THE CONSTITUTIONAL LIMITS ON RATEMAKING: A RESPONSE TO WILLIAM POND

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I. Introduction

The need to determine the constitutional limits of state action in setting utility rates has proved to be a difficult task. Since the 1944 decision in *FPC v. Hope Natural Gas Co.*,[1] the Supreme Court has analogized the problem to other forms of price fixing and allowed commissions to set the proper balance between investor and consumer interests in what has become known as the "end-result" test.[2] The approach has presented tradeoffs between the consumer and investor interests in rate levels, but the Court seldom addressed the issue of which interest gives way when one of the two could not be satisfied within the "zone of reasonableness."[3] In *Duquesne Light Co. v. Barasch*,[4] the Supreme Court recently reaffirmed the use of the end-result test it adopted in 1944. Even with this reaffirmation, however, the "embarrassing question"[5] of what constitutes a taking remains.

The basic ambiguity of the end-result test established by the Supreme Court in *Hope* and reaffirmed in *Duquesne* has encouraged attempts to frame standards to solve current investor and consumer problems. In a recent article,[6] William Pond offered his view of the *Hope* case in response to recent academic efforts[7] and judicial decisions holding that the consumer's interest prevails over the investor's in those instances in which both cannot be satisfied. According to Pond, the 1923 decision in *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*[8] established a constitutional minimum level of rate relief which commissions and courts must afford to utilities and their investors.[9] Pond then concludes that the apparent failure of the courts and commissions to follow that standard has lead to unnecessary attacks on the investor interest.[10]

Pond's attempt to reconstruct the constitutional standard of the inves-

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1. FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

2. *See infra* notes 14-41 and accompanying text.

3. *See infra* notes 42-59 and accompanying text.

4. Duquesne Light Co. v. Barasch, 109 S. Ct. 609 (1989). For a discussion of the case, *see infra* text accompanying notes 60-92.

5. Smyth v. Ames, 169 U.S. 466, 546 (1898).

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

7. Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. Rev. 65 (1985).

8. Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of W. Va., 262 U.S. 679 (1923).

9. Pond, *supra* note 6, at 13-31.

10. *Id.* at 9-13.

tor's interest, however, deserves careful scrutiny for two reasons. First, he fails to recognize the legitimate basis of regulatory ratemaking and the Supreme Court's tempering of the eminent domain analogy in *Hope*.[11] Second, Pond misstates the constitutional requirements of investor protection found in *Hope* and subsequent decisions.[12] He then uses these arguments to support an agenda to "constitutionalize" the recovery of any prudent investment regardless of its usefulness to the consumer, a result that neither *Hope* nor the Court's more recent decision in *Duquesne* supports.[13] Taken together, Pond's arguments would improperly guarantee to the utility or an investor a return on investment that current constitutional and economic understanding does not justify.

II. The First Mistake: The Basis of State Authority

Pond begins his criticism of current constitutional practices of the courts by creating a false dichotomy between price setting in regulated and unregulated industries. He argues that the distinction is based on the inability of the regulated entity to discontinue service:

> The regulation of prices of services under the police powers is constitutional only if the regulatees are given the right to discontinue their services. Telephone companies, electric power companies and other public utilities do not have the right to discontinue their services. It follows that their rates cannot be constitutionally subjected to regulation under the police powers.[14]

He succinctly concludes, "[P]rice control under the police power cannot be applied to the fixing of reasonable rates for individual utility companies."[15] While Pond presents an interesting argument, it is plainly inconsistent with *Hope*.

Initially, one wonders what the basis is for this distinction. If the state has the authority to regulate at all, it is based on its authority to regulate under some facet of the police powers. It is not necessary, however, to enter into any theoretical debate. If Pond were correct, one would expect some division in the Supreme Court decisions concerning the limits of state power to regulate prices. Such is simply not the case. The Supreme Court in several decisions already has recognized that the source of state authority to fix prices is the same whether one is addressing a utility or a milk producer.[16]

Two years prior to the *Hope* decision, the Court rejected the limitations on police power suggested by Pond in *FPC v. Natural Gas Pipeline Co.*[17] In that case, the Supreme Court upheld the Natural Gas Act[18] against due process and commerce clause attacks. At the heart of the decision was the constitutional power of Congress to address the substantive issues under its "police"

11. *See infra* notes 14-41 and accompanying text.
12. *See infra* notes 42-49 and accompanying text.
13. *See infra* notes 93-97 and accompanying text.
14. Pond, *supra* note 6, at 5.
15. Pond, *supra* note 6, at 3.
16. *See infra* notes 17-41 and accompanying text.
17. FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942).
18. Natural Gas Act, 15 U.S.C. §§ 717-717z (1982).

powers so as to set rates that were "just and reasonable." The Court affirmed that power, stating:

> It is no objection to the exercise of power of Congress that it is attended by the same incidents which attend the exercise of the police power of a State. The authority of Congress to regulate the prices of commodities in interstate commerce is at least as great under the Fifth Amendment as is that of the States under the Fourteenth to regulate the prices of commodities in intrastate commerce.[19]

As commerce in natural gas was within the powers of Congress, it was a proper subject for price regulation.[20] The Court made no distinction between the various types of industries as Pond would suggest.

In a concurring opinion in which Justice Douglas, the author of the *Hope* opinion, joined, Justice Black reinforced the common nature of general price fixing by the state and price and entry regulation. First, the concurrence noted that the process of ratemaking was a statutorily created form of price fixing and that the Court had begun to avoid striking down these kinds of statutes on due process grounds.[21] A footnote at this point of the decision is particularly revealing: as in the majority decision's discussion of the scope of Congress' authority under the fifth amendment,[22] the references are to those decisions that reject *Lochner*-type attacks on various governmental regulations setting prices.[23] The choice was one of allocating political power and the Court rejected its assertion of authority to scrutinize the constitutionality of legislation at the same level that it had done previously. The decision explicitly recognized that "price fixing [was] to be a constitutional prerogative of the legislative branch."[24] The Court's approval of the Natural Gas Act thus was a rejection of the judicial interference resulting from the application of the due process and commerce clauses to assert substantive review.[25] Quite simply, the Court rejected a distinction between price fixing and price and entry regulation.

Two years later in the *Hope* decision, Justice Douglas reiterated the same theme in his discussion of the right of Congress to assert legislative authority in price and entry regulation. "Rate-making is indeed but one species of price-fixing."[26] There is no separation between those activities in which the regulated party can withdraw his investment and those activities in which he cannot. Although ratemaking, like other forms of price fixing, can reduce the value of the property regulated, the regulation is not invalidated.[27] At this point, the logical citation would have been to *Bluefield* if the Court had

19. *Natural Gas Pipeline Co.*, 315 U.S. at 582.

20. *Id.* at 582-83.

21. *Id.* at 599 (Black, J., concurring).

22. *Id.* at 582.

23. *Id.* at 599 note 1 (citing United States v. Darby, 312 U.S. 236 (1941); Sunshine Coal Co. v. Adkins, 310 U.S. 381 (1940); United States v. Rock Royal Coop., 307 U.S. 533 (1939); Mulford v. Smith, 307 U.S. 38 (1939); Nebbia v. New York, 291 U.S. 502 (1934)).

24. *Id.* at 600.

25. *Id.*

26. *Hope*, 320 U.S. at 601.

27. *Id.*

intended to maintain the analogy to the tight eminent domain limitations to price and entry regulation. Instead, Justice Douglas cited Justice Holmes' opinion in *Block v. Hirsch*,[28] in which the Court upheld a rent control statute over a due process takings challenge, and *Nebbia v. New York*,[29] in which the Court upheld a state statute regulating the price of milk.[30] Neither *Block* nor *Nebbia* presented an industry that was statutorily prevented from abandoning its business. Thus the analogy that the Court draws upon is divorced from its prior due process analysis in which there was a perception that particular property was given over to public service.

The right of the company to leave the regulated activity is important to the analysis, but in a different sense than that suggested by Pond. One of the factors that the Court used to justify the area rates in the *Permian Basin Area Rate Cases*[31] was the fact that the commission would permit abandonments for those companies that showed the rates adversely affected them. In addressing the constitutional issue, the Court seemed to rely on alternative frameworks. The Court again approved the limitation on commission action in due process language that the regulation not be arbitrary, discriminatory, or unrelated to the policy provided by the legislature.[32] But any rate between the maximum set by the consumer interest and the minimum set by the investor interest could not "properly be attacked as confiscatory."[33] Thus both due process and eminent domain-type limitations emerge in the decision.

On the critical question whether the investor's interest is impaired in a particular case, an issue that squarely presented the property questions, the Court avoided a clear position and looked to procedure rather than substance. First, the Court noted that the Commission had provided a mechanism for individual producers to demonstrate that the area rate was too low. Second, the Commission would permit abandonment of a certificate as an alternative to setting a higher rate.[34] The Court, however, approved this latter alternative to raising rates.[35] Thus, the Court seemed to recognize implicitly a floor to avoid a taking. If the rate was too low, then the producer could withdraw service. This discussion then would seem to support Pond's contention that there is a distinction between price regulation in which the investment can be removed and that in which the investment cannot.

The Court further lowered the standard for investor protection in *Permian*. The producers legitimately questioned whether they could be forced to continue service at a loss.[36] First, abandonment could result in a total loss of the investment. Second, a delay of abandonment likewise could result in losses. The Court concluded that the violation could be avoided because the Commission had provided for an ill-defined review process and suggested that

28. Block v. Hirsch, 256 U.S. 135 (1921).
29. Nebbia v. New York, 291 U.S. 502 (1934).
30. *Hope*, 320 U.S. at 601.
31. Permian Basin Area Rate Cases, 390 U.S. 747 (1968).
32. *Id.* at 769-70.
33. *Id.* at 770.
34. *Id.* at 771.
35. *Id.* at 773.
36. *Id.* at 770.

it would permit abandonment.[37] The right to recover costs to the investor for legitimate service to some extent, however, would be lost during the period in which the commission considered the rate increase or request for abandonment. Thus, the notion that the producer could hope to recover the costs of its operation, if those costs exceeded the area rates, was doubtful at best. In this light, there was no constitutional requirement that the producer be afforded the opportunity to recover its costs as defined by the *Bluefield* standards.

Furthermore, as Justice Douglas noted in a dissenting opinion in *Permian*,[38] the process of setting rates at a group level exaggerated the unlikelihood of determining that the rates were "just and reasonable." Though he accepted that circumstances might dictate the use of group ratemaking, he noted that the commissions must demonstrate that the data on which the decision rested be typical and representative of the group.[39] In his view, the commission failed to establish that the information on which it relied met that standard.[40] The result was to make the review process impossible.[41] In a very important way, the dissent correctly noted that the commission was permitted to divorce the process of ratemaking for individual cases of need or expectation. As a result, the investor interest in large part was a matter of administrative discretion.

Thus, Pond's attempt to separate price fixing and price and entry regulation will not withstand careful analysis. Since at least the *Hope* decision (and probably more accurately since the *Natural Gas Pipeline* decision), ratemaking and price fixing have been based on the same theory of state police power. This conclusion, however, does not permit unfettered state action. As with any form of regulation, price fixing or ratemaking may not operate to take property without due process or adequate compensation. Thus, Pond's first mistake need not be fatal if his second argument concerning the scope of the protection afforded by the end result test of *Hope* is accurate. Unfortunately, it is not.

III. THE SECOND MISTAKE: THE SCOPE OF THE *Hope* TEST

The second mistake in the analysis of the constitutional standard proposed by Pond is his description of the scope of the *Hope* holding. He attempts to limit the results of *Hope* in two ways. First, he correctly states that the decision rejected the use of the fair value test of ratemaking.[42] Second, in contradiction, he then incorrectly concludes that the decision did not establish a new constitutional dimension to the decision concerning the investor interest established by *Bluefield*. He concludes that the scope of *Hope*:

37. *Id.*

38. *Id.* at 829 (Douglas, J., dissenting).

39. *Id.* at 831.

40. *Id.* at 832-37.

41. *Id.* at 837. Justice Douglas focused on the fact that "[t]he ultimate thrust of the [Natural Gas] Act reaches the individual producer; and unless we know what the group rate in final analysis does to it or disables it from doing we cannot perform our duty of judicial review." *Id.*

42. Pond, *supra* note 6, at 11.

"So long as rate orders met the end result test of *Bluefield*, commissions were now free to use any type of rate base or, indeed, no rate base at all."[43] The *Hope* decision itself belies Pond's qualification and demonstrates a distinct change in the level of constitutional protection which investors could expect.

At the heart of the analysis offered by Pond is his reading of *Hope* such that the minimum protection afforded to the investor is that stated in *Bluefield.*.[44] In that case, the Supreme Court concluded that a public utility is entitled to a rate that affords the company revenues sufficient to earn a return equal to that of companies of similar risk, assure confidence in its financial soundness, and to enable it to raise money.[45] Rates that failed to provide for such a return were confiscatory.[46] With the presumption that *Bluefield* remains a complete statement of a constitutional standard for ratemaking, Pond misconstrues several important points in the *Hope* decision to reach the conclusion that *Bluefield* states the constitutional minimum of investor protection.

First, Justice Douglas' opinion in *Hope* does not stand for the proposition that the investor must receive the *Bluefield* level of return. In fact, there is no reference to *Bluefield* in the *Hope* decision. In the salient section, Justice Douglas carefully defines the interest of the investor in a manner that parrots the language of *Bluefield*.[47] But Justice Douglas precedes this statement with a definition of the required just and reasonable rate as one that balances the interests of the consumer and the investor.[48] He does not define that rate as one which solely provides the investor the opportunity to recover his investment and something more.

As expressed by Justice Douglas, the balancing test may result in very real investor losses and return levels that do not meet *Bluefield* requirements. Because the regulation of rates is merely another form of price fixing,[49] the regulator need not assure net revenues to the utility.[50] If regulation could result in no generation of net revenues, then the *Bluefield* minimums could not be achieved. Yet, there would not necessarily be a confiscation of the investment.

Pond dismisses this point on the basis that the utility is not protected from economic changes that could result in reduced revenue.[51] He must make this concession because the Supreme Court in *Market Street Railway*[52] concluded that the investor interest stated in *Hope* did not protect a nearly

43. *Id.* at 10.

44. *Bluefield*, 262 U.S. 679.

45. *Id.* at 692-93.

46. *Id.* at 690.

47. *Hope*, 320 U.S. at 603. It is interesting that even this reference to the investment standard that sounds so similar to *Bluefield* does not contain a single citation to that case. The Court's apparent attempt to reject the substantive due process approach of its recent predecessors again is readily apparent by this omission.

48. *Id.*

49. *See supra* notes 14-41 and accompanying text.

50. *Hope*, 320 U.S. at 603.

51. Pond, *supra* note 6, at 23-24.

52. Market St. Ry. Co. v. Railroad Comm'n of Cal., 324 U.S. 548 (1945).

defunct rail system in San Francisco from a rate reduction that could not provide a return to the investors consistent with the investor interest stated in *Hope*. The Court suggested a basic limitation on the proper reading of *Hope*: "All that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully. There was no suggestion that less might not be allowed when the amount was all that the company could earn."[53] The Court further explained, "The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces."[54] These statements are hardly a ringing endorsement of the *Bluefield* standard as a constitutional minimum, especially since the utility was still privately owned and in operation at the time of the commission decision reducing its rates. Thus, the notion that *Bluefield* is a minimum constitutional standard is incorrect when applied to economic failures.

Second, the *Hope* opinion suggests that the consumer interest could be used to impair the interest of the investor.[55] The Court did not answer the questions of what that impairment might be and when it might be justified, for in *Hope* the evidence demonstrated that the investor interest had been met.[56] The Court extensively reiterated the company's successful financial record to demonstrate that the end result of the commission's rate reduction was not unreasonable.[57] Thus, the Court suggested but did not answer in *Hope* the issue which is central to the analysis proposed by Pond.

That potential limitation on the investor interest did not prevent Pond from arguing that the Court adopted the *Bluefield* standard as a minimum. In his argument, Pond states that the Court's extensive reiteration of the company's financial record demonstrates that "[t]he Court . . . did not establish a new substantive end result test that differed from that of *Bluefield*."[58] The opinion of the Court, however, stated:

> The conditions under which more or less might be allowed are not important here. Nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint.[59]

The Court then extensively reviewed the financial record of the company to determine that the investor interest was not impaired and agreed with the Commission that the return was sufficient to protect the investor and company. Because the Court concluded that the investor interest was not impaired, any further analysis was unnecessary. In short, the reasoning of the Court in *Hope* was quite different from that suggested by Pond.

53. *Id.* at 566.

54. *Id.* at 567. The Court then suggested that investors could expect only the nominal return and the substantial loss if the plant is worth only its salvage or scrap value. *Id.*

55. *Hope*, 320 U.S. at 603.

56. *Id.*

57. *Id.* at 603-05.

58. Pond, *supra* note 6, at 13.

59. *Hope*, 320 U.S. at 603.

IV. THE RETURN OF THE EMINENT DOMAIN ANALOGY

Hope thus offers a very flexible standard for rate making, and this flexibility proves daunting to those that argue for a particular basis for constitutional review such as the prudent investment test. The concurrence in *Duquesne*, for example, reflected a desire for some sort of defined standard such as the prudent investment test.[60] Likewise, in *Jersey Central Power & Light Co. v. FERC*,[61] the appellate court went to great lengths to avoid saying that the Commission should have considered whether the return was fair based on a prudent investment test but came to that result anyway. In this vein, Pond bluntly states, "If an investment in an excluded, cancelled generating plant was prudent when made, the rate of return must be adjusted so as to meet the requirements of the *Bluefield* and *Hope* end result tests."[62] As noted above, *Hope* did not require that end result, and the Court's recent decision in *Duquesne* emphatically rejects the adoption of the prudent investment standard as a constitutional requirement.

In the *Duquesne* decision, the Court again returned to the eminent domain analogy for a limitation to price and entry regulation.[63] Unlike its predecessors, the decision reflected a decidedly stronger notion of protection of the investor interest and clear reference to the *Bluefield* standard.[64] The Court, however, rejected the conclusion that the Constitution required a return on prudent investment.

The facts of the *Duquesne* case are familiar to utilities with nuclear construction programs. Duquesne and Pennsylvania Power Co. (Penn) joined with several other utilities in 1967 to plan and construct seven nuclear power plants.[65] Because of economic and regulatory changes that affected the nuclear industry in general, the group cancelled four of the seven projects in 1980.[66] Duquesne and Penn then sought in rate cases to recover the costs of the cancelled plants.[67] As a result of a special investigation, the Pennsylvania commission concluded that the costs were prudently incurred and in a subsequent rate case authorized both Duquesne and Penn to amortize the costs over ten years.[68] In the meantime, the Pennsylvania legislature enacted a statute that precluded the inclusion of construction costs in rate base or as a part of rates (as expenses) until the facility provided useful service to the public.[69] In

60. *Duquesne*, 109 S. Ct. at 620-21 (Scalia, J., concurring).

61. Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1181 (D.C. Cir. 1987). The court in a footnote correctly stated that the prudent investment test is not a constitutional requirement, but then suggested that prudent investment may require a return on assets that are not used and useful. *Id.* at 1181 n.3. The effect may very well be a *de facto* adoption of the prudent investment test. For a discussion of this case and its implications, *see* Hoecker, *"Used and Useful": Autopsy of a Ratemaking Policy*, 8 ENERGY L.J. 303 (1987).

62. Pond, *supra* note 6, at 27 & at 30.

63. *Duquesne*, 109 S. Ct. at 615.

64. *Id.* at 619.

65. *Id.* at 612.

66. *Id.* at 613.

67. *Id.*

68. *Id.* at 613-14.

69. *Id.* at 613.

the rate cases, the commission permitted amortization despite the statutory provision, concluding that the statute prevented only the inclusion of the costs in the rate base.[70] In a subsequent appeal of the commission's decisions, the Pennsylvania Supreme Court reversed and held that the statute constitutionally precluded recovery of the cancelled plant costs.[71] As a result, the state court decision prevented Duquesne and Penn from recovering $35 million and $9.6 million, respectively.[72] The effect of the disallowance on the rates of the companies, however, was relatively limited: the potential annual reduction amounted to one-half percent or less.[73] Nonetheless, the companies appealed this decision to the Supreme Court.

In an opinion joined by five members of the Court, which affirmed the state court's decision, Chief Justice Rehnquist began his analysis with an explicit reference to the Fifth Amendment's Takings Clause:

> Although [the utilities'] assets are employed in the public interest to provide consumers of the State with electric power, they are owned and operated by private investors. This partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment.[74]

The Chief Justice then noted that "[t]he guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory."[75] He continued, "[i]f the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."[76]

The majority decision then tackled the "embarrassing question"[77] of when the state might overstep this constitutional limitation. Avoiding a discussion of specific limitations, the Court relied on the *Hope* decision for the conclusion that the Constitution did not require a specific formula for testing rate recovery.[78] More importantly, the Court concluded that the mechanisms for setting rates did not generally have constitutional dimensions:

> We also acknowledged in that case [*Hope*] that all of the subsidiary aspects of valuation for rate-making purposes could not properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree. Today we reaffirm these teachings of *Hope Natural Gas*: "[I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is

70. *Id.* at 614 (citing Pennsylvania Pub. Util. Comm'n v. Pennsylvania Power Co., 60 Pub. Util. Rep. 4th 305 (1984) and Pennsylvania Pub. Util. Comm'n v. Duquesne Light Co., 52 Pub. Util. Rep. 4th 644 (1983)).

71. Barasch v. Pennsylvania Pub. Util. Comm'n, 516 Pa. 142, 532 A.2d 325 (1987), *rev'g*, Cohen v. Pennsylvania Pub. Util. Comm'n, 90 Pa. Commw. 98, 494 A.2d 58 (1985).

72. *Duquesne*, 109 S. Ct. at 613.

73. *Id.* at 618.

74. *Id.* at 615.

75. *Id.* (citing FPC v. Texaco Inc., 417 U.S. 380 (1974); FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942); Covington & Lexington Turnpike Road Co. v. Sandford, 164 U.S. 578 (1896)).

76. *Id.* at 616.

77. Smyth 169 U.S. at 546.

78. *Duquesne*, 109 S. Ct. at 617.

> not then important."[79]

Based on this standard, neither the Duquesne or Penn rates were unreasonable because the rate impact of each disallowance was minor.[80]

As in prior cases, the Court rejected the attempt by several intervenors to supplant the end result test of *Hope* with the prudent investment test as a constitutional standard.[81] Citing its repeated refusals to upset the approach of deference established by *Hope*, the Court concluded:

> [C]ircumstances may favor the use of one rate making procedure over another. The designation of a single theory of rate making as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. The Constitution within broad limits leaves the States free to decide what rate-setting methodology best meets their needs in balancing the interest of the utility and the public.[82]

As the Court required a balancing of investor and consumer interests in *Hope*, so too the Court looked to the commissions to set the balance among the competing interests in rate regulation. Thus, Pond's suggestion that the Constitution requires a return on all prudent investment is unsupported.

Were this the end of the Court's discussion, it would appear unremarkable; however, the majority opinion discussed the investor interest in a way that recalls the *Bluefield* standard. Echoing *Bluefield*, the Court first focused on the investment decision and rate of return as touchstones for assessing whether an unconstitutional taking had occurred.

> [W]hether a particular rate is "unjust" or "unreasonable" will depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return. At the margins, these questions have constitutional overtones.[83]

The Court further noted that there was no showing that the rate orders impeded the companies' ability to raise capital or secure operating money.[84] Sensitive to the *Hope* prescription, however, the Court determined that the marginal impact which the disallowance of cancelled plant costs had on rates had little effect on the relevant results and parties.[85] The Court further noted that the same rate outcome could have been achieved by including the cancelled plant costs and lowering the allowed rate of return.[86] Thus, it is the end result and not the road leading to it that is important.

Second, in rejecting the companies' argument that the statute requiring that the property be used and useful was theoretically inconsistent with the rest of the Pennsylvania statutory scheme, again the Court focused only on the effect of the statute on the utility and its investors and did not consider the *Hope* test's role in balancing various interests. Though the opinion noted that

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79. *Id.* at 617 (quoting *Hope*, 320 U.S. at 602).
80. *Id.* at 618.
81. *Id.*
82. *Id.* at 620.
83. *Id.* at 617.
84. *Id.*
85. *Id.* at 618.
86. *Id.*

the effects of various parts of the rate making structure may cancel out each other, the Court concluded, "[T]he Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect."[87] Even this conclusion looked to the effect on the investor because one of the elements in evaluating a particular rate system is "the return investors expect given the risk of the enterprise."[88] Thus, repeated changes in a statutory or administrative approach that protected consumers from bad results "would raise serious constitutional questions."[89] The Court, however, concluded that the statutory changes by the Pennsylvania legislature in this case were not of constitutional dimension.[90]

Despite this strong emphasis on the investor interest, however, the decision rejected the notion that the *Bluefield* standard is the required end result. The Court generally stated that the investor's expectation of a return is but one factor in setting the rate of return.[91] In the absence of abusive or repeated denials of an adequate return, the state may change the statute in such a way as to deny recovery of investment without fear of committing a constitutional taking.[92] The Court recognized in *Duquesne* that consumers could not be burdened with prudently incurred costs of unproductive assets, just as it concluded in *Market Street* that economic failure could result in investor losses.

V. THE POTENTIAL COST OF ADOPTING THE PRUDENT INVESTMENT STANDARD

The apparent fit between the proposed constitutional standard of prudent investment and traditional ratemaking provides an important element of appeal to Pond's argument. If, as Pond notes, the sole purpose of rate regulation is to prevent the untoward effects of monopoly,[93] and if the cost of service results in a rate that exceeds that which would not exploit consumers, then consumers must suffer.[94] Pond justifies this result by reference to the competitive world that the regulator uses as a guide:

> [T]he minimum non-confiscatory rate merely permits the utility company to recover the cost of providing service. This is, of course, the rule in the competitive field and does not constitute an abuse of monopoly power. It follows that a minimum nonconfiscatory rate can never be unreasonable as violating the legal protection of the consumer.[95]

This statement, however, fails to give proper effect to the competitive market. In a competitive environment, the producer who could not produce at a nonexploitative price would fail. Its product would not be valued by the con-

87. *Id.* at 619.
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. Pond, *supra* note 6, at 23.
94. *Id.* at 30.
95. *Id.* at 30-31.

sumer at the cost necessary to produce it, and the consumer would then purchase from a lower cost alternative producer.

It is only because the utility is the sole producer that one can argue that the cost must be passed through. Yet such a result could very well be exploitative. If the goal of rate regulation is to protect the utility consumer from monopoly effects as Pond suggests, then it follows that the commission is justified in assigning the prudent but useless costs of the mistake to the utility. The investment is not injured in a constitutional sense since it is already devalued. Here, the *Market Street Railway* decision is relevant. In the same manner that the investors lost value because of the obsolescence of the system in the *Market Street Railway* case,[96] so too the investors lose value in the recent cases concerning plant cancellations due to economic or regulatory changes that have little or nothing to do with the basic rate making process. It is the basic economic failure of these projects that makes them no longer valuable or useful for service to customers. Flat growth, increased safety and environmental requirements, poor management, and inflation all have worked to create tremendous pressures on these companies to maintain profits.[97] Under these circumstances, there is no taking for which a commission or the ratepayers can be made responsible.

VI. CONCLUSION

In the final analysis, the argument suggested by Pond is based on the apparent agenda of resuscitating the prudent investment test as a constitutional standard. The reasons for this are to an extent understandable. Recent events have not been kind to utilities or their investors. However, the economic realities that caused these concerns face all investors, and they are compensated for that risk by the rate of return and the market reaction to that return. If an investment turns out poorly, the Constitution does not require that injury to be transferred to ratepayers.[98] "Providing a return sufficient to maintain the financial integrity of a sound company is one thing; restoring financial integrity is another."[99] The Constitution does not require the latter, and on that even Pond must agree.

96. *See supra* notes 51-54 and accompanying text.

97. Charnoff, *Why Management Did It All Right: Overregulation and Other Acts of God*, 33 U. KAN. L. REV. 481, 486 (1985). In late 1987, commissions either by decision or settlement had disallowed $6.6 billion due to alleged mismanagement. Of total plant costs this amounted to nearly 16%. Laros and Haubold, *The Shifting Standard of Prudence*, 120 PUB. UTIL. FORT. 21, 22 (Oct. 29, 1987).

98. It does not follow that the ratepayer may not absorb some of that injury. Statutory provisions that dictate or invite the use the prudent investment standard may cause the same result as offered by Pond. That result, however, is a function of statutory construction and a choice made by state and federal legislatures and their respective administrative agencies. It is not a choice required by the Constitution.

99. *In re* Public Serv. Co. of N.H., 130 N.H. 265, 277, 539 A.2d 263, 270 (1988).