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Pennsylvania Law Preventing Public Utilities from Recovering Financial Losses Through Rates or Amortization Upheld

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ILLINOIS TAX (from page 99)

Concurring Opinions

Justice Stevens and Justice O'Connor disagreed with the majority's reasons for concluding that the Tax Act does not discriminate against interstate commerce. Justice Stevens noted that at least on the surface, the Tax Act appears to discriminate against interstate commerce because interstate calls bear a heavier tax burden. However, both Justices Stevens and O'Connor concluded that the practical economic effect of

the Tax Act is to proportionately tax both intra-state and interstate calls. Justice O'Connor also disagreed with the majority's application of the internal consistency test to state taxes challenged under the Commerce Clause. Finally, Justice Scalia concurred with the judgment of the majority and stated that only those taxes that facially discriminate against interstate commerce violate the Commerce Clause.

Mary L. Smith

PENNSYLVANIA LAW PREVENTING PUBLIC UTILITIES FROM RECOVERING FINANCIAL LOSSES THROUGH RATES OR AMORTIZATION UPHELD

In *Duquesne Light Co. v. Barasch*, — U.S. —, 109 S. Ct. 609 (1989), the United States Supreme Court held that a Pennsylvania statute preventing a public utility company from recovering construction costs of cancelled plants does not violate the Takings Clause of the fifth amendment of the Constitution. The Court ruled that a state is free to set rates for public utilities which balance the interests of the utilities and the public.

Background

In 1967, two public utility companies, Duquesne Light Company ("Duquesne") and Pennsylvania Power Company ("Penn Power"), decided to increase their generating capacity. Duquesne and Penn Power entered into an agreement with several other electric utilities to construct seven nuclear generating units. In 1980, the construction of four of the facilities was halted in part due to the Arab oil embargo and the Three Mile Island accident. The demand for electricity as well as the desirability of nuclear energy as a means to meet that demand had changed. Duquesne and Penn Power respectively had expended \$34,697,389 and \$9,569,665 in construction costs by the time the project was cancelled.

In 1980 and 1981 Duquesne petitioned the Pennsylvania Public Utilities Commission ("the PUC") to gain permission to recoup its losses

over a ten-year period. The PUC found that the cancellation of the project was reasonable given the circumstances and permitted Duquesne and Penn Power to amortize expenditures over a ten-year period. In 1982, Duquesne again petitioned the PUC to obtain a rate increase. In 1983, the PUC allowed Duquesne to increase its revenues \$105.8 million to a total yearly revenue exceeding \$800 million. The rate increase included \$3.5 million in revenue which represented the first payment to Duquesne for its loss from the plants' cancellation. The PUC granted Penn Power the authority to increase its revenues by \$15.4 million to a total of \$184.2 million. This increase included the first year of the ten-year amortization recovery.

Prior to the close of the Duquesne rate proceeding in 1982, the Pennsylvania legislature enacted a law which amended the Pennsylvania Utility Code ("the Act"). The Act prohibited the cost of construction of a utility plant undertaken by a public utility from being included in the rate base or in rates charged by the utility until the facility is "used and useful" to the public. Pa. Stat. Ann. tit. 66, § 1315 (Purdon 1988). Pursuant to the Act, the Pennsylvania Office of the Consumer Advocate ("the Consumer Advocate") requested that the PUC reconsider its order allowing Duquesne to amortize its losses. The PUC reaffirmed its prior decision, interpreting the Act as excluding the costs of canceled facilities from the rate base but not as precluding recovery of costs through amortization.

The Consumer Advocate appealed the PUC's decision to the Pennsylvania Commonwealth Court, which held that the PUC had interpreted the Act correctly. The Consumer Advocate then appealed to the Pennsylvania Supreme Court.

The Pennsylvania Supreme Court reversed the decision of the lower court, holding that the Act prohibited recovery of the costs for the canceled facilities either through inclusion in the rate base or by amortization. The Pennsylvania Supreme Court rejected the utility companies' assertion that the fourteenth amendment to the Constitution precluded taking without just compensation. The court observed that the "'just compensation' safeguar[d] to a utility by the fourteenth amendment... is a reasonable return on the fair value of its property at the time it is being used for public service." 109 S. Ct. at 614. Because the facilities in question were never used by the public and no operating expenses had been incurred by the utilities, there was no constitutional right to recovery.

Duquesne and Penn Power appealed to the United States Supreme Court. They contended that the Act's prohibition against recovering the costs of construction in their rates violated the Takings Clause of the fifth amendment of the Constitution.

Basis of the Supreme Court's Jurisdiction

The Supreme Court first inquired into its jurisdiction to decide the case. Under 28 U.S.C § 1257(2), the Court has authority to review a final judgement from a state's highest court where a state statute is challenged and the state court holds the statute is not repugnant to the Constitution. Because the Supreme Court of Pennsylvania had held the Act to be constitutional, the United States Supreme Court had jurisdiction to review the judgment.

The Supreme Court held that even though public utilities serve the needs of the public, they are subject to the Takings Clause of the fifth amendment because they are owned by private investors. Therefore, the rate methods set by a public utilities commission must not result in a confiscation of property without just compensation. The Court discussed the constitutional ramifications of rate-setting methods used by utilities. The Court stated that a rate is confiscatory if it is so low that it destroys the value of the property for all the purposes for which it was acquired and deprives the utility of its property without due process of law. Consequently, if a rate does not afford sufficient compensation to a utility then the utility has not been afforded just compensation as guaranteed by the Takings Clause.

History of Rate Setting Methods: Fair Value and Historical Cost Rules

The Court reviewed two past rate-setting methods which met the constitutional minimum. Once considered the only constitutionally acceptable method of setting rates, *Smyth v. Ames*, 169 U.S. 466 (1898), the fair value rule is based on the operation of the competitive market. The fair value rule provides that rates be set in accordance with the actual present value of the assets employed in public service. Under this rule, if a utility's investment is good, the utility earns an above-cost return. If the investment is a poor one, however, it has no fair value and thus justifies no return. Subsequently, the Court held an alternative approach to be an acceptable method of fixing utility rates. *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Under the historical cost or prudent investment rule, the utility is compensated at actual cost for all investments which are prudent when made, regardless of whether the investments are deemed necessary or beneficial in hindsight.

The Court noted that the Pennsylvania rate-setting method is based on a modified historical cost standard. The Court emphasized that it is not the rate-setting method but the impact of the rate order that is dispositive. If the cumulative effect of the rate order is not unreasonable, any judicial inquiry is at an end. When a particular rate is confiscatory, however, it must be more closely scrutinized. The Court indicated that one element pertinent to the setting of rates is the return investors expect given the risk of the undertaking. Whether a rate is unjust is contingent on what is a fair rate of return under a particular rate-setting method, as well as on the amount of capital upon which investors are entitled to earn a return. Constitutional implications arise when a state arbitrarily switches rate-setting methods in such a way that the utility or investors bear the risks of bad investments and are denied the benefits of good investments.

Pennsylvania's Rate-Setting Method Held to be Constitutional

The Court held that the impact of the Pennsylvania Supreme Court's rate orders did not violate the Takings Clause of the fifth amendment. The Act's prohibition against amortized recovery would only deny Duquesne's annual allow-

(continued on page 102)

PUBLIC UTILITIES (from page 101)

ance by 0.4% and Penn Power's annual allowance by 0.5%. Therefore, the overall impact of the rate orders was not confiscatory. The Court reasoned that the reduced rates would not undermine the financial soundness of either utility nor would the rates deprive individual investors of just compensation.

Duquesne and Penn Power asserted that the Act was inconsistent because the "used and useful" standard normally is associated with the fair value approach and Pennsylvania used the historical cost method. Duquesne and Penn Power argued further that the Act undermined the PUC's duty to balance the interests of the consumer and the investor. The Court rejected both of these arguments. Because the PUC is an arm of the state legislature it is competent to set utility rates. Furthermore, utility rates are not subject to attack merely because a combination of rate-setting methods are used.

The Court also rejected the contention that the historical cost rule should be adopted as the single constitutional standard. A public utilities commission need not follow any single standard

or combination of standards when setting rates. Such a rule would limit alternatives that may be beneficial to both consumers and investors. The Constitution provides broad guidelines wherein the state legislatures and utility commissions are free to decide the rates that best serve the interests of the public and the investors.

Concurring and Dissenting Opinions

Justices Scalia, White and O'Connor concurred. They noted that although the Constitution does not dictate a rate-setting method, the historical cost or prudent investment method should always be considered when assessing the constitutionality of the impact of a particular rate order.

Justice Blackman dissented. He believed the Court did not have jurisdiction to hear the case because there was no final judgment before the Court. The Pennsylvania Supreme Court had invalidated the rate orders set by the PUC and remanded the case for further ratemaking. Because no new rates had been set, the judgement of the Pennsylvania Supreme Court was not final.

Martha D. Owens

WEST VIRGINIA STATUTE REGULATING FUNERAL INDUSTRY IS NOT PREEMPTED BY FEDERAL REGULATION AND DOES NOT VIOLATE THE FIRST AMENDMENT

In *National Funeral Services, Inc. v. Rockefeller*, 870 F.2d 136 (4th Cir. 1989), the United States Court of Appeals for the Fourth Circuit held that a West Virginia statute regulating preneed funeral contracts was not preempted by the Federal Trade Commission's ("the FTC's") Funeral Rule. 16 C.F.R. 453 (1989). The court also held that the statute did not violate the right to free commercial speech guaranteed by the first amendment of the Constitution.

West Virginia Statute

In 1955, the West Virginia legislature determined that preneed funeral contracts were void unless all proceeds of the contract were placed in trust pending the contract beneficiary's time

of need. Since that time, the state legislature imposed increasingly strict regulations upon preneed funeral contracts. The current West Virginia statute ("the Act"), W. Va. Code § 47-14-1 (1983), encompasses all preneed sales of burial goods, funeral goods, and funeral services, and declares any contract void which is not solicited, drafted, and executed in accordance with the Act. The statute also requires that all sellers of such goods be licensed by the state and that all employees of a seller be certified by the state. The Act permits the advertisement of preneed funeral contracts. However, in an effort to reduce fraud and protect privacy, it prohibits two types of solicitation: 1) in-person or telephone solicitation of potential purchasers who are in nursing homes, hospitals, and private residences, and 2) any solicitation of relatives of persons near death. The Act regulates the terms of the sale by mandating that ninety percent of the contract proceeds be placed in a trust pending the contract beneficiary's time of need, and that stated procedures for the disposition of trust income be observed.