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 291 (1923) (Brandeis and Holmes, J.J., dissenting) [hereinafter *Southwestern Bell Tel.*]. *But cf.* Jersey Central III, 810 F.2d at 1189 (Starr, J. concurring) ("The utility is not a servant to the state; it is a for-profit enterprise which incurs legal obligations in exchange for state-conferred benefits.").

Companies may naturally have resisted classification of all or part of their activities as devoted to a public use because of the limitations which government might place on their earning power. However, as regulatory law developed, companies became more completely devoted to public uses (even overtly supportive of regulation by the state) and increasingly subject to some form of price-fixing by public institutions. Under such modern circumstances, earnings might logically be maximized by arguing either that the assets of the company determined to be in the public service are of higher value, or that a greater proportion of the companies' total assets or expenditures are dedicated to a public use. The final argument is the crux of the historic "used and useful" debate between regulated industries and regulators. Revisionist theories of regulation suggest that business insisted on regulation in several instances, thereby obviating the need to seek the value of private property in commercial markets. G. KOLKO, THE TRIUMPH OF CONSERVATION: A REINTERPRETATION OF AMERICAN HISTORY, 1900-1916 (1963).

producer or consumer, the economic climate (*i.e.*, the prospect of relative increases or decreases in the value of property due to inflation or deflation), and finally the prevailing means of measuring the worth of utility properties.

The historic distinction between what is and what is not employed or devoted to a public use, in other words what is "clothed with a public interest" so as to warrant economic constraint by society, relates to the distinction in ratemaking theory between what is and what is not used and useful to the public service. Both are fundamentally considerations of equity between the interests of the providers and the consumers of a service.[8] Accordingly, regulation by the state is limited both in its control of private property and the benefits it may bestow on the public by the extent to which private activity or property is colored and thereby governed by the public interest. The legal analogy used by the Court in 1894 as a means of explaining the "taking" of private property for public use in return for just compensation was, of course, the law of eminent domain.[9] Not until *Smyth v. Ames*,[10] however, did the Supreme Court formulate a coherent test of the extent to which regulated companies were protected from legislative expropriation on behalf of the public, that is, what compensation was due. Ascertaining how much compensation a utility deserves begins with deciding what property is truly committed to public service.

Before *Smyth v. Ames*, regulatory agencies were already excluding from "the valuation," *i.e.*, the rate base, property that was not actually employed in the utility function.[11] The "fair value" cases which followed *Smyth v. Ames*, and which arose from state and local regulatory actions, adopted the used and useful principle.[12] Ratemaking treatises written from the "fair value" standpoint used the term but analyzed only the valuation portion of the theory.[13]

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8. *But see* Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. REV. 65 (1985). Drobak found that, since *Hope*, the Constitution permits investors' financial interests to be readily subordinated to those of the public. *Id.* at 97. However, "the extreme financial harm that commissions may impose on utility investors without violating the Constitution" at some point results in an unconstitutional confiscation of capital. *Id.* at 124. The view that the used and useful test carries out this balance in favor of the public and against investors, *id.* at 94, is adopted by the concurring opinion in *Jersey Central III*, 810 F.2d at 1180-81. *See infra* Section III.

9. Reagan v. Farmers' Loan & Trust Co., 154 U.S. 362, 410 (1894).

10. Smyth v. Ames, 169 U.S. 466 (1898).

11. San Diego Water Co. v. City of San Diego, 118 Cal. 556, 50 P. 633 (1897) (excluding property "now not available for present use"); Capital City Gaslight Co. v. City of Des Moines, 72 F. 829 (C.C.S.D. Iowa 1896); Covington & Lexington Turnpike Road Co. v. Sandford, 164 U.S. 578, 596-98 (1896).

12. *See, e.g.*, San Diego Land & Town Co. v. National City, 174 U.S. 739, 756 (1899) ("What the company is entitled to demand, in order that it may have just compensation, is a fair return upon the reasonable value of the property at the time it is being used for the public."); Willcox v. Consolidated Gas Co., 212 U.S. 19, 41 (1909) ("There must be a fair return upon the reasonable value of the property at the time it is being used for the public."); Cumberland Tel. & Tel. Co. v. City of Louisville, 187 F. 637, 642, 646-48 (C.C.W.D. Ky. 1911), *rev'd*, 225 U.S. 430 (1911), (referring to a return on property "at the time it is being used for the public"); Minnesota Rate Cases, 230 U.S. 352, 354-55 (1913) ("The ratemaking power is legislative power and necessarily implies a range of legislative discretion .... The basis of calculation is the fair value of the property used for the convenience of the public."); Lake Hemet Water Co. 1917A Pub. Util. Rep. (PUR) 468, 477-78 (Cal. R.R. Comm'n 1917) (deducting from the valuation of an overbuilt system the investment in excess capacity).

13. H. FLOY, FAIR VALUE FOR RATE-MAKING 54-99 (1916) ("Present value means the 'here and

Despite this off-handed treatment of "used and useful," the valuation of "fair value" theorists held closely to what may be termed an immediate use doctrine. The New York Public Service Commission articulated the standard:

> Consumers should not pay in rates for property not presently concerned in the service rendered, unless—
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> (1) Conditions exist pointing to its immediate future use; or
>
> (2) Unless the property is such that it should be maintained for reasonable emergency or substitute service; and in studying these two exceptions the economic factor should be carefully considered.[14]

The used and useful principle fits comfortably into fair value theory as a kind of method of inventory of currently operative items of physical plant. Moreover, recurring references to the principle in the case law prior to *Hope* served to associate used and useful with the liturgy of fair value ratemaking.

In 1898, when the Supreme Court found in *Smyth v. Ames*[15] that a Nebraska law fixing unreasonably low freight rates violated the Fourteenth Amendment, public utility regulation was a local affair with an unmistakably populist and experimental air to it. Ratemaking methodologies were only beginning to coalesce around a consistent framework of constitutional, economic, and accounting principles. Commentators have customarily viewed the case to some degree as the first to formulate a consistent approach to ratemaking matters, notable with respect to rate base valuation. Justice Harlan's oft-cited holding in *Smyth v. Ames* influenced the tenor and course of ratemaking policy for two generations:

> We hold . . . that the basis of all calculation as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the *fair value* of the property being *used by it for the convenience of the public* . . . . What the company is entitled to ask is a fair return upon the value of that which it *employs for the public convenience.*[16]

This required, among other things, that the rate base (net value of investment in earning assets) must be "valuated" at its present market cost or its reproduction cost (the Court specified several factors to be considered) and consist of property devoted to a public use.[17] The Court thereby set forth the idea that the only public utility property eligible to earn a return must be used in the public service.

Smyth v. Ames profoundly affected utility regulation until the 1940s. Its bold declaration of a ratemaking standard that would protect utility investors

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now' value of the property used, useful, or reasonably required for the service being rendered." *Id.* at 70); *see also* C. GRUNSKY, VALUATION, DEPRECIATION AND RATE-BASE 17-19, 150-62 (1922).

14. Elmira Water, Light & R.R., 1922D Pub. Util. Rep. (PUR) 231, 238 (N.Y. Pub. Serv. Comm'n 1922).

15. "The case . . . climaxed two decades of decisions in which the court gradually took unto itself the power of reviewing the reasonableness of rate regulation." Barron, *The Evolution of* Smyth v. Ames, 28 VA. L. REV. 761, 762 (1942).

16. *Smyth*, 169 U.S. at 546-47 (emphasis added).

17. *Id.* Justice Harlan's affirmance of Circuit Judge (later Justice) David Brewer is thought generally to be a restatement of the latter's opinion below. Brewer's ideas reflected a close identification of rate regulation with the law of eminent domain and thus held that property *taken* for public purposes must be paid for in terms of its actual value. Barron, *supra* note 15, at 791. Ames v. Union Pac. Ry. Co., 64 F. 165, 177 (C.C.D. Neb. 1894).

from an illegal taking of their property filled a troublesome void. It also vexed public utility commissions in its imprecision and theoretical circularity.[18] Until the *Hope* case, methodological inquiries in ratemaking focused almost exclusively on the content and value of rate base, rather than on the appropriate rate of return on rate base. Because of the widespread deference originally given *Smyth v. Ames*, the used and useful principle that it inspired is associated inextricably with the valuation of rate base controversy. Briefly summarized, that controversy—called by Professor Bonbright "the most widely disputed legal issue in the history of American public utility regulation"[19]—sprang from the Court's insistence that a fair return on property used for the public convenience must be based on its current value, not only its actual cost to investors. Measurement of such value, variously described in terms of comparative price levels, present market prices, and reproduction costs, was more suited to assessors of physical property rather than accountants.[20]

After *Smyth v. Ames*, the courts fretted for years over whether particular industries were affected with a public interest and whether the Constitution therefore barred state interference with free market activity. In *Nebbia v. New York*, 291 U.S. 502, 525 (1934), the Court abandoned that concern in recognition that regulation, whatever its object, afforded due process if it was neither unreasonable nor arbitrary.[21] By that time, used and useful was widely used to identify those assets that were "taken for public use"[22] and for which pri-

18. 1 A. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 37-39 (1970).

19. J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 159-191 (1961).

20. The fair value principle endured until the 1940s but by then it had long since been discredited as "delusive," "legally and economically unsound," and exposing "the investor and the public to danger of serious injustice," depending on the price levels at the time of a rate case. It was fraught with circularity because a regulated utility's property values depended in part on the level of the utility rates which, in turn, would depend on valuation. *Southwestern Bell Tel.*, 262 U.S. 276, 290-292, 304 (1923) (Brandeis and Holmes, J.J., dissenting). Justice Brandeis' belief in a cost-oriented rate base principle was prescient. He nevertheless favored recovery of all capital invested to provide the public with service as a matter of constitutional necessity, absent imprudence. *Id.*

Surprisingly, the valuation method survived long enough to be applied by the Federal Energy Regulatory Commission in exercising its authority over oil pipeline rates. This authority, which the FERC inherited in 1977 from the Interstate Commerce Commission was historically rooted in reproduction cost theory. Texas Midland R.R., 75 I.C.C. 1 (1918), provides a summary of oil pipeline valuation concepts based on the Valuation Act, 37 Stat. 701 (1913) (codified in Interstate Commerce Act, 49 U.S.C. § 10781 (1982)), which required a report of the reproduction cost of property "owned and used" by a common carrier. Into the 1980s, the FERC sought to retain the valuation approach, which it deemed clumsy but usable. Williams Pipe Line Co., 21 F.E.R.C. ¶ 61,260, at 61,636-37, 61,706 (1982) (Opinion No. 154) (quoting Farmers Union Cent. Exch. v. FERC, 584 F.2d 408 (D.C. Cir. 1978)). After a final rejection in court, the old methodology was discarded in favor of a trended original cost approach. Williams Pipe Line Co., 31 F.E.R.C. ¶ 61,377 (1985) (Opinion No. 154-B). *See* Farmers Union Cent. Exch. v. FERC, 734 F.2d 1486 (D.C. Cir. 1984), *cert. denied sub nom.* Williams Pipe Line Co. v. Farmers Union Cent. Exch., 469 U.S. 1034 (1984).

21. *See* A. KAHN, *supra* note 18, at 3-8.

22. A belief in a statutory "taking" of property for public use is reflected in Justice Brandeis' concurrence in *Southwestern Bell Tel.*, 262 U.S. at 290-91; *see also* Washington Gas Light Co. v. Baker, 188 F.2d 11, 18 (D.C. Cir. 1952). But compare Judge Starr, concurring in *Jersey Central III*, who now finds "that a taking occurs not when an investment is made . . . but when the balance between investor and ratepayer interests—the very function of utility regulation—is struck improperly." *Jersey Central III*, 810 F.2d at 1191. If, as in Judge Starr's view, the act of regulation is not in itself a taking (absent a confiscatory

vate companies were entitled to a fair return from the public. *Nebbia* rendered this function academic for the most part. Used and useful therefore came increasingly to serve its other role of placing definite limitations on the cost responsibilities of the persons receiving utility services.

A classic formulation of this approach was written in 1934 by Justice Cardozo.[23] He discussed how one decides when operative gas fields might reasonably be expected to be "in use" or productive so as to warrant inclusion in rate base. Cardozo recognized that the purchase of unoperated real estate contained the risk that no benefit would accrue to whomever supplied the capital. However, Cardozo was more concerned that, without some additional factor such as a deteriorating gas supply situation which might justify an innovative rate base treatment, there was a serious potential for abuse to present and even future ratepayers if they were compelled to pay for assets deliberately held idle.

> There will be no need in the computation of the rate base to include the market or the book value of fields not presently in use, unless the time for using them is so near that they may be said, as least by analogy, to have the quality of working capital. The arrival of that time cannot be known in advance through the application of a formula, but within the margin of a fair discretion must be determined for every producer by the triers of the facts in the light of all the circumstances . . . . Leases bought with income, the proceeds of the sale of gas, and thus paid for in the last analysis through the contributions of consumers, ought not in fairness to be capitalized until present or imminent need for use as sources of supply shall have brought them into the base upon which profits must be earned. To capitalize them sooner is to build the rate structure of the business upon assets held in idleness to abide the uses of the future. At times the immediate purpose of buying up extensive tracts is to forestall or stifle competition that might bring the prices down. There is adequate compensation for investment so remotely beneficial when the cost of renewing fields in present operation, and thus replenishing the capital, is paid out of gross earnings as an expense of operation, with a proportionate increase of the prices to be charged for gas thereafter . . . . Postponement of other profit until the stage of imminent or present use is not an act of confiscation, but a legitimate exercise of legislative judgment.[24]

A decade after *Nebbia*, in the *Hope* decision, the Court finally eschewed the scholastic fascination with rate base formulation. It circumscribed judicial review of agency ratemaking decisions by declaring a court's responsibilities at an end if it had ascertained that the total effect of a rate order under review was not unjust or unreasonable.[25]

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rate), the question of whether facilities were devoted to, or actually used and useful in, the public service is reduced to mere instrumentalism. "As I see it, the 'used and useful' rule is but another . . . safeguard [imposed for the benefit of ratepayers]." *Id.* at 1190. *See infra* section III.

23. Columbus Gas & Fuel Co. v. Public Utils. Comm'n, 292 U.S. 398, 406-07 (1934).

24. *Id.* at 406-07 (footnote and citations omitted).

25. A line of cases in the 1930s foreordained the end of the fair value approach. In Los Angeles Gas & Elec. Corp. v. Railroad Comm'n, 289 U.S. 287, 307 (1933), the Court used reproduction cost rate base to reduce rates at the height of the Depression but concluded that it was not the exclusive test; ratemaking would be left to regulatory agencies absent a showing that confiscatory rates were imposed. The Court found value-based rates to be confiscatory in Lindheimer v. Illinois Bell Tel. Co., 292 U.S. 151, 175 (1934). It upheld an agency refusal to consider evidence of reproduction costs and the substitution of historical cost evidence. Railroad Comm'n v. Pacific Gas & Elec. Co., 302 U.S. 388, 396-98 (1938). "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas." FPC v.

In the final analysis, the practical difficulties inherent in the fair value approach insured the courts' retreat from such a fixed constitutional standard for ratemaking and from close judicial scrutiny of the ratemaking processes. As the basic legal standards of rate regulation changed, used and useful was limited in the ways that it could be applied. "[W]ith the demise of 'fair value,' " stated the Court of Appeals in the recent *Jersey Central III* case, " 'used and useful' ceased to have any constitutional significance, and the [Federal Energy Regulatory] Commission has at times departed from this standard. It is now simply one of several permissible tools of ratemaking, one that need not be, and is not, employed in every instance."[26] But, as the *Jersey Central I* court had made clear, used and useful had not been overridden by the *Hope* end result test, for to have done so would have revolutionized ratemaking.[27] Used and useful, like many other ratemaking tenets, has supposedly retained its vitality[28] although it no longer served to insulate investors from confiscatory rates that regulators might impose.

If Justice Brandeis' prudent investment theory had come to predominate utility ratemaking after *Hope*, used and useful would today be an artifact. In arguing that the Constitution protected the *capital* supplied by investors and not their property as currently valued, he had recognized that the fair value test of what rate is "confiscatory" went only to whether it was compensatory, not whether it was reasonable, and that the *Smyth v. Ames* Court had designed a ratemaking theory impossible for regulatory commissions to use or for courts to review.[29] Although the predisposition of legislatures and commissions toward original cost ratemaking following *Hope* owes much to this argument, had investors been entitled to recover all prudently incurred costs, prudent investigations would be the first, not the last, resort of agencies suspecting excessive returns. It would be the dispositive issue in modern ratemaking.[30] In holding that *Hope* permitted use of the prudent investment rate base formula by the District of Columbia commission, Judge Bazelon in 1952 observed that "[a]ppraisal of the . . . theory reveals that the 'used and

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Natural Gas Pipeline Co., 315 U.S. 575, 586 (1942). "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling." *Hope*, 320 U.S. at 602. The end-result formulation finally rejected the meticulous court review of highly theoretical rate base formulas, but most state agencies and the FPC were already predisposed to shelve fair value in favor of an examination of historical costs.

Before *Hope*, the statutory mandate of the Federal Power Commission had departed from fair value standards. Both the Federal Power Act (FPA) (sections 3(13), 4(b), 14 and 208) and the Natural Gas Act (NGA) (sections 6 and 9(a)) relied on net-investment concepts in their valuation and depreciation provisions. FPA, 16 U.S.C. §§ 791-828c (1982); NGA, 15 U.S.C. §§ 717-717z (1982). Section 208(a) of the FPA was construed as a definite departure from the fair value doctrine and evidence of reproduction cost was ruled excludible. Chicago Dist. Elec. Generating Corp., 2 F.P.C. 412, 419 (1941). *See infra* note 33.

26. *Jersey Central III*, 810 F.2d at 1175. *See infra* note 125.

27. *Jersey Central I*, 730 F.2d at 823.

28. *See* Drobak, *supra* note 8, at 122 (citing *Toledo Edison Co. v. Public Utils. Comm'n*, 12 Ohio St. 3d 143, 465 N.E.2d 886 (1984) (per curiam).

29. *Southwestern Bell Tel.*, 262 U.S. at 296. *See* J. BONBRIGHT, *supra* note 19, at 165; M. GLAESER, *supra* note 7, at 320; *see also supra* note 20.

30. The court in *Jersey Central II* expressly favored the prudent investment theory as "far more sensible" than used and useful because it treated utilities more like other businesses by allowing early recovery of investment in future enterprises. *Jersey Central II*, 768 F.2d at 1504 n.4. *Cf. infra* note 140.

useful' standard is no necessary part of it."[31] But, as courts have long recognized, the prudent investment rate base principle "was not to become the prevailing rule."[32]

II. USED AND USEFUL SINCE *HOPE*

When at last *Hope* cast aside fair value ratemaking for an "end result" that was plain just and reasonable, it was implementing a statutory command. In the Natural Gas Act and Federal Power Act, the Congress had already suggested ratemaking based on original cost, including the cost of capital, and the widely-accepted *Bluefield* standard that a utility must be allowed a return on investment that meets capital attraction and prudent management standards.[33] Cases arising under the Federal Power Act, Natural Gas Act, and analogous state laws continued to adhere to the used and useful principle in the context of original cost ratemaking and the fundamental statutory objective that rates be just and reasonable. The corpus of regulatory and court opinion prescribes that a utility's operating expenses may not be recovered in rates and that even prudently-incurred costs of plant will not be included in rate base, unless a benefit from such expenditures inures to the benefit of present ratepayers.[34]

In the context of *Hope*, used and useful developed a greater degree of flexibility than could have been expected under the rigors of the fair value approach to rate base. Post-war economic conditions contributed to this.

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31. Washington Gas Light Co. v. Baker, 188 F.2d 11, 19 (D.C. Cir. 1952). Recognizing that the D.C. commission operated under law similar to that administered by the FPC, Judge Bazelon's opinion states that *Hope* permits agencies to adopt "any method of *valuation* for rate base," even if that includes retention in rate base of the originally prudent but now obsolete plant until its costs are recovered. *Id.* at 14, 18-19 (emphasis added). *See also* NEPCO Mun. Rate Comm. v. FERC, 668 F.2d 1327, 1333 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982), where a utility sought to use Justice Brandeis' theories to justify a return on a cancelled nuclear plant.

32. Democratic Cent. Comm. v. Washington Metro. Area Transit Comm'n, 485 F.2d 786, 801 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 935 (1974).

33. Bluefield Waterworks and Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679 (1923).

The Federal Water Power Act of 1920 prescribed that a licensee would be compensated for its net investment if the United States exercised eminent domain power to take the water power project when the license expires. Federal Water Power Act of 1920, § 14(a), 16 U.S.C. § 807(a) (1982). Sections 4(b) and 208(a) of the Federal Power Act and section 6(a) of the Natural Gas Act authorize the Commission to ascertain the "actual legitimate cost" of public utility property for ratemaking purposes. FPA, 16 U.S.C. §§ 797(b), 824g(a) (1982); NGA, 15 U.S.C. § 717e(a) (1982).

The term "used and useful" was adopted in section 9(a) of the Natural Gas Act, which authorized the Commission to set depreciation rates for the "used and useful" property of natural gas companies. 15 U.S.C. § 717h(a) (1982). The parallel provision of the Federal Power Act, section 302(a) does not refer to "used and useful" property. 16 U.S.C. § 825a(a) (1982).

34. *E.g.*, Tennessee Gas Pipeline Co. v. FPC, 561 F.2d 955, 958 (D.C. Cir. 1977) (overhead costs held "not incurred for the benefit of *present* customers"); In Tennessee Gas Pipeline Co. v. FERC, 606 F.2d 1094 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920, *cert. denied*, 447 U.S. 922 (1980), the court stated that

> [a]lthough methods for determining values of rate base items have evolved since *Smyth v. Ames*, the precept endures that an item may be included in rate base only when it is 'used and useful' in providing service. In other words, current rate payers should bear only legitimate costs of providing service to them.

Id. at 1109.

Inflation, attrition of utility earnings over the effective period of a rate, and regulatory lag in approving rates served to distort the perceived relationship between investments made and rates paid in accordance with those investments. Fair value ratemaking, its tortuous methodologies aside, was value-based and forward-looking. On the other hand, original cost ratemaking, its easy application of book values notwithstanding, promises in times of inflation only to return a utility's investments in dollars of declining value. Regulatory agencies responded to these phenomena with future test years that contained estimates of future revenues and expenses, and with higher rates of return. However, just as used and useful once restrained the potential of fair value ratemaking to inflate rates without relation to actual dollars spent, so it may now (by synchronizing the payment of rates and incurrence of costs) militate against the natural tendency of original cost-based rates to retard earnings in the face of inflation and escalating costs.

The used and useful principle fared poorly under the *Hope* standards and Congress' modern regulatory mandates. The law of used and useful is still unsettled and is further complicated by the controversy surrounding the latitude agencies should exercise in applying rules of policy. In the provocative area of cancelled nuclear plant costs, sharp divisions among jurists over the deference owed an agency applying a general policy to specific facts that portend an unfortunate impact from the rate at issue, occasion similar divisions over the used and useful doctrine. It is variously described as an "impregnable barrier" to inclusion in rate base evincing the FERC's supposed hostility to "end result" examinations,[35] a "policy of flexibility" based on "venerable authority" but not a binding rule,[36] and a widely-applicable "substantive rule or ratemaking" that governs more than just the misfortunes of nuclear power generation.[37] This confusion is instructive, however, for it suggests that, as a ratemaking tool, used and useful has been administered in an *ad hoc* fashion. It is no longer the fundamental nature of the concept but the propriety of its particular application that foments debate.

Lest used and useful appear to lose all form and content, its basic themes bear recitation. Regulatory commissions have used it to exclude fixed costs from rate base under a traditional benefit analysis; in addition, expenses or variable costs not associated with physical plant are similarly denied recovery as a part of cost of service also because no benefit accrues to the ratepayers.[38]

35. *Jersey Central III*, 810 F.2d at 1187.

36. *Id.* at 1191 n.3 (Starr, J., concurring, citing Denver Union Stock Yard Co. v. United States, 304 U.S. 470, 475 (1938)). In the heyday of fair value ratemaking, courts were at great pains to figure precisely whether the fair value of used and useful property had been duly protected in rates. The Supreme Court's 1938 *Denver Stock Yard* decision typifies that exercise and, perhaps because it came so late and even Justice Brandeis assented to it, it is most frequently cited for the used and useful principle. Its traditional approach is designed to protect utility property from being illegally taken and to protect consumers from exploitation at the hands of monopolists. *Denver Stock Yard* contains none of the risk or benefit analysis now common in determining what gets included in rate base or cost of service. *See*, Brief for Respondent FERC at 11 n.6, *Jersey Central I*, 730 F.2d 816 (D.C. Cir. 1984).

37. *Jersey Central III*, 810 F.2d at 1199 (Mikva, Wald, Robinson and Edwards, J.J., dissenting.)

38. When *Hope*, following Brandeis' concurrence in *Southwestern Bell Tel.*, began measuring the investors' interest in terms of capital invested rather than property owned, it arguably extended the

Furthermore, the flexibility to craft ratemaking practices for which *Hope* was an augury, results in a pastiche of criteria for identifying which items are used and useful,[39] as well as distinguishable exceptions or departures to the direct benefit rule. Generally speaking, the case law regards costs incurred and investments made used and useful if: (1) there is a direct and immediate benefit to customers; traditionally, the investment is in a plant that is operational now or in a future test year or in the period during which the rates may reasonably be expected to be in effect; (2) the investment or expense, even if not affording an immediate tangible benefit, meets certain secondary benefit criteria, such as reasonably foreseeable plant completion, a necessary cost of continuing business (including land acquisition to enhance gas reserves or other reasonable plans and commitments to dedicate property to public service), or assets held in reserve to ensure service reliability; or (3) the expenditure is necessitated by the projected immediate needs of the ratepaying public.

A. Applications of the Principle

Not surprisingly, the used and useful case law of regulatory agencies is largely concerned with assets eligible for rate base, *i.e.*, the investment in physical plant upon which utilities may earn a return. Soon after the passage of the Federal Power Act, the FPC utilized strict rules of rate base treatment; for instance, costs were includible in rate base only if facilities were considered "permanently and regularly used" to provide service. A *portion* of even existing facilities were disallowed if "not actually used in rendering service." This is, of course, the practice that subsequent authorities regard as the "rule" of used and useful.[40] While this test appears sufficiently straightforward, however, there is no indication that the FPC would have excluded facilities not regularly contributing to electrical generation, if they provided, say, a necessary reserve of capacity.[41] Later commissions in fact applied the rule flexibly. Historically, land held by public utilities for future use was eligible for rate base treatment, if it was shown that such property could become part of a plant in service.[42] Early used and useful cases involved total disallowances in

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philosophy of used and useful to all parts of a rate, including expenses which represent a liability for investors even though not "sunk" capital.

39. Looking at the same facts, jurists have developed divergent appreciations of what constitutes a binding used and useful rule. The majority and concurrence in *Jersey Central III* denied that the Commission had an ironclad used and useful rule because of the recognized departures from it. 810 F.2d at 1183, 1188. The dissent presumes that the *NEPCO* decision is typical of the Commission's used and useful policy as a whole. *Id.* at 1198.

40. Interstate Power Co., 2 F.P.C. 71, 75-76, 92 (1939). *Cf.* Peoples Gas Light & Coke Co., 27 Pub. Util. Rep. 3d (PUR) 209, 217-19 (1959). *See supra* note 34.

41. Assets allegedly dedicated to operating contingencies must nevertheless be reasonable and supported on the record. Chicago Dist. Elec. Generating Co., 2 F.P.C. 412, 424 (1941), *modified*, 8 F.P.C. 746 (1949). Wisconsin Tel. Co. v. Public Serv. Comm'n, 30 Pub. Util. Rep. New Series (PUR) 65, 110-14 (Wis. 1939).

42. Detroit Edison Power Co., 54 F.P.C. 3012 (1975). Land held for future use is here distinguished from equipment (plant) held for future use, which is disallowed except where it is shown to involve a necessary cost of the continuing business. *Cf.* Order No. 420, *Accounting Treatment for Land Held for Future Utility Use and for Profits or Losses Realized Through Sales of Those Lands*, 45 F.P.C. 106, *modified*, 45 F.P.C. 340 (1971) (This order requires a "definite plan" for use in utility operations to qualify for

accord with the traditional rule that insulated ratepayers from compensating a utility for costs that had not yielded a benefit directly. The FPC disallowed the cost of facilities that were experimental,[43] the cost of abandoned facilities,[44] the cost of real estate held for future use at a time or in a manner too "indefinite,"[45] interest, taxes and related expenses incurred during a suspension in construction activity,[46] charges such as salaries and surveys related to future property acquisitions,[47] and the cost of materials intended for, but not used in, plant construction.[48] These disallowances naturally bore an entirely different relationship to the total utility investment than does a cancelled nuclear facility under recent conditions.

Dealing with the costs of ongoing construction has long been a difficult issue. The solution adopted by the FPC and the FERC originally squared with the demands of used and useful. Utilities were permitted to capitalize interest on funds used to build new plant (Allowances for Funds Used During Construction or AFUDC), but no return was drawn on such monies until the date of plant operation, at which time the costs of the plant, including interest, is added to rate base.[49] The traditional rule prescribes that such costs are not eligible for rate base treatment until the "addition or facility becomes available for service."[50] Utility economics over the last decade nevertheless led the FPC and the FERC to revise in part its treatment of the costs associated with plant under construction (construction work in progress or CWIP). In its first and highly tentative liberalization of used and useful, as applied to all electric plant, the FPC stated:

> The question of the proper treatment for ratemaking purposes of capital expenditures which have not yet been placed in service is one which is subject to a play of conflicting principles. On the other hand, public utility regulation has generally adhered to the principle that a rate base should only include items which are "used and useful." On the other hand, regulation has also always recognized that the expense of financing construction to serve customers is itself a legitimate expense which must ultimately be borne by the ratepayers.[51]

In Order No. 555, the Commission acknowledged that departures from

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inclusion in rate base; gains or losses upon disposition pass to ratepayer. This applies to natural gas companies also.).

43. Pennsylvania Water & Power Co., 8 F.P.C. 1, 48 (1949), *aff'd*, 193 F.2d 230 (D.C. Cir. 1951), *aff'd*, 343 U.S. 414 (1952) (rollover dam devices).

44. *Id.* at 59 (transmission towers).

45. *Id.* at 63-65; Chicago Dist. Elec. Generating Co., 2 F.P.C. at 421.

46. Chicago Dist. Elec. Generating Co., 2 F.P.C. at 422; Pennsylvania Water and Power Co., 8 F.P.C. at 45 (where no showing was made that the expenditures helped to shorten the subsequent construction time).

47. Pennsylvania Water and Power Co., 8 F.P.C. at 50-51 (expenses bore an "exceedingly minor relation to project cost work").

48. *Id.* at 56.

49. Order No. 561, *Order Adopting Amendments to the Uniform System of Accounts for Public Utilities and Licensees and for Natural Gas Companies*, 57 F.P.C. 608 (1977); *see also* Order No. 561-A, 59 F.P.C. 1340 (1977).

50. Order No. 561-A, 59 F.P.C. at 1364-65.

51. Order No. 555, *Order Adopting in Part Construction Work in Progress Rulemaking and Terminating Proceeding*, 56 F.P.C. 2939, 2940 (1976), *aff'd sub nom.* Oglethorpe Elec. Membership Corp. v. FERC, 574 F.2d 637 (D.C. Cir. 1978).

used and useful were warranted where the intergenerational equities made it acceptable for the current generation of ratepayers to pay immediately in rates for capital investment in environmental protection (pollution control devices such as scrubbers for coal burning plants) and conservation (fuel conversion measures to discourage use of oil and gas) which were made necessary by the demand of current users of power. In light of the deteriorating financial condition of electric utilities, the FPC went even further and opened the door for a more wholesale departure from used and useful if a utility could demonstrate its severe financial difficulty. With only one exception,[52] utilities were unable to take advantage of this opportunity during the seven years it was in effect. In practical terms, Order No. 555 never strayed far from the used and useful rule.

The FERC's most controversial application of used and useful involved recovery of costs for unsuccessful nuclear power supply projects by means other than inclusion in rate base. A return *on* such an investment was treated as contrary to used and useful, although reimbursement by ratepayers through amortization was not.[53] The Commission rejected NEPCO's request for rate base treatment and cited as justification only the administrative law judge's rationale, namely that ratepayers are not required to ensure a return on utility investments that are not used and useful. While the judge acknowledged that utility investors cannot be shielded from risk, he nevertheless concluded that "NEPCO should be entitled to recoup its Salem Harbor [cancelled plant] expenditure" because no one disputed that the investment was prudent.[54] Gas rate cases also reflected the general policy of excluding from rate base plant

52. *See* Montaup Elec. Co., 19 F.E.R.C. ¶ 61,062 (1982).

53. New England Power Co., 8 F.E.R.C. ¶ 61,054 (1979), *aff'd. sub nom.* NEPCO Mun. Rate Comm'n v. FERC, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982) (denial of rate base treatment for the costs of a nuclear power project abandoned due to changed circumstances). *See infra* Section III. In a case involving abandoned or unsuccessful gas projects, the FERC adopted a harder line and refused even to allow recovery of the company's costs. Although the denial of costs rests mainly on the speculative nature of the gas projects, the Commission made a jurisdictional distinction between unsuccessful gas and electric projects with respect to judging who should bear the costs of failure. Whereas the Commission does not authorize construction of electrical generation facilities under the Federal Power Act, its rates are always regulated by the FERC or the states and ratepayers are thereby assured of a benefit from successful plants (and presumably, may legitimately share in the risks of failures). Under the Natural Gas Act, however, the Commission authorizes or "certificates" natural gas facilities and it is comfortable denying any recovery of costs incurred developing (1) projects that fail before receiving or being eligible for a certificate or (2) synthetic gas projects that do not require a certificate under the NGA and which may not have benefitted jurisdictional ratepayers even if successful. Natural Gas Pipeline Co., 27 F.E.R.C. ¶ 61,201, at 61,379-81 (1984). The Court of Appeals affirmed, stating that "[w]e think the Commission could reasonably find that SNG and LNG facilities have no analogues in the electrical industry. Failed generation facilities may, of course, involve highly advanced technology, such as nuclear reactors. But Natural has not shown that its . . . projects were, when undertaken, as likely to be completed successfully and to benefit ratepayers as the failed electrical plans for which the Commission has permitted amortization." Natural Gas Pipeline Co. v. FERC, 765 F.2d 1155, 1168 (D.C. Cir. 1985).

54. New England Power Co., 8 F.E.R.C. at 61,175. The size of the potential losses in cancelled nuclear plants relative to utility capital structures may help resurrect a modified prudent investment approach. The reviewing court stated that used and useful requires that current ratepayers should bear only legitimate costs of providing them service. Nevertheless, equity required that NEPCO be given its costs as a reasonable balance of investor and consumer interests. Clearly, the Commission adhered to used and useful strictly as a rule of rate base eligibility.

expenses not considered directly used and useful. Unlike electric cases involving plant under construction, however, the gas decisions of the FPC and FERC have established neither minor variations like Order No. 555 nor the more dramatic departures like Order No. 298.[55] Any cost associated with a gas plant under construction has generally been includible in rate base when the project is "dedicated to the service of the consumers" and will otherwise be disallowed as "not incurred for the benefit of present consumers who will be required to pay the just and reasonable rates."[56]

On the whole, the FERC's used and useful approach in natural gas rate cases is typified by more rigorous adherence to the traditional rule, whether the cost of plant or other expenses are at issue. As noted, the FERC has been affirmed in its refusal to treat the gas and electrical industries uniformly because, on one hand, it authorizes gas supply projects under the NGA and resists rate treatment for projects it refuses to authorize and, on the other hand, the costs it is asked to allow in wholesale electric rates relate to projects approved generally by states.[57]

In addition, the interrelationship of producer and pipeline certification may also bear on whether a facility may be regarded used and useful. A pipeline company takes risks when it builds a pipeline where the contracts with producer-suppliers have not been certificated. Therefore, certification of the pipeline's facilities is without prejudice to a used and useful determination in future rate cases.[58]

Just as the FPC and the FERC did in their early electric rate decisions, however, they also implemented a traditional used and useful rule by disallowing costs, claimed by natural gas companies, that have been viewed as "conjectural,"[59] that involve excess capacity arising from "an improvident venture,"[60]

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55. *See infra* notes 79-82 and accompanying text.

56. Tennessee Gas Pipeline Co., 54 F.P.C. 1558, 1562 (1975) (overhead costs), *aff'd*, 561 F.2d 955 (D.C. Cir. 1977). *See* Memphis Natural Gas Co., 3 F.P.C. 566, 569 (1943). *See also* Ohio Fuel Gas Co., 5 F.P.C. 144, 146 (1946); City of Detroit v. Panhandle E. Pipeline Co., 3 F.P.C. 273, 285 (1942).

57. *See supra* note 53.

58. Northern Natural Gas Co., 34 F.P.C. 507, 513-14 (1965).

59. Natural Gas Pipeline Co., 27 F.E.R.C. ¶ 61,201 (1984) (holding that investment in foreign LNG and domestic SNG projects is too remote, speculative, and risky, and that the costs of studies for the Gas Arctic project are not includible in rates because pursuit of a certificate involves business risks), *aff'd*, Natural Gas Pipeline Co. v. FERC, 765 F.2d 1155 (D.C. Cir. 1985); Northern Natural Gas Co., 3 F.E.R.C. ¶ 61,131 (1978); Texas E. Transmission Corp., 4 F.E.R.C. ¶ 61,368 (1978); Transcontinental Gas Pipe Line Corp., 58 F.P.C. 2038 (1977), *aff'd sub nom.* Tennessee Gas Pipeline Co. v. FERC, 606 F.2d 1094 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 (1980) (four unsuccessful SNG projects excluded from rate base); Transwestern Pipeline Co., 53 F.P.C. 1287 (1975), *aff'd*, Silentman v. FPC, 566 F.2d 237 (D.C. Cir. 1977) (investors must bear the financial and technical risks until a project is completed; no charges allowed until project is used and useful); Canadian River Gas Co. v. Public Serv. Comm'n, 3 F.P.C. 32, 52 (1942) (property additions); City of Cleveland v. Hope Natural Gas Co., 3 F.P.C. 150, 157 (1942); Illinois Commerce Comm'n v. Natural Gas Pipeline Co., 2 F.P.C. 218, 228 (1940) (capital improvements not yet made).

60. Godfrey L. Cabot, Inc., 4 F.P.C. 174 (1944):

> It was . . . the hope for large industrial sales which determined the size of the facilities provided. The companies do not contend that the excess capacity is either used or useful in rendering present service, and any attempt to saddle excessive costs for depreciation and return on the domestic consumers would be manifestly unfair and unreasonable.

that relate to unsuccessful, abandoned, or dismantled projects,[61] retired plant,[62] research, development and demonstration expenses,[63] or that are "entrepreneurial" in nature.[64]

As regulators explored ratemaking innovations that would generate capital resources and innovation over time, they necessarily eroded what might be regarded as the used and useful policy. Yet even in those instances where identifiable ratepayers were not immediately benefitted, rate base treatment does not "depart" from the principle entirely. Consider the following inclusions in rate base: investment in properties representing plant held for future use, especially those properties such as real estate related to exploration and the effort to maintain natural gas supplies,[65] including properties which the agency recognizes as not used or having any direct relationship to service during the test period,[66] certain research and development projects,[67] abandoned storage programs and dry hole drillings,[68] loans and advances for gas purchase

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Id. at 185. The FPC stated that companies have an obligation to identify property no longer used and useful and to show adjustments to cost and depreciation.

61. Columbia Gas Transmission Corp., 13 F.E.R.C. ¶ 61,102 (1980) (though partly usable by other companies, studies performed for Gas Arctic/Northwest Project group—the loser in competition for a certificate of public convenience and necessity—are not directly used and useful to Columbia's ratepayers); Michigan Wis. Pipeline Co., 13 F.E.R.C. ¶ 61,254 (1980); Tennessee Gas Pipeline Co., 48 F.P.C. 149, 156 (1972), *aff'd*, Tennessee Gas Pipeline Co. v. FPC, 487 F.2d 1189 (1973) (prudent costs of unsuccessful LNG projects); Uniform System of Accounts, 18 C.F.R. Part 201, Account 426.5 (1987) (planning costs of an abandoned project taken below-the-line); Penn-York Natural Gas Corp., 5 F.P.C. 33, 35-36 (1946).

62. Cities Serv. Gas Co., 3 F.P.C. 459, 466, 471 (1943).

63. Tennessee Gas Pipeline Co., 48 F.P.C. 149, 156 (1972) (even though the unsuccessful LNG project was property of a depreciable nature which might warrant rate base treatment, it conferred no benefit to customers who had contracted to buy LNG if it became available). At the height of the gas shortage, spiraling inflation, and calls for conservation, the FPC reversed itself and in Order No. 566 issued accounting rules to "stimulate the R&D efforts" of jurisdictional companies. Order No. 566, *Research, Development & Demonstration; Accounting; Advance Approval of Rate Treatment*, 58 F.P.C. 2238 (1977). *See infra* note 67.

64. Columbia Gas Transmission Corp., 13 F.E.R.C. ¶ 61,102 (1980). *See* Natural Gas Pipeline Co., 27 F.E.R.C. ¶ 61,201 (1984).

65. Southern Natural Gas Co., 29 F.P.C. 323, 339 (1963); Phillips Petroleum Co., 24 F.P.C. 537, 565, 703-04 (1960) (undeveloped offshore leases, if warranted "in view of the necessity that all producers acquire additional reserves"); Cities Serv. Gas Co., 3 F.P.C. at 467-68 ("property devoted to the public service"); City of Cleveland, 3 F.P.C. 150, 174 (1942) (unoperational acreage "necessary and useful, or imminently useful, in rendering service"); Illinois Commerce Comm'n v. Natural Gas Pipeline Co., 2 F.P.C. 218, 228 (1940) ("future reasonable estimates of property additions").

66. El Paso Natural Gas Co., 22 F.P.C. 260, 269 (1959), *rev'd on other grounds*, 281 F.2d 567 (5th Cir. 1960) (evidence shows the likelihood that El Paso will build facilities if gas is developed); Michigan Wisconsin Pipe Line Co., 51 F.P.C. 2408, 2411 (1974), *modified*, 52 F.P.C. 342 (1974) (conventional fuel projects may receive different rate treatment than non-conventional projects).

67. 18 C.F.R. Parts 101 and 201, Accounts 103, 107, and 188 (1987). The Commission's provisions for advance rate treatment of R&D projects for electric utilities, 18 C.F.R. § 35.22 (1987), and natural gas companies, 18 C.F.R. § 154.63a(a)(2)(V) (1987), established by FPC Order No. 566 are still effective. Both provisions require evidence that a project "has a reasonable chance of benefiting the ratepayer in a reasonable period of time. . . ." *Cf.* Public Util. Comm'n v. FERC, 660 F.2d 821 (D.C. Cir. 1981).

68. Northern Natural Gas Co., 45 F.P.C. 1050 (1971); Midwestern Gas Transmission Co., 32 F.P.C. 993 (1964), *modified*, 44 F.P.C. 721 (1970); Southern Natural Gas Co., 29 F.P.C. 323 (1963), *modified*, 29 F.P.C. 433 (1963), 29 F.P.C. 779 (1963); El Paso Natural Gas Co., 22 F.P.C. 260 (1959); Phillips Petroleum Co., 24 F.P.C. 537, *aff'd*, 373 U.S. 294 (1963).

contracts,[69] costs of certain qualified advance payments made by pipelines to producers,[70] and costs of experimental projects specifically recognized by the agency as a means of demonstrating the feasibility of a new technology.[71] Agencies acknowledge that the demands of modern utility economics warrant what they consider definite departures from used and useful. But, the rate treatment given in these and other instances to property held, research performed, or other investments made in reasonable anticipation of the true needs for, and probable costs associated with, the future plant attests to the elasticity of the used and useful principle.

B. Departures from the Principle

We have seen that adherence to the used and useful principle is sometimes a matter of degree. Arguably, the inclusion in rate base of investment such as lands held for future use and research and development projects, are what modern ratemaking heralds as "pragmatic adjustments"[72] or a means of reconciling diverse interests.[73] They in fact represent a broadening of the standard of used and useful. In these instances, state and federal agencies determined that the resulting service reliability and economic efficiencies would indeed benefit the ratepaying public within a reasonable time.[74] This rationale is not entirely distinguishable from that underlying the traditional used and useful rule. The similarities between used and useful and various conventional notions of matching costs and benefits have not prevented the FPC and the FERC from signaling "departures" from the basic rule, however. For example, in considering the advance payment programs that the FPC and the

69. El Paso Natural Gas Co., 22 F.P.C. at 269 (necessary expenditure to obtain new gas reserves).

70. Order No. 410, *Accounting and Rate Treatment of Advance Payments to Suppliers for Gas*, 44 F.P.C. 1142 (1970), *aff'd*, 467 F.2d 361 (D.C. Cir. 1972); Order No. 410-A, 45 F.P.C. 135 (1971), *aff'd*, 467 F.2d 361 (D.C. Cir. 1972). Other advance payment orders are Order No. 441, *Accounting & Rate Treatment of Advance Payments to Suppliers for Exploration & Lease Aquisition of Gas Producing Properties*, 46 F.P.C. 1178 (1971), *aff'd*, Public Serv. Comm'n v. FPC, 467 F.2d 361 (D.C. Cir. 1972); Order No. 465, 48 F.P.C. 1550 (1972), *rev'd on other grounds*, United Gas Pipe Line v. FERC, 597 F.2d 581 (5th Cir. 1979); Order No. 499, 50 F.P.C. 2111 (1973). This practice was upheld in Tennessee Gas Pipeline Co. v. FERC, 606 F.2d 1094 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920, *cert. denied*, 447 U.S. 922 (1980).

71. Great Plains Coal Gasification Assocs., 9 F.E.R.C. ¶ 61,221 (1979) (cost sharing permitted during the developmental phase before the project was in service), *vacated on other grounds sub nom.* Office of Consumers' Counsel v. FERC, 655 F.2d 1132 (D.C. Cir. 1980). The Commission favored strict adherence to the prohibitions of the used and useful doctrine where, as in *Great Plains*, it would be unable to regulate the price of the gas produced and thereby prevent ratepayers from absorbing the losses if the project failed. Cost recovery was afforded in that case, however, on the theory that it was a special research and development project—a theory which did not prevent the court from reversing the Commission on jurisdictional grounds. *Id.* at 1147.

72. Permian Basin Area Rate Cases, 390 U.S. 747, 777 (1968), *reh'g denied*, 392 U.S. 917 (1968); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 586 (1942). "The legal system does not compel rigidity, or bureaucratic inflexibility, least of all in the area of energy policy where flexibility may be essential to the public interest." Consolidated Gas Supply Corp. v. FPC, 520 F.2d 1176, 1185 (D.C. Cir. 1975) (quoting Public Serv. Comm'n v. FERC, 511 F.2d 338, 353 (D.C. Cir. 1975)).

73. Mobil Oil Corp. v. FPC, 417 U.S. 283, 331 (1974).

74. For a state court analysis of used and useful, upholding inclusion in rate base of plant construction to be completed by the end of a future test year, see Baltimore Gas & Elec. Co. v. People's Counsel, 220 Md. 373, 152 A.2d 825 (1959).

FERC created to help stimulate production and help pipelines secure necessary new gas reserves, the court emphasized that these interest free loans were a:

> departure from the usual rule of public utility regulation . . . that current rates should reflect the cost of supplying service to current ratepayers . . . .[75]
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> . . . .
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> . . . The FPC early adopted the 'used and useful' standard and has not departed from it without careful consideration of the wisdom of requiring current rate payers to bear costs of providing future service . . . .[76]
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> . . . .
>
> The Commission has taken the position that any departure from such a well-rooted regulatory principle must be affirmatively authorized and that an authorized departure must be presumed limited to its express terms.[77]

Further, the FPC's decision to allow CWIP in rate base for pollution control, fuel conversion, and instances of severe financial difficulty, contained this equivocal declaration:

> [T]his Commission . . . will not adhere to an absolute rule that plant must be 'used and useful' in the traditional sense before it may be included in rate base. Of course, in a very real sense, a plant under construction, which will go on line in the future, is quite useful to consumers.[78]

When, the FERC allowed fifty percent of eligible CWIP in rate base in Order No. 298, it made clear that, interperiod equity notwithstanding, it was engaging in one of the "widely recognized exceptions and departures" from used and useful:

> [T]his Commission—as well as many state regulatory authorities—have re-examined the basis for exclusion of CWIP from rate base and have often disregarded the 'used and useful' concept when the reliability of future service is in doubt . . . . The Commission need not, in this proceeding, pronounce further on the validity of the 'used and useful' concept. However, it must be re-emphasized that the "used and useful" concept, if administered inflexibly and without regard to other equitable and policy considerations, may fail the interests of both the electric utility industry and its ratepayers.[79]

This apologia notwithstanding, these departures from established principles did not reject the basic principle that ratepayers should pay only for a benefit or a service received, viz, the rationale underlying the used and useful principle. The salient consideration is *when* that service is provided or the benefit conferred. To appreciate how conservative were these departures, one must recognize that advance payments were designed to ensure timely addi-

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75. *Tennessee Gas Pipeline Co.*, 606 F.2d at 1100.

76. *Id.* at 1109.

77. *Id.* at 1110.

78. Order No. 555, 56 F.P.C. 2939, 2943 (1976).

79. Order No. 298, *Construction Work in Progress for Public Utility; Inclusion Costs in Rate Base*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,455, at 30,507, 48 Fed. Reg. 24,323 (1983), *aff'd in part, vacated and remanded in part*, Mid-Tex Elec. Coop. v. FERC, 773 F.2d 327 (D.C. Cir. 1985). *Cf.* Mid-Tex Elec. Coop. v. FERC, 822 F.2d 1123 (D.C. Cir. 1987) (affirming the Commission's interim rule (Order No. 466) which reestablished the same CWIP formula as Order No. 298, pending final Commission action to resolve the latter's legal infirmities). Order No. 474, *Construction Work in Progress*, 39 F.E.R.C. ¶ 61,334, 52 Fed. Reg. 23,948 (1987).

tions to gas reserves for the use of pipeline ratepayers;[80] that the FERC only once granted CWIP in rate base for severe financial difficulty under Order No. 555;[81] and that Order No. 298 put ratepayers at risk for carrying charges on only half of current construction costs for power generation facilities and went to considerable lengths to support this innovation on the basis of intergenerational equities and economic efficiency. Rate base treatment or other inclusions of cost in rates have not often been afforded in total disregard of the principles of used and useful, namely that the costs borne by the public must bear a direct relationship to benefits derived even when identified as departures.

The distinction between what is used and useful and what is a "recognized" exception (and therefore a legitimate way also to earn a return on an otherwise disallowed expenditure) may involve, for example, the extent to which one identifiable "generation" of ratepayers may in fact subsidize another. The distinction between groups of ratepayers is practically and theoretically difficult. Tapping the financial resources of current ratepayers for the benefit of a future and indeterminate ratepaying public is generally recognized as a departure from the traditional principle that current ratepayers should not be required to subsidize others' service, never to share in the benefits arising from their investment. As the Commission nonetheless stated in Order No. 298, "the needs of the future must be met. Those needs can to some extent be financed by the persons who will directly benefit, but such a nice alignment of benefit and burden is not always possible."[82] The problem with matching benefits and costs is sociological and economic and reflects the limitations of the traditional rule. The prospect is therefore that it will be overtaken by its exceptions.

The departures from used and useful may arise from extenuating circumstances and, therefore, suggest that innovative rate base treatments are not, strictly speaking, exceptions to the rule. For example, the rate base treatment for the programs of advance payments from gas pipelines to producers was

80. "It is the Commission's view that, particularly at the present time when there are indications of a natural gas shortage, it is not in the public interest for pipeline companies to bear the cost of assuring themselves and their customers of a future supply of natural gas." Order No. 410, 44 F.P.C. 1142, 1144 (1970). In reviewing FPC Order No. 410 and its progeny, the Court of Appeals in the *Tennessee Gas Pipeline* case concerned itself in large part with the payment of "extended front-end advances" by pipelines, which the Commission did not expressly authorize and which increased pipeline rate bases and therefore rates without providing a foreseeable benefit to ratepayers. It concluded that "agency silence in these circumstances must be construed to mean that traditional [used and useful] principles retain their vitality." 606 F.2d at 1110. There was a question then about the proper scope of the departure authorized in terms of the timing of advance payments. *Cf. id.* at 1126 n.14 (Wilkey, J., concurring). The court also noted that if pipeline expenditures for unsuccessful SNG projects were not used and useful and also fell outside of recognized used and useful exceptions such as research and development, the Commission might in its discretion render them ineligible for rate base treatment. *Id.* at 1123-24.

81. Montaup Elec. Co., 19 F.E.R.C. ¶ 61,062 (1982). In Order No. 298, the Commission acknowledged that it could justify (on economic grounds) inclusion of all CWIP in rate base, but declined to do so in favor of a balance between present and future ratepayers, both of which groups have a stake in service reliability. Order No. 298, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,497, 30,526.

82. *Id.* at 30,501.

assumed by the *Tennessee Gas* court to offer benefits (i.e., new gas supplies) to current ratepayers:

> One such departure was the advance payment program. At the very least it contemplated that current rate payers would shoulder the costs (i.e., the financing charges) of qualifying advance payments. This was intended to expedite the development of additional gas reserves by providing supplemental sources of capital, which would be used to provide service for future rate payers. Such a *modification* of the "used and useful" principle was thought justified in view of the discouraging supply forecasts and the general correspondence between classes of current and future rate payers. Consumers would eventually have to bear the costs of developing needed gas supplies. In theory the advance payment program promised to provide that gas at the lowest ultimate cost.[83]

In other instances, the inclusion in the rate base of electric utilities of expenses related to pollution control and fuel conversion was designed by the FPC to spare future generations of ratepayers the cost associated with rectifying the untoward uses of certain fossil fuels presently. In Order No. 555, the FPC stated:

> [I]t is the profligacy of the present generation which requires the new facilities, and we consider that the equitable argument favoring this allocation of costs is sufficient to tip the balance in favor of the allowance of CWIP on these facilities.[84]

The intergenerational equity theme that figures so prominently in explaining most departures from a traditional used and useful formulation demonstrates repeatedly the qualified nature of those departures. But commissions and courts seldom expressly recognize that present and future benefits to the ratepaying public are concentric and that the used and useful principle can be flexibly applied. In 1974, however, the Court of Appeals upheld a Public Service Commission (District of Columbia) decision to include CWIP in rate base and agreed with the Commission statement that "the funds invested in construction are being used for the benefit of the public just as much as funds invested in plant in service."[85] The *Goodman* court endorsed the view that funds are not necessarily used and useful "only when they are currently invested in completed plants."[86] The FERC relied in part on *Goodman* to defend Order No. 298 before the courts. It had already recognized in the CWIP rule that the law does not always require an exact alignment of costs with contemporaneous benefits to meet the test of used and useful. "Even under a strict application of the 'used and useful' doctrine, current ratepayers pay for facilities necessitated by past demand and for the capi-

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83. *Tennessee Gas Pipeline Co.*, 606 F.2d at 1109-10 (emphasis added). The critical underlying assumptions in such cases are that additional gas was in fact available, geologically and technologically speaking, and that capital formation was the major obstacle to getting it. In other words, the addition to gas reserves that would benefit ratepayers was foreseeable if financial problems could be overcome. *Cf.* Northern Natural Gas Co., 34 F.P.C. 507 (1965). "If Natural wishes to build in the face of the risk that there will be no gas supply [*i.e.*, that pipeline may be built before producers are certificated], its customers should not have to pay for construction not used and useful." *Id.* at 513.

84. Order No. 555, 56 F.P.C. at 2943-44.

85. Goodman v. Public Serv. Comm'n, 497 F.2d 661, 668 (D.C. Cir. 1974). It is significant that the local commission administers a statutory scheme for setting rates identical to the Natural Gas Act.

86. *Id. Accord*, Mid-Tex Elec. Coop. v. FERC, 773 F.2d 327, 346 (D.C. Cir. 1985).

tal costs of unused capacity."[87] The Commission intimated what the *Goodman* court had acknowledged explicitly, viz, that used and useful can be legitimately applied with the intergenerational benefits and equities in mind.

In two important used and useful cases, the courts made clear that "current ratepayers should bear only legitimate costs of providing service to them."[88] That standard is satisfied in ways that are compatible with the expansive used and useful doctrine of *Goodman*, however. If rates effectively allocate the present cost of utility services to those currently receiving a benefit from that investment, clearly an equitable balance is struck between ratepayers and investors under a traditional formulation of used and useful. In addition, the cost of "benefits" other than operable plant, namely investments made to ensure future service reliability in anticipation of the demands of future ratepayers, are, in the view of the FERC and many state commissions that include CWIP in rate base, legitimate costs of providing service to current ratepayers. Thus, in balancing equities among generations of ratepayers, an alignment of investors' costs and ratepayers' benefits over the long term is also achieved. A similar rationale for apportioning costs occurs under the rubric of risk allocation. Its objectives are similar to used and useful.

The "risk" with which regulators are mainly concerned these days are prudent investments that are made in the normal course of utility business to provide service to ratepayers, and that then either fail, yield poor results (*e.g.*, capacity underutilization), or produce long-delayed benefits and returns. In balancing the ratepayers' reasonable expectations of a correlation between rates and service and the utility's need to maintain financial integrity, attract capital, and compensate shareholders, considered in light of the types of investment involved, the FPC and the FERC have determined in various ways who bears such risks.

The costs of the failed gas supply projects embarked upon during the gas shortages of the 1970s were generally allocated to investors. For example, in denying any cost recovery for a company's investment in a failed SNG project, the FERC reasoned in effect that ratepayers need not pay, either through rate base treatment or cost of service treatment (amortization), for service not received.[89] The reviewing court affirmed, stating:

> The Natural Gas Act simply does not guarantee the shareholders of even a prudently managed utility that ratepayers can always be stuck with the bill for supply projects that turn out to be total failures, however praiseworthy the utility's motives for undertaking those projects may have been.[90]

Neither cost of service nor rate base treatment is countenanced when highly speculative or exotic gas supply projects, projects developing potential non-

87. Order No. 298, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,508.

88. *Tennessee Gas Pipeline Co.*, 606 F.2d at 1109; NEPCO Mun. Rate Comm'n v. FERC, 668 F.2d 1327, 1333 (D.C. Cir. 1981).

89. Natural Gas Pipeline Co., 27 F.E.R.C. ¶ 61,201, at 61,379-80 (1984). *See* Texas E. Transmission Corp., 58 F.P.C. 2412, 2422-23 (1977); Transcontinental Gas Pipe Line Corp., 58 F.P.C. 2038 (1977), *aff'd in part and remanded in part sub nom.* Tennessee Gas Pipeline Co., 606 F.2d 1094 (1979). Commission and court decisions often discuss used and useful and risk allocation together. *See* Columbia Gas Transmission Corp. 13 F.E.R.C. ¶ 61,102 (1980).

90. Natural Gas Pipeline Co. v. FERC, 765 F.2d 1155, 1163-64 (D.C. Cir. 1985).

jurisdictional supplies, or nonrecurring costs are involved. Those expenditures are left on the doorstep of investors. But, when the risks are associated with project costs deemed integral to normal utility operations, they are held to constitute legitimate costs of providing service to ratepayers. For instance, the costs of failed gas storage projects[91] and dry hole drilling[92] are amortized through the utility's cost of service. When used and useful prevents inclusion of such costs in rate base, it therefore denies a return on a utility's failures. But the lack of a direct benefit to ratepayers will not by itself insulate them from sharing the risks of failure.

The Commission indicated that it might also favor recovery in a pipeline's cost of service of the prudent investment made in conventionally-financed abandoned gas projects, even though the project is not used and useful and the company might therefore deserve no return on that investment.[93] Generally speaking, however, recovery of such failed plant costs receives more generous treatment when an electric generating plant is involved.[94] In Opinion No. 49, the Commission wasted little paper in agreeing with the ALJ that, perhaps because no party objected, NEPCO should recoup all its costs in an abandoned nuclear facility. The cryptic risk allocation analysis by the judge invoked used and useful and denied the company any return on investment.[95] Neither the Commission nor the courts, however, considered disallowing the cost of the failed nuclear facility at issue on grounds similar or analogous to those relied on in evaluating gas supply projects. The differences between the FERC's Natural Gas Act and Federal Power Act jurisdiction constitutes one major justification for the discrepancy.[96] In sum, under the risk allocation rationale employed by the FERC the potential risk to gas company investors frequently encompasses the total capital that the company has invested while the risk to electric utility shareholders generally is not greater than the foregone profits from the failed facility.[97] This type of analysis mimics used and

91. *Id.* at 1164-65, *citing* Tennessee Gas Pipeline Co., 48 F.P.C. 149 (1972); *cf.* Northern Natural Gas Co., 45 F.P.C. 1050 (1971); Southern Natural Gas Co., 29 F.P.C. 323 (1963).

92. Phillips Petroleum Co., 24 F.P.C. 537 (1960), *aff'd sub nom.* Wisconsin v. FPC, 303 F.2d 380 (D.C. Cir. 1961), *aff'd*, 373 U.S. 294 (1963); El Paso Natural Gas Co., 22 F.P.C. 659 (1959).

93. Trailblazer Pipeline Co., 18 F.E.R.C. ¶ 61,244, at 61,502-03 (1982), *aff'd*, 23 F.E.R.C. ¶ 62,355 (1983). Abandoned gas supply projects that are "project financed" are treated differently. In *Trailblazer*, recovery of any equity investment was waived and foreclosed, although recovery of the debt service was allowed if the project failed. *Id.* Ozark Gas Transmission Sys., 16 F.E.R.C. ¶ 61,099 (1981). In the estimation of the Court of Appeals in *Jersey Central III*, the discussion in *Trailblazer* of cost recovery of conventionally-financed abandoned plant signaled a potential liberalization by the Commission of its philosophy regarding recovery of abandoned plant costs, thereby legitimizing JCP&L's expectation that it might obtain not only amortization of its investment in the Forked River nuclear plant but also the carrying charges on the debt and preferred stock portion of the unamortized balance. *Jersey Central III*, 810 F.2d at 1184.

94. This is acknowledged by both the *Jersey Central III* majority and the dissent. *Id.* at 1185, 1202.

95. New England Power Co., 8 FERC ¶ 61,054, at 61,175 (1979).

96. *See supra* note 53.

97. Neither regulation nor the Constitution ensures utilities a profit. Market Street R.R. Co. v. Railroad Comm'n, 324 U.S. 548 (1945) (*citing Hope*, 320 U.S. 591, 603 (1944)); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 590 (1942); *NEPCO Mun. Rate Comm'n*, 668 F.2d at 1333. It is not always predictable (and *Jersey Central III* adds to the confusion) what additional risks of loss, other than a return,

useful and is applied in conjunction with it. However, risk allocation admits far greater flexibility in policymaking.

Modern end result ratemaking is somewhat inhospitable to the simple idea that only the cost of actually providing service at a specific time should be included in the rates of the recipients of that service. Future test years,[98] original cost ratemaking[99] and marginal cost pricing[100] have evolved to account for complex economic and even social phenomena and to mitigate the effects of regulatory lag. A certain amount of cross-subsidization among ratepayer groups is inherent in such practices. Used and useful nevertheless continues to police entry into rate base and to help allocate the risks of certain investments between ratepayers and investors. But, because it is invoked talismanically and without analysis, used and useful tends toward anemia.

In recent gas rate cases before the FERC, the Commission trial staff has attempted to place natural gas pipelines at risk to recover their cost over greater volumes of throughput by arguing that unused pipeline capacity is not used and useful.[101] On pipeline systems that are experiencing lost sales and constricted transportation markets, captive customers naturally absorb greater portions of a pipeline's embedded costs, unless the company can be made to bear a greater share of the risk of these declining throughputs. In initial decisions[102] that fail to evaluate staff's used and useful theory, this position has

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a regulated company will be required to bear, however. As the *NEPCO* case suggests, the size of the potential loss may affect regulators' decisions more than accepted principles of ratemaking law.

98. Rates based on future costs, captured in theory under forward-looking test periods, were found to be within the agency discretion permitted under *Hope* and *Permian Basin*. This was deemed one way to account for events such as inflation and to set rates at a level that will approximate costs during the rate's effective period. American Pub. Power Ass'n v. FPC, 522 F.2d 142, 145-46 (D.C. Cir. 1975).

99. As the FERC noted in Order No. 298, "original cost rate base methodology . . . places a disproportionate share of the burden of a facility on consumption in the early years of its useful life." Order No. 298, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,455, at 30,497, 48 Fed. Reg. 24,323 (1983).

100. In Opinion Nos. 186 and 186-A, the FERC allowed the Wisconsin Electric Power Company to depart from traditional average cost pricing of electricity in favor of marginal cost-pricing, which is designed to improve allocation of society's resources by pricing goods and services at the cost of producing one more unit. Wisconsin Elec. Power Co., 24 F.E.R.C. ¶ 61,299 (1983) [hereinafter Opinion No. 186]; Wisconsin Elec. Power Co., 25 F.E.R.C. ¶ 61,240 (1983) [hereinafter Opinion No. 186-A], *rev'd sub nom.* Electric Consumers Resource Council v. FERC, 747 F.2d 1511 (D.C. Cir. 1984). *See also* Huntington, *The Rapid Emergence of Marginal Cost Pricing in the Regulation of Electric Utility Rate Structures*, 55 B.U.L. Rev. 689 (1975). Although used and useful is properly associated with the revenue requirement rather than with rate design or pricing, it is rooted in original embedded cost doctrines, not in value of service or resource cost concepts.

101. *E.g.*, Initial Brief for Commission Staff at 117, Producers Gas Co., Nos. ST83-429-000, *et al.*, (Apr. 1, 1986).

102. Colorado Interstate Gas Co., 35 F.E.R.C. ¶ 63,043, at 65,141-47 (1986) (Staff would place on shareholders the burden of a permanent loss of sales markets due to conservation, plant closures and conversion to coal by imputing historically high volumes to current service. Judge Levant found no minimum throughput condition in the pipeline's certificate and therefore held that an imprudence showing (not made here) was the only available way to shift the costs of underutilized capacity.); Producer's Gas Co., 35 F.E.R.C. ¶ 63,042, at 65,119-20 (1986) (In proposing a rate design, Staff selected volumes of throughput that approximated the system design capacity of the pipeline so that shareholders bore the risks of any overconstruction and underutilization. Judge Benkin applauded the objective but found the result unfair because such a rate structure would deny the pipeline an opportunity to make a profit. "No natural gas pipeline, even one designed with the utmost prudence, is full to its capacity all the time." *Id.* at 65,119).

been rejected as contrary to test year ratemaking which, in the gas area, relies heavily on evidence of actual historical experience.[103] The Commission has not, at this writing, decided whether its ALJs were correct on this issue. In the past it suggested that the capacity utilization issue involved the pipeline's prudence in purchasing and marketing rather than its rate design.[104] Unless a pipeline were shown to be systematically imposing on customers the cost of facilities which it has no intention or chance of utilizing for their benefit, the Commission would do well to consider the throughput issue purely in terms of risk allocation, without resorting to the shibboleths of rate base regulation. The language of used and useful would clutter and confuse the issue; there are no discrete costs to be disallowed or separate facilities for which the utility may be denied recovery or a return. Rates that are based in part on optimum throughput levels simply mitigate adverse rate impacts on consumers by redistributing the risks and burdens of underrecovering the costs of an already operational unit.

The Commission stated more appropriately in the proposed rule that led to Order No. 436, that the unamortized balance of the costs a pipeline incurs to buy out or reform its take-or-pay obligations should not be given rate base treatment. Citing the Commission's *NEPCO* decision, the Commission relied on a used and useful rationale. "Since the ratepayers will never have the benefit of this gas, nor recoup the monies expended, they should not be expected to provide the pipeline with return dollars."[105] The Commission thereby offered used and useful as a basis for excluding from rate base certain contract buy-out costs; but it also proposed to afford pipelines an opportunity to amortize all or a share of such costs through increased rates, whether in the form of demand-related or commodity charges. Although ratepayers would neither benefit from gas delivered under the contract nor recoup funds contributed to reform gas purchase obligations, they would not be relieved of paying at least some buy-out costs. The result is consistent with *NEPCO*; it reflects a sharing of risk as opposed to the benefit analysis common to used and useful and relied on by the Commission when addressing whether to allow a return on an investment.

The Commission is now examining how it might allocate take-or-pay costs in circumstances more typical than the "safe harbor" proposal which was ultimately not included in Order No. 436. When costs are incurred to jettison high-cost gas supply contracts under which gas was once taken or which represented needed reserves, it seems clear that the Commission will require that ratepayers share those costs, just as NEPCO ratepayers must pay for that company's investment in a facility that would have provided a benefit before it became uneconomical to complete. But used and useful is yet to be mentioned in the Commission's major take-or-pay pronouncements. Used

103. Transwestern Pipeline Co., 32 F.E.R.C. ¶ 61,009, at 61,035 (1985); Alabama-Tennessee Natural Gas Co., 25 F.E.R.C. ¶ 61,151, at 61,425, *modified*, 27 F.E.R.C. ¶ 61,006 (1983). *See* 18 C.F.R. § 154.63(e)(2) (1987).

104. Tennessee Gas Pipeline Co., 21 F.E.R.C. ¶ 61,004, at 61,009 (1982).

105. Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, IV F.E.R.C. Stats. & Regs. ¶ 32,408, at 33,133, 50 Fed. Reg. 24,130 (1985) (proposed May 30, 1985).

and useful can supply a theoretical justification for increasing the cost responsibility of ratepayers. Where the contracts underlying buy-out or reformation costs do not represent gas that was deliverable to ratepayers, however, the *NEPCO* approach is less supportable than total disallowance, which the Commission previously determined to be appropriate for certain failed gas supply projects. For example, if gas subject to a take-or-pay contract was actually sold elsewhere, pipeline customers will naturally object to subsidizing the pipeline's efforts to buy-out its obligations because the gas under contract was not used and useful to them. Similarly, used and useful may figure in debates over allocation to ratepayers of the costs incurred prepaying for gas if the gas subsequently became unavailable to customers when the chance to take, or "make-up," the gas under the contract is expired. These circumstances pose the most difficult policy questions relating to burdensome gas supply contracts. Neither used and useful nor risk allocation analyses lessens the difficulty of this conundrum.

The FERC has wrestled with the ways in which the ratepayers would share the risks of take-or-pay buy-outs and other contract reformation costs. Regardless of the policy it finally adopts,[106] the *Jersey Central III* decision portends increased numbers of *Hope* end result hearings as opposed to generic or summary resolutions of the cost allocation and rate design aspects of the issue, when pipelines raise claims that they are severely harmed by accrued take-or-pay indebtedness or even by the costs incurred avoiding greater indebtedness. We now return to that court case.

III. THE CONTRIBUTION OF *JERSEY CENTRAL III*

The FERC in 1982 followed its earlier *NEPCO* decision[107] and summarily rejected the request of JCP&L to recover in its rates both the costs of a cancelled nuclear facility and some of its carrying charges,[108] despite the company's allegations of severe financial hardship. Judge Bork's 5-to-4 majority opinion, written pursuant to *en banc* review, concluded that JCP&L's claim of financial distress constituted a "serious *Hope* challenge" and that the Commission was therefore obligated to build a record, balance investor and ratepayer interests, and ascertain whether in light of these the end result of its entire opinion was reasonable. The court found unavailing the Commission's reliance on the *NEPCO* precedent against including in rate base a cancelled nuclear facility that would never provide service to the public.[109] Supposedly, the *NEPCO* outcome did not constitute an "ironclad rule." Rather, the court held that *NEPCO* stood only for the proposition that abandoned plant could

106. *See, e.g.*, Order No. 500, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 40 F.E.R.C. ¶ 61,172 (1987) (Interim Rule and Statement of Policy).

107. *See supra* notes 53 and 54.

108. Jersey Central Power & Light Co., 19 F.E.R.C. ¶ 61,208 (1982).

109. *Jersey Central III*, 810 F.2d at 1183-86. The Commission's difficulties on appeal were exacerbated by its indecision about whether the *Hope* "end result" test of a rate's reasonableness pertained only to those assets eligible for rate base treatment or whether the overall effect of the rate order, including excluded investments, must be taken into account. *Id.* at 1178. The FERC's counsel ultimately agreed with JCP&L that *Hope* required the broader view, leaving the court free to consider whether prohibiting a return on the nearly $400 million ran afoul of *Hope*. *Hope*, 320 U.S. at 603.

be excluded from rate base based on a balancing of the competing interests in that case.[110] What the Commission had failed to do in the JCP&L situation, the court concluded, was to perform a similar balancing, as *Hope* requires, when confronted with "material differences between [JCP&L's] situation and those presented in the *NEPCO* line of cases."[111] In a concurring opinion, Judge Starr rejected used and useful as unreliable and concluded that the Commission failed to perform adequate analysis to avoid a possibly illegal "taking" of JCP&L's investment.[112]

The dissenters, Judge Mikva writing, would have upheld the Commission's action as reasonable and within the letter of its previously-announced policy to exclude from rate base all costs of an abandoned nuclear plant. The Commission, argued the dissent, need not have conducted a separate *Hope* inquiry if its final rate determination, which could have allayed JCP&L's financial concerns through, say, rate of return adjustments, produced a reasonable end result.[113] "The issue is one of timing."[114] JCP&L's attack on the used and useful principle should have been unavailing, claimed the dissent, because the Commission had established the used and useful rule in *NEPCO* as a "substantive rule of *policy*" for dealing with cancelled plant costs.[115] JCP&L had aimed to upset that policy, not simply to get a hearing. By granting that wish, the court sanctioned the *ad hoc* construction of utility rates, claimed the dissent, and ensured regulatory uncertainty.[116]

The *Jersey Central* debate specifically raises two issues worth explaining here, namely the status of used and useful and the constitutional implications of applying it.[117] First, the court questions whether the Commission had really developed a uniform "used and useful" approach and, if it had, the extent to which used and useful (or other discrete policy determinations within a ratemaking proceeding) can be made without an agency first balancing interests under *Hope*. The *NEPCO* decision announced no "ironclad" used and useful rule, states the majority, citing to the FERC's affirmance and reiteration of the administrative law judge's belief that the rule prevented him

110. *Jersey Central III*, 810 F.2d at 1183-84.

111. *Id.* at 1184.

112. *Id.* at 1188-94 (Starr, J., concurring).

113. *Id.* at 1215 (Mikva, J., dissenting).

114. *Id.* at 1196.

115. *Id.* at 1198 (emphasis in original).

116. *Id.* at 1203.

117. *The Jersey Central* decisions have already been critiqued by a panel entitled *Hope* Renewed: The Re-Emergence of Constitutional Due Process Issues in Ratemaking, Federal Energy Bar Association Annual Meeting (May 14, 1987). Among the perceived weaknesses in the court's approach are: (1) the implication that the *Hope* "end result" test gives utilities a constitutional guarantee of rates sufficient to maintain their financial integrity; (2) that no genuine fact dispute regarding JCP&L's plant existed and that a hearing was therefore not warranted; (3) that the court added procedural burdens in violation of Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, 435 U.S. 519 (1978), by requiring an "end result" hearing at an inappropriate point in the ratemaking process and by allowing defeat of summary dispositions whenever colorable arguments of a "taking" under the Fifth Amendment are made; and (4) the decision broadens the role of judicial review of agency ratemaking in contravention of the basic objective of *Hope*. Read narrowly, on the other hand, the decision may stand only for the proposition that an extra measure of reasoned decisionmaking, based on a fact-finding, may be required where the pleadings suggest greatly increased likelihood of a confiscatory rate.

from putting cancelled plant in rate base.[118] Viewing the *NEPCO* case as an application of a principle consistently established by the Commission, rather than as a balancing, the dissent attacks the court for destroying the *NEPCO* precedent (*i.e.*, that no return is allowed on an abandoned nuclear plant) as a substantive rule of policy. It also cites the cases that follow *NEPCO* to show that the issue had been considered settled.[119] The debate then spilled into the natural gas arena, where the Commission's application of used and useful differs from electric precedent, as we have seen. In analyzing the *Trailblazer* decision,[120] the two sides strongly disagree on the legal significance of the Commission's statement that it might permit recovery of debt service by conventionally-financed pipelines. The majority perceived a coming liberalization in the treatment of all abandoned plant costs, while the dissent regarded this part of *Trailblazer* as dicta because the pipeline was project-financed and different rates policies therefore apply.

Granted, the FERC applies used and useful in a less-than-systematic fashion. It has never clearly explained its used and useful theories or the scope and intent of its so-called departures from used and useful. It has not examined critically the breadth of possible used and useful applications and it shades used and useful into theories of intergenerational equity and risk allocation. The reasons for having differing used and useful rules in gas and electric cases are not entirely satisfying and, as *Jersey Central* demonstrates, contribute a lack of certainty about Commission actions.

These opacities aside, the Commission had by the early 1980s established a clear policy direction with respect to cancelled nuclear generation facilities. While the Commission's Opinion No. 49 fails to announce itself as a new policy applicable to any filing like NEPCO's, the hypothesizing by the *Jersey Central III* court about the winds of liberalized rate base treatment blowing up North Capitol Street is logically unconvincing as a justification for JCP&L's decision to discount the importance of *NEPCO* and its progeny. Certainly, the Commission's decision in *NEPCO* to exclude from rate base the investment in a cancelled nuclear plant represents a more compelling precedent than its statement (or dictum) in *Trailblazer* that both equity investment and carrying charges *might* be recoverable *if* the failed pipeline had been conventionally-financed. Even if, as the court majority held, the Commission evinced an open-mindedness or "flexibility" about how to apply the used and useful principle to cancelled plants, this would ordinarily have little independent legal significance in light of a consistent, albeit brief, line of cases on the issue.

Of course, this analysis begs the central question in the case: is there any ratemaking principle that can stand if it (alone or in combination with other

118. *See supra* notes 53 and 54 and accompanying text. Judge Bork construes Opinion No. 49 as a classic balancing of interests and the court's subsequent affirmance of it as approval of used and useful squarely on facts that showed no countervailing considerations.

119. Black Hills Power & Light Co., 19 F.E.R.C. ¶ 61,302 (1982); Central Maine Power Co., 18 F.E.R.C. ¶ 61,126 (1982); Ohio Edison Co., 18 F.E.R.C. ¶ 61,010 (1982); Northern States Power Co., 17 F.E.R.C. ¶ 61,196 (1981), *aff'd sub nom.* South Dakota Pub. Utils. Comm'n v. FERC, 690 F.2d 674 (8th Cir. 1982).

120. *See supra* note 93 and accompanying text.

policies) might affect investors (or ratepayers, for that matter) severely? The court's mode of analysis, relying as it does on the vagaries of Fifth Amendment doctrine, makes an answer difficult. The Constitution may not protect investors from extreme financial harm at the hands of regulators if, for example, investments in failed projects are dissallowed.[121] In the final analysis, *Jersey Central III* makes the balancing of interests under *Hope* the anterior procedure to which each and every ratemaking decision is subordinated, as opposed to the standard against which the composite of such decisions is judged. This is what the dissent views as transgressing "the line between legitimate judicial review and judicial substitutions for agency processes."[122] The Commission policy set in the *NEPCO* "line of cases" is diminished in import not by any compelling end result demonstration but by factual assertions that in the court's view completely distinguished the *Jersey Central* case, namely a loss "at the order of magnitude of nearly $400 million,"[123] the company's financial distress, and a proposed 15-year amortization period. In light of such facts, the court held the FERC responsible to measure the impact of its rate base ruling, without reference to other aspects of the rate, such as the rate of return, and without JCP&L raising what the dissent calls "adjudicative facts," *i.e.,* the connection between its financial problems and the Commission's decision in this instance.

In sum, the *Jersey Central III* court views *Hope* sitting astride the rate setting process, commanding not only just and reasonable rates but passing on all intermediate ratemaking decisions and the constituent elements of any final rate order. One cannot read the *Jersey Central* decisions themselves, however, without concluding that a reasoned explanation by the Commission of its public interest criteria and its thinking generally would have ended or greatly limited the entire controversy. The court, however, took maximum advantage of the Commission's failure to explain itself adequately to formulate an expansive and potentially intrusive theory of how to apply *Hope*. *Jersey Central III* may be an invitation to attack agency precedents and policies through various factual suppositions about end results. It nevertheless also invites a more thoughtful exposition of agency rules and policies than the Commission exhibited in *NEPCO*.

The court was more clearly adventurous with respect to the constitutional implications of the Commission's *NEPCO* decision. The majority opin-

121. Drobak, *supra* note 8, at 112-25. "Most scholars conclude that the Constitution requires ratemakers to set rates that satisfy the investor interest of *Hope*. Many state courts and agencies agree. This prevalent interpretation is incorrect, however, because it overlooks the potential for the public interest to outweigh the investor interest." *Id.* at 96-97 (footnotes omitted).

122. *Jersey Central III*, 810 F.2d at 1215. The importance of the public interest involved is the primary factor in the balance, not necessarily the gravity of the deprivation visited upon investors' interests. *See* Drobak, *supra* note 8, at 96-97. The *Hope* balancing of interests appears circumscribed more by the requirements of reasoned decisionmaking than by any constitutional prohibition against confiscatory rates. "The court's responsibility is not to supplant the Commission's balance of these interests with one more to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors." Permian Basin Area Rate Cases, 390 U.S. 747, 792 (1968).

123. This amount might have comprised the potential "loss" if ratepayers had not been required from the outset to underwrite the principal in the cost of service portion of their rates, but the FERC never considered such an approach—under used and useful or any other theory.

ion in *Jersey Central III* and the concurrence of Judge Starr in particular rest on the notion that the Commission in *NEPCO* was engaging in confiscation in violation of the "takings" clause of the Fifth Amendment. It is this aspect of the decision that most appears contrary to the theme of *Hope* and the heralded shift from fair value to end result ratemaking, viz, that the courts will not disturb how agencies balance the interests of investors and consumers if the outcome is not unjust and unreasonable.[124] When *Hope* abandoned the constitutional protections that *Smyth v. Ames* had given the present value of property committed to public use, it left regulators free to achieve results as circumstances and current economic thinking dictated, even if that meant rates that would previously have been deemed clearly confiscatory.[125]

Jersey Central III tows the takings doctrine into uncharted waters. One may surmise that it has done so to reinstitute a greater degree of constitutional protection for the investor interests that had withered under *Hope*.[126] The court feared that used and useful may require a utility to bear a disproportionate share of losses incurred through no fault of its own. If, as the dissent claimed, its preference was a "pure prudent investment theory,"[127] presuma-

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124. FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585-86, 606-07 (1942); *Hope*, 320 U.S. at 602, 603; *Permian Basin*, 390 U.S. at 767.

125. Because of the acceptance by the *Hope* Court of Brandeis' view that the Constitution protects investors' capital and not their property, courts presumed that used and useful "ceased to have any constitutional significance . . . ." *Jersey Central III*, 810 F.2d at 1175. On one hand, it is clear that *Hope* and modern statutory just and reasonable standards substituted a balancing of interests for the guarantee of a return on the "fair value" of any investor's property rendered used and useful in the public interest, including any appreciation in the value of that property. On the other hand, however, the commitment of capital to public use, *i.e.* to be used and useful in the public service, remains constitutionally significant in that utility ratepayers still have an obligation, admittedly a less definite one since the *Hope* decision, to provide just compensation for the public use of private resources. Used and useful once helped define the acceptable boundaries of just compensation by describing what property was subject to the fair value methodology; part of the constitutional function, going back to *Smyth v. Ames*, was to identify when a "taking" of property occurred. That function plausibly endures as a signal of the ratepayer's obligation to compensate investors. For it is arguable in regulating utilities that government, by restricting the disposition of private property, performs a taking for which compensation is required. R.A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN, 74-77, 93-96, 100-04, 274-82 (1985); Drobak, *supra* note 8, at 98-112. *But cf. supra* note 22. In the result-oriented world since *Hope*, constitutional constraints, not just used and useful, have been relaxed and rates that are unjust to investors (*i.e.*, that do not fully compensate for capital rendered used and useful in the public service) are no longer necessarily confiscatory under the Fifth Amendment.

126. Drobak, *supra* note 8, at 88-98, discussed the modern new emphasis on the public need for efficient regulation in comparison to the right of individual investors to a return on investment. "No constitutional objection arises from the imposition of maximum prices merely because . . . the value of regulated property is reduced as a consequence of regulation." FPC v. Hope Natural Gas Co., 320 U.S. 591, 601 (1943). "Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." *Permian Basin*, 390 U.S. at 769. In that regard, it is instructive to compare the *Jersey Central III* decision with Justice Douglas' dissent in *Permian Basin*. While he agreed rates based on average costs to a group were acceptable, he believed that the FPC had failed to show how the rates would impact individual producers. *Permian Basin*, 390 U.S. at 329-30 (Douglas, J., dissenting).

127. *Jersey Central III*, 810 F.2d at 1215. This view of the court's position squares with its analysis of when a rate may be unconstitutionally exploitative:

> We have already held that including prudent investments in the rate base is not in and of itself exploitative, *Washington Gas Light Co. v. Baker*, and no party has denied that the Forked River

bly any application of used and useful would be considered offensive to the requirement of just compensation. The court insisted, however, that the FERC may employ used and useful so long as the rate it produces is just and reasonable, and that it did not hold that an agency illegally confiscates capital if prudent investments are excluded from rate base.[128] But, the court was clearly convinced that the Commission's *NEPCO* policy is confiscatory as it applies to JCP&L's investment in the Forked River plant and as the FERC's rate treatment affected the utility's precarious financial state.

According to the court, "[u]nder *Hope* . . . the only circumstance under which there is a possibility of a taking of investor's property by virtue of rate regulation is when a utility is in the sort of financial difficulty described in Justice Douglas' opinion."[129] In other words, without financial hardship there can be no illegal taking. The view that the constitutionality of a rate cannot be determined without regard to the various factors affecting the interests of investors finds support in the writing of one commentator:

> [O]ne of the most important teachings of *Hope* [is] that, the constitutional test requires focusing on the investors' earnings and not on the utility's property. It may be useful to compute new utility rates with traditional methodology, including return on rate base, but once the new rates are determined, the constitutional ratemaking doctrine requires determining the new rates' financial effects on investors. To make an accurate determination, it is essential to calculate the returns to investors on all capital that is prudently invested in the utility's business, not just the capital that corresponds with the plant included in the rate base under the used and useful test. Otherwise the calculations will not show the actual effect on investors.[130]

Under this test, the circumstances raised by JCP&L's pleadings—*i.e.*, that it had been denied long-term credit and had paid no dividends in four years—do not succumb easily to summary disposition. Based on this, the court then supposes there may be a constitutional obligation to provide a better, or even a higher than normal, return[131] and to satisfy JCP&L's investors'

> investment was prudent. Indeed, when the regulated company is permitted to earn a return not on the market value of the property used by the public, see *Smyth v. Ames*, but rather on the original cost of the investment, placing prudent investments in the rate base would seem a more sensible policy than a strict application of "used and useful," for under this approach it is the investment, and not the property used, which is viewed as having been taken by the public.

Id. at 1181 n.3. *See also Jersey Central II*, 768 F.2d at 1504 n.4. The Court in this passage appears to disparage the used and useful principle as antagonistic to any balance of interests capable of being fair to investors. The theory espoused by Justice Brandeis, that utilities are entitled to a return on all capital prudently invested for the public use has not been widely accepted and was not adopted by the *Hope* court. *See supra* notes 28-31 and accompanying text.

128. *Jersey Central III*, 810 F.2d at 1181 n.3. For a different view of takings, see *supra* notes 22 and 125 and *infra* note 136.

129. *Jersey Central III*, 810 F.2d at 1181. The court stated, however, that even where financial difficulty exists the utility is entitled only to be heard as to the weight such circumstances should be given under *Hope*. *Id.*

130. Drobak, *supra* note 8, at 121. On this issue, the Commission's counsel was not originally prepared to concede that used and useful did not effectively limit the scope of the constitutional analysis. *See supra* note 109.

131. *Jersey Central III*, 810 F.2d at 1181 n.3; but compare the dissent's evaluation of what *Hope* requires in this regard:

> It specified the interests at issue but did not require that rates fulfill them in order to be non-

interests—the financial integrity of the business, maintenance of credit, and an ability to attract capital—if the rate is to be non-confiscatory.[132]

The *Jersey Central III* analysis goes too far in this regard. It is not unconstitutional for investors to bear the risks of an investment that benefits no one; the Constitution does not necessitate that ratepayers pay anything in such circumstances.[133] Even if potential harm to investor interests is extreme, countervailing public interests may justify that end result.[134]

Application of used and useful to exclude substantial prudent investments from rate base or cost or service should be permitted in the face of a constitutional challenge if a reviewing court has a basis for believing that such a countervailing public interest is being served. Of course, to invoke that level of analysis based on a claim that a rate will result in an unconstitutional taking, a utility must come forward with a showing of facts that would invoke the Fifth Amendment to circumscribe an agency's broad latitude under *Hope*.

The court's alarm at the imminent threat to JCP&L's investor interests has resurrected an interest in the constitutional limitations of rate regulation that harkens back to the fair value era. Other takings analyses have focused less intently on the investors' interests. In the *Permian Basin* decision, the Supreme Court reviewed area-wide gas producer rates based on average costs. The rates had been attacked as denying cost recovery and returns on investment to individual producers and therefore as confiscatory. The Court nevertheless emphasized the breadth of agency discretion and the zone of reasonableness at which the agency could aim in rate setting, holding that an unconstitutional taking occurred only when the utility was denied *both* an exit from the regulated activity and the relief necessary to keep it in business.[135] Moreover, the *Jersey Central III* court chose not to delay judgment until the FERC could mitigate any constitutional harm.[136] But, JCP&L's allowed rate of return, which might have compensated for a rate reduction caused by the *NEPCO* used and useful approach, never became an issue in the *Jersey Central* case because the court interposed the balancing requirements of *Hope* after only one aspect of the rate proposal had been considered.

Nothing in the *Hope* or *Permian Basin* decisions requires the fulfillment of investor expectations. Nor does *Hope*, which dealt with claims of prior financial distress, support the view that such problems make it more likely that a rate is confiscatory. The *Jersey Central III* court objected primarily to

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> confiscatory . . . . The Court examined what was "important" "from the investor or company point of view" and found that the rate at issue fully satisfied any legitimate investor interest . . . . The *Hope* Court did not define "unjust or unreasonable;" nor did it articulate where a rate would be confiscatory. It certainly did not hold that the end result could be condemned if the investor criteria defined in the case were not fulfilled.

Id. at 1210-11 (citations omitted).

132. *Id.* at 1178, 1181 & n.3.

133. Drobak, *supra* note 8, at 124. *Permian Basin* did not involve a utility's financial crisis, and the potential for losses by regulated entities was less definite in that case. Nevertheless, the losses that the producers feared were nonrecovery of actual sunk costs, not just a failure to earn returns on investment.

134. Drobak, *supra* note 8, at 123.

135. Permian Basin Area Rate Cases, 390 U.S. 747, 770, 772-73 (1968).

136. *See id.* at 770. In *Permian Basin*, special relief provisions ensured an opportunity to recover costs.

the agency's failure to make findings about the probable impact of its decision to exclude the Forked River plant from rate base.[137] The *Hope* hearing then required by the court would logically serve only to ascertain whether JCP&L had accurately portrayed its plight, not whether the interests at stake were properly balanced. Clearly, *Hope* leaves such factual determinations to agencies such as the FERC. But *Jersey Central III* concluded that, without evidence to the contrary, JCP&L had in fact made out a case of confiscation. For example, the court stated that "Jersey Central has presented allegations which, if true, suggest that the rate order almost certainly does not meet the requirements of *Hope Natural Gas*."[138]

The *Jersey Central III* decision contributes little new thinking to the history of used and useful. This perhaps is not surprising. In *NEPCO*, there was no FERC explanation of why the consumer interests in that case outweighed any investor expectations in a return on investment. Had the Commission performed such an analysis, especially pursuant to a hearing on JCP&L's financial status, the court may have been satisfied. It is unclear. The court certainly did not foreclose the Commission from developing a "universal and unyielding" used and useful rule by eliminating the "previous circumstance-bound enunciation" of it.[139] Faced with the pleadings of *Jersey Central*, however, the majority was unwilling to accept as binding the summary use of a precedent that it concluded was weakened because it and other cases were distinguishable on the facts.

Jersey Central III reflects a hostility to used and useful that arises out of the court's puzzlement over how and why the Commission applied *NEPCO* as it did. The court's use of the takings doctrine to defeat the modest application of the used and useful rule led the dissent to believe that the majority wished mainly to rid modern ratemaking of this atavistic doctrine because of the disproportionate threat it poses to investors' interest in recouping the enormous cost of cancelled nuclear facilities.[140]

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137. *Jersey Central III*, 810 F.2d at 1181.

138. The concurring opinion acknowledges the ad hoc and factual nature of the law of taking. *Id.* at 1192 (Starr, J., concurring) (citing Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979)). *Cf.* Drobak, *supra* note 8, at 99. Judge Starr's view is that an illegal "taking" occurs only when the balance between investor and ratepayer is "struck unjustly." *Jersey Central III*, 810 F.2d at 1191. The dissent accedes to this view based on its reading of *Permian Basin*, where establishment of maximum rates within a zone of reasonableness, and based on consideration of the various interests to be reconciled, was held constitutionally permissible. *Id.* at 1210 (citing *Permian Basin*, 390 U.S. at 770). If the test of constitutionality is a just balancing, one may reasonably expect more ad hoc rate setting judgments by agencies, not to mention post hoc rationalizations by the courts. Moreover, the notion that investment in a regulated utility does not constitute a taking appears contrary to the scholarship that Judge Starr cites. *Cf. supra* notes 22 and 125. The issue is whether the commitment of resources to public use and consequently submission to regulation by government (*i.e.*, a taking) is rewarded by just compensation in light of the interests to be balanced. Judge Starr's analysis, like the majority's, rests on a weighing of factors with which the FERC failed ostensibly to deal, namely the potential for loss, the level of state interference with investor expectations, and the character of government actions. At bottom, however, it too is a plea for reasoned decisionmaking.

139. *Jersey Central III*, 810 F.2d at 1187.

140. "The majority's sympathy for Jersey Central appears driven by its agreement that the used and useful doctrine is outdated and should be replaced with a prudent investment approach." *Id.* at 1215 (Mikva, J., dissenting).

IV. CONCLUSION

Regulators still determine whether utility investments are or are not used and useful in the public service and thereby establish whether or when certain investments are recoverable. It is a credible practice. This study nevertheless shows how flexibly the standard is applied. Used and useful no longer necessarily requires that there be a direct and immediate benefit to identifiable ratepayers. It is often used interchangeably with other equitable ideas and modern risk allocation concepts and, regrettably, is invoked without explanation. Its continued viability as a substantive rule of policy will therefore depend on the quality of agency decisionmaking. Given the limited importance of used and useful in the era of end results and its constitutional limitations under *Hope Natural Gas*, the usefulness of used and useful is imperiled.

Pre-*Hope* ratemaking would have denied a return on, and a return of, the cost of any cancelled or otherwise unused plant on the theory that, because property was not used and useful, it was not taken for the public use. The just compensation requirement of the Fifth Amendment was inapplicable to such assets. After *Natural Gas Pipeline*, *Hope* and *Permian Basin* revised both judicial review standards and the focal point of the constitutional calculus, the ratemaking climate changed in ways bound to affect the used and useful doctrine. First, companies by mid-century were devoting all their assets and energies to public utility service and became eligible to request recovery of all prudent investments and to earn a return on those investments that bore even a reasonable relationship to their long-term as well as near-term service objectives. The criteria of used and useful broadened while its constitutional meaning diminished. It continued to be invoked to protect consumers from bearing certain risks associated with speculative investments and providing profits on prudent investments gone sour, but used and useful ceased to deny utilities access to the ratepayer's purse simply because a utility asset was not actively employed and no immediate service or benefit was being supplied.

This less surgical application of used and useful developed in large part as a recognition among regulators and the public that, to quote Judge Starr, "the utility business represents a compact of sorts."[141] Utilities operating as monopolies entirely in the public service are a permanent part of the American landscape, and when they suffer, whether from economic vicissitudes, extraordinary losses, mismanagement, or regulatory misjudgment, ratepayers pay the consequences. In other words, the risks of the business are more intimately shared than ever. Thus, when utilities commit capital in reasonably prudent pursuit of their obligations to invest in future service and to convey benefits to future as well as present ratepayers, agencies may decide to afford rate base treatment or cost of service recovery to investments not then providing service to consumers. Such so-called departures from traditional used and useful, whether called risk allocation or something else, do not often contravene the purpose and rationale of used and useful when the interests of the ratepaying public generally are taken into account. Naturally, the present value of utility property that is used and useful is no longer constitutionally

141. *Id.* at 1189.

protected, but *Hope* did not leave the original investments that shareholders make in plant employed for public use vulnerable to ready confiscation.[142] Nevertheless, investors' interests have certainly come to weigh less heavily in the ratemaking process than that of consumers.[143]

The court in *Jersey Central III* dealt with used and useful as if it were redressing an historical imbalance of investor versus ratepayer interests. Therein lies at least a plausible explanation for the court's pre-occupation with a constitutional question as admittedly fact-bound as is the law of takings under the Fifth Amendment, even though the FERC's arguable lack of reasoned decisionmaking presented it with a ready basis for reversal in light of JCP&L's dire straits. Is the court merely urging the Commission to justify its decision to employ used and useful in the face of a utility's near insolvency or is it prescribing a constitutional counterweight to consumer interests? Whichever it is, the remand seems extraordinary upon reflection. First, the *Hope* hearing that the court requires is not likely to lead the Commission to a different balancing of interests. Moreover, the FERC had never contemplated denying NEPCO or JCP&L recovery through rates of the principal invested in their now-useless nuclear facilities. It had therefore not applied used and useful to deal a mortal blow to investors' interests; under *NEPCO* the risks of failure were shouldered largely by ratepayers.

The court decision nevertheless helps show the deficiencies in the used and useful analysis. Used and useful, as a legal demarcation, rests upon judgments about the appropriate timing of benefits relative to the incurrence of costs and the eligibility of certain types of investments for rate base or cost of service treatment. It does not really address what concerned the court most, namely the financial harm to a utility caused by denying it a return on an enormous investment. So, clearly dissatisfied with the generic *NEPCO* policy of equipoise between ratepayers' interests in rates that directly reflect the costs of service and investor interests in sharing risks and maintaining the viability of the business, the court ridiculed not simply the FERC's lack of reasoned decisionmaking in applying *NEPCO*, but its insensitivity to the likelihood of a confiscatory rate.

The ascendance of economic analysis in utility regulation was a second development that affected used and useful. It has renovated both the language and the methods of utility regulation. Used and useful is a lawyer's idea; risk allocation, price signals, marginal costs and economic efficiency belong to the economists.[144] The flexibility inherent in the *Hope* formula translates into a

142. *See supra* note 125.

143. *Cf. Jersey Central III*, 810 F.2d at 1191. Here Judge Starr found used and useful "skewed in favor of ratepayers." *Id.* This is an ironic reversal from its role as a measure of the utility's right to just compensation after *Smyth v. Ames*. Even today, however, used and useful (or the prospect of a used and useful determination) may work to the detriment of consumers and benefit investors. A utility with a large capital asset may go to extraordinary lengths, including attaching high-cost energy supplies, to avoid having that asset out of service and possibly excluded from rate base. Thus, rate base protections may be translated by utility management into overinvestment, sometimes called the Averch-Johnson effect, or at least into decisions made only to protect the utility's rate of return. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 368 & n.127 (1983).

144. *See* 1 A. KAHN, *supra* note 18, at 56-57. Significantly, "used and useful" does not appear in the

myriad of ratemaking practices that will seek not only to ensure an equitable exchange of value but to affect consumption, production, and distribution behaviors, and even create markets. If the end result is the thing, intermediate rules and principles tend to lose their importance. But without these principles, each case would be treated as unique and each end result might be judged differently. In this regard, *Jersey Central III* poses troublesome possibilities.

The sheer magnitude of the investment in nuclear plants that stand rusting and idle without having produced a single kilowatt-hour portends the impoverishment of many electric companies. Similarly, the take-or-pay exposures of natural gas companies is also large and threatens their solvency in some cases; in buying out long-term, high-cost gas contracts and thereby limiting future indebtedness, gas pipelines are incurring costs that will never translate into a cubic foot of gas for consumption. Used and useful offers a clear resolution to who pays such costs but one that may under some circumstances be draconian. In response to this gathering cloud, *Jersey Central III* would impose new procedural obligations on regulators. It does not materially narrow or improve an agency's choices, however. If, for example, a "*Hope* hearing" demonstrates that a return of, and, in the case of investment in plant, an extraordinary return on, an investment that provides no benefit to ratepayers is essential to avert a utility bankruptcy, the court's decision suggests that the agency *must* supply relief, if such a rate is not exploitative of consumers. This leaves unresolved whether consumers are exploited as a matter of law if required to guarantee public utility solvency.

To the extent intermediate ratemaking principles survive the end result test as applied by *Jersey Central III*, used and useful will also endure as such a principle because its appeal is fundamental. The public should indeed pay for what it gets and get what it pays for. Unless this is more precisely explained and applied, however, agencies and courts will overlook used and useful for other means to accomplish the particular end results they desire.

FERC's latest inquiries on how to design rates to achieve the most economical results. *Regulation of Electric Rates for Resale and Transmission Service*, IV F.E.R.C. Stats. & Regs. ¶ 35,519, 50 Fed. Reg. 23,445 (1985) (Phase I) (proposed rule June 4, 1985), 50 Fed. Reg. 27,604 (1985) (Phase II) (proposed rule July 5, 1985); *Natural Gas Pipeline Ratemaking, Risk and Financial Implications After Partial Wellhead Decontrol*, IV F.E.R.C. Stats. & Regs. ¶ 35,517, 50 Fed. Reg. 3801 (1985) (proposed rule Jan. 1, 1985).