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NOTES

THE "FAIR VALUE" TEST IN MONTANA PUBLIC UTILITY RATE REGULATION

Certain enterprises are so intimately bound up with the public welfare, so affected with a public interest, that they became quasi-public enterprises. Chief among these are the utilities. They are granted by government the security of an assured market, freedom from competition and even the right of eminent domain, but in turn this unique type of business is subject to restraint. While the ordinary enterprise is entitled to seek maximum profits, the public utility may not. Its special status obliges it to limit its profit to that which is fair and reasonable.

In the nineteenth century a feeling grew that some supervisory body with power to create and enforce its own rules was needed to control the operation of public utilities. Illinois finally led the way by creating the first mandatory commission in 1871 to govern and establish maximum rates for railroads and warehouses. The constitutionality of such a rate-making body was upheld in 1876 in Munn v. Illinois. Thereafter the federal government and all of the states undertook similarly to delegate rate-making responsibility to administrative agencies, most often called a "Public Service Commission." Though this was admittedly a delegation of legislative power, the permissibility of such an arrangement was upheld by the Supreme Court. Four years after the Munn decision the Supreme Court established the principle that a public utility is entitled to earn a reasonable return from its property dedicated to public use, and that the fixing by a state of unreasonable rates for a utility amounted to the taking of property without due process of law. However, within this constitutional framework the action of the rate-making agency is controlled by the standards set up in the statute through which it received its delegation of authority.

THE MONTANA STATUTES AND THE FAIR VALUE TEST

The Montana Public Service Commission was established in 1921 to carry out the following public policy: "Every public utility is required to furnish reasonably adequate service and facilities. The charge made by any public utility . . . shall be reasonable and just, and every unjust and unreasonable charge is prohibited and declared unlawful." In carrying out its duty of ascertaining the reasonableness of rates the Commission is provided with a statutory guide, which provides in part: "The commission may, in its discretion, investigate and ascertain the value of the property

194 U.S. 113 (1876).
2 Id. at 133. See also Billings Utility Co. v. Public Service Comm’n, 62 Mont. 21, 203 Pac. 366 (1921).
4 Great Northern Utilities Co. v. Public Service Comm’n, 88 Mont. 180, 293 Pac. 294 (1930).
5 Revised Codes of Montana, 1947, §§ 70-102, 72-101; Great Northern Utilities Co. v. Public Service Comm’n, 88 Mont. 180, 293 Pac. 294 (1930). (Hereinafter Revised Codes of Montana are cited R.C.M.)
6 R.C.M. 1947, § 70-105.
of every public utility actually used and useful for the convenience of the public.”’ It should be noted that the language of the statute is clearly only permissive, and that reference is made only to “value.” The terms present value, fair value, prudent investment, original cost, actual legitimate cost, and reproduction cost new, terms used frequently in discussing proper rates, do not appear in it.

At the time these statutes were enacted the constitutional due process requirement applicable to state rate commission action was set forth by the United States Supreme Court in Smyth v. Ames. In that case the Court made the statement that “the basis of all calculations 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.”’ Having thus, in two words, denominated the doctrine which was to dominate all regulatory efforts for the next forty-six years, the Court then added the statement which was to become the stumbling block of all efforts to apply it:’

And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth.

Out of this dictum, obviously meant only as a partial enumeration of the many factors to be given “such weight as might be just and right in each case,” subsequently grew the “fair value” doctrine. As developed in later cases the doctrine came to be associated with and characterized by an undue emphasis on reproduction cost (at present prices) as the primary element of value. The other factors set forth in the enumeration in Smyth v. Ames, though occasionally considered, have been regarded as of minimal importance.

In spite of the permissive wording of the rate statute, the early Montana cases required the Commission to ascertain present property values. In one case the Montana Supreme Court said:’

7R.C.M. 1947, § 70-106.
8169 U.S. 446 (1898).
9Id. at 546 (Emphasis added).
10Id. at 546-47.
12R.C.M. 1947, § 70-106, quoted in text at note 7 supra.
13Great Northern Utilities Co. v. Public Service Comm’n, 88 Mont. 180, 293 Pac. 294, 303 (1930) (Emphasis added).
Any order made by the Commission must be just and reasonable. What is a reasonable charge, or a just and reasonable order, must depend upon the facts in each case. What a utility 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.

And in Tobacco River Power v. Public Service Commission it stated:4 "[W]e believe that section 3884, infra, [now R.C.M. 1947, section 70-106] indicates that present fair value of the utility should be ascertained for the purposes of rate making." In support of both decisions the court cited the Minnesota Rate Cases5 and Smyth v. Ames.6

It is not questioned that the Supreme Court of Montana made a correct interpretation of the law as it then stood. Regardless of any statutory enactment in this state, by reason of the decision by the United States Supreme Court in Smyth v. Ames the constitutional interpretation of "reasonable and just" rates required that the rates be established on the basis of the "fair value" of the property of the utility. That this was the substantive constitutional requirement at that time is demonstrated by the holding of the United States Supreme Court in Denver Union Stock Yard Company v. United States, where the Court ruled:7

[A]s of right safeguarded by . . . the Fifth Amendment, appellant is entitled to rates, not per se excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of the property used, at the time it is being used, to render the services.

However, even at the time of that emphatic statement of the rule, the process of change had started.

**OBJECTIONS TO THE FAIR VALUE AND REPRODUCTION COST CONCEPTS**

The concept of "fair value" as a rate base was unsound even at the time of its inception. Smyth v. Ames was based on an erroneous analogy to eminent domain. It was there reasoned that since indemnification for the full value of property was required when it was condemned by the state, the preservation of the full value of private property devoted to public services was required when its use was regulated by the state. Any impingement upon that value was regarded as a taking of property without just compensation in violation of the due process clause.8 The fallacy in the analogy is apparent. Any limitation upon earnings—the essence of rate regulation—necessarily affects the value of the going concern.9 In
Federal Power Commission v. Hope Natural Gas Company,\textsuperscript{20} (treated more fully below) the United States Supreme Court recognized this: "The heart of the matter is that rates cannot be made to depend upon ‘fair value’ when the value of the going enterprise depends on earnings under whatever rates may be anticipated."

The original need for a "fair value" rate base no longer exists. In Southwestern Bell Telephone Co. v. Public Service Commission\textsuperscript{21} Justice Brandeis said:

The adoption of present value of the utility’s property, as the rate base, was urged in 1893, on behalf of the community; and it was adopted by the courts, largely, as a protection against inflated claims based on what were then deemed inflated prices of the past [citing authority]... Those were the days before state legislation prohibited the issue of public utility securities without authorization from state officials; before accounting was prescribed and supervised; when outstanding bonds and stocks were hardly an indication of the amount of capital embarked in the enterprise; when depreciation accounts were unknown; and when book values, or property accounts, furnished no trustworthy evidence either of cost or of real value. Estimates of reproduction cost were then offered, largely as a means, either of supplying lacks in the proofs of actual cost and investment, or of testing the credibility of evidence adduced, or of showing that the cost of installation had been wasteful.

Further, fair value as a rate base is wholly indefinite and uncertain. In the forty-six years Smyth v. Ames ruled the question, the Supreme Court never succeeded in defining the value required by its decisions.\textsuperscript{22} In criticizing the rule Judge Learned Hand said: ‘‘Merely to leave the question with a caution that several elements are to be considered is to abandon any effort to solve it.’’\textsuperscript{23} And in the same vein Justice Brandeis stated:\textsuperscript{24}

Obviously, ‘‘value’’ cannot be a composite of all these elements. Nor can it be arrived at on all these bases. They are very different; and must, when applied in a particular case, lead to widely different results... The result, inherent in the rule itself, is arbitrary action, on the part of the rate regulating body.

Consideration of reproduction cost (which is the primary basis of ‘‘fair value’’) renders the ‘‘fair value’’ rate base unworkable. The great delay and expense involved in eliciting reproduction cost evidence is notorious. The concurring opinion in Federal Power Commission v. Natural Gas Pipeline Co. states:\textsuperscript{25}

\textsuperscript{20}320 U.S. 591, 601 (1944).
\textsuperscript{21}262 U.S. 276, 298-99 (1923).
\textsuperscript{22}2 Bonbright, Valuation of Property 1119 (1937).
\textsuperscript{25}315 U.S. 575, 605 (1942). See also 2 Bonbright, Valuation of Property 1105 (1937); Driscoll v. Edison Co., 307 U.S. 104 (1939).
The havoc raised by insistence on reproduction cost is now a matter of historical record. Mr. Justice Brandeis in the Southwestern Bell Telephone case demonstrated how the rule of Smyth v. Ames has seriously impaired the power of rate-regulation and how the 'fair value' rule has proved to be unworkable by reason of the time required to make the valuations, the heavy expense involved, and the unreliability of the results obtained.

In addition, a rate base dependent upon reproduction cost estimates lacks stability and certainty because of the continually fluctuating nature of those costs.°

And finally, the "fair value" rate base lacks any real significance in fixing just and reasonable rates. This is apparent from the fact that utilities have thrived and have been willing, anxious, and able to render service for long periods under rates which would be "confiscatory" under the doctrine of Smyth v. Ames. As Bonbright has said: "In short, it was good business to submit to confiscation!"°° This anomaly is explainable in part, at least, from the fact that a large part of utility properties were and are purchased with the proceeds of long term bonds issued at low interest rates. In such a situation to follow a reproduction-cost-new rate base, especially in times of inflation, is to take no cognizance of the immense resulting windfall to stockholders arising from the fact that the interest obligation on the bonds remains static.°° Such undue returns to equity investors, capitalizing on "fair value" rate bases, undoubtedly contributed to the wild speculation in utility securities and the holding company debacles of the late 1920's.

Eventually the logic of these arguments began to have some effect on the thinking of the courts.

THE RETREAT FROM SMYTH V. AMES

In at least four decisions since 1930 the United States Supreme Court indicated that it was more concerned with the results under the rates prescribed than it was with the method used by the commission in fixing rates.°° In a fifth case, Federal Power Commission v. Hope Natural Gas Company,°° the Supreme Court indicated just how much it had changed its views on this question. The Hope case involved the Federal Natural Gas Act which directs the Federal Power Commission to determine "just and reasonable" rates,°° and authorizes it to "investigate and ascertain the
actual legitimate cost... and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.' An original cost rate base figure had been used by the Commission, although it had permitted the introduction by the company of reproduction cost evidence. The Court of Appeals reversed and held it to be "clear that the statute contemplates that the [rate] base should be determined in accordance with existing legal rules," i.e., the 'fair value' doctrine of Smyth v. Ames. In reversing the Court of Appeals the Supreme Court held that Congress had not required the use of any particular formula. The Court said, in part: "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned invalid, even though they might produce only a meager return on the so-called 'fair value' rate base.' Thus the forty-six year epic ended.

The Hope case was soon followed by Colorado Interstate Gas Co. v. Federal Power Commission and Panhandle Eastern Pipe Line Co. v. Federal Power Commission where the Court reaffirmed its acceptance of actual legitimate costs and reasserted that the Federal Natural Gas Act is concerned only with the end results of rate orders when viewed in their entirety.

It is apparent from the foregoing that the United States Supreme Court is now committed to the view that there is no constitutional requirement that utilities be permitted to earn a "fair return" on the "fair value" of the property devoted to public use. It should be clear that the Hope decision has bearing on state rate orders as well as federal rate orders, for the requirements of due process are similar for each. As the Court reiterated in Hope, quoting its earlier decision of Federal Power Commission v. Natural Gas Pipeline Co., "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.' Indeed the Hope case has had a far reaching effect on state determinations of this matter as indicated by the following summary of the cases as of 1954:

The evidence discloses that of the forty-three states [including the District of Columbia] included in this survey, four use original cost or prudent investment as the rate base and did so prior to the Hope case; nine follow fair value according to its traditional meaning; eight have adopted original cost as the measure of fair value; and nineteen have explicitly changed from fair value to

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314 F.2d 287, 295 (4th Cir. 1963).
320 U.S. 591, 605 (1944).
324 U.S. 635, 649 (1945).
315 U.S. 575, 582 (1942).
Cal., Mass., Wis., and possibly Wash.
Uli, Ind., Mich., Mont., N.D., Ohio, Pa., and probably S.D. and N.M.
original cost or prudent investment. Thus the disintegration of the fair value formula has been rapidly accelerated by the Hope decision. Of all the predictions commonly made at the time of the decision, the one anticipating the decline of reproduction cost and fair value in rate-making has proved most accurate.

MONTANA RATE REGULATION THEORY

The Montana Public Service Commission has not chosen to forsake the fair value theory with its heavy emphasis on a reproduction cost rate base. The primary responsibility for any forward step in this regard is with the Commission, not the courts, for it is the Commission that must first act pursuant to direct legislative authority; then, upon review, recognizing that the fixing of rates is a legislative function, the courts should make allowance for Commission expertise in such matters.

The Montana Supreme Court, exercising its review function, has come forth with some alarming constructions of the Montana regulatory statutes. In State ex rel. Olsen v. Public Service Commission the Commission had granted an increase in rates based on the average fair value of the company’s property devoted to intrastate service for the year of the order, 1953. The protestant contended, as it had once before, that the Hope Natural Gas case had discredited the fair value doctrine and thus changed the rule in Montana. The court affirmed the Commission’s order and thus reached the proper result, since the order was based on substantial evidence and under the broad wording of the statutes the Commission seems free to choose any type of rate base. But the opinion is replete with unfounded constructions of the regulatory statutes.

After setting forth Revised Codes of Montana, 1947, section 70-106, the court went on to say: “The language of the statute is clear that the Commission shall determine ‘the value of the property of every public utility actually used and useful for the convenience of the public.’” A little further on is this statement: “While our statute does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates.” And still further: “The trend, of all judicial utterances examined even in states in which the statute does not require value to be considered as a factor as Montana does, is to permit the commissions to exercise their discretion in establishing a proper rate base. . . .” How or why the imperative shall is read into the permissive may

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43原文成本或谨慎投资。因此，公平价值公式的瓦解速度由霍普决定。在所有预测中，在时间决定的，是认为的生产成本和公平价值在率作的预测已经证明是准确的。

MONTANA RATE REGULATION THEORY

蒙大拿公共服务委员会没有选择放弃公平价值理论，它着重于生产成本率基。主要责任在此进程中首先是委员会，而不是法庭，因为它在直接立法权限作出第一动作；然后，在审查中，认识到定价是立法功能，法庭应允许委员会在这些问题中作出专家建议。

蒙大拿最高法院，在行使审查功能，有一个令人震惊的蒙大拿监管法规的解释。在State ex rel. Olsen v. Public Service Commission的会议中，委员会已经授予增加率基于公司的财产平均公平价值的年份的内州服务，1953。抗议者声称，这以前曾有一次，霍普自然气案已经将公平值理论和改变规则在蒙大拿。法庭确认委员会的决定，并且因此达到了合适的结果，因为决定基于实质证据和在宽泛的措辞下，委员会似乎自由选择任何类型的率基。但是这个意见是充斥着与未建立的建设性的监管法规的解释。

在陈述 Revised Codes of Montana, 1947, section 70-106, 法院接着说：”用语的法律是明确的，委员会应确定‘每一家公共公司的财产实际使用和对公众的便利的值。’”再小一点的继续在是这个声明：”我们的法律没有建立公式来决定公平价值，它确实要求这样的值被找到和被用作基在定价。”再进一步地说：”所有的司法陈述检查，即使在法律没有要求值被考虑作为因素作为蒙大拿的行为，是允许委员会在建立一个合适的率基......”为什么或为什么在命令中应有权的应被读入的许可的可能？
of the statute is never explained by the court. It is submitted first that such a construction can only lead to confusion, and second, that the court should at least treat the matter with consistency. Only two pages later in answer to the contention of the protestant that Revised Codes of Montana, 1947, section 70-106, makes it incumbent upon the commission to make an independent investigation of its own before increasing rates, the court stated that the statute was permissive only. To state that in this instance the court appears to be engaged in judicial legislation is to state the obvious.

The only reference in the decision to the Hope case is that it has no effect on the law in Montana. It seems clear that the court, even if it did not expressly so state, decided the case on the basis of the precedent of the Tobacco River decision. Yet no attempt was made by the court to face up to the issue raised by the fact that the Supreme Court in Hope had finally abrogated the Smyth v. Ames requirement of fair value, which if not openly acknowledged, certainly supplied the compelling rationale of the Tobacco River decision.

Compare with this Montana rationale the position of the Supreme Court of Utah when faced with a nearly identical problem. The Utah rate regulation statute provides that the rates established by the commission shall be just and reasonable and that the commission "shall have the power to ascertain the value of the property of every public utility." In Utah Power & Light Co. v. Public Service Commission the Utah Commission had ordered a rate decrease. The company appealed directly to the Utah Supreme Court contending that it was entitled to a reasonable return on the "fair value" of its property, and that the commission could not determine a rate base founded on cost. The company originally based its claim for "fair value" on both a constitutional and a statutory right, but between the time of its original brief and its reply brief the Supreme Court decided the Hope Natural Gas case, and the company dropped its constitutional argument, conceding that Hope had destroyed any claim for such relief. It insisted instead on its statutory right to "fair value." In response to this claim the court held that the Utah statute could not be construed as a mandate requiring the commission to act on a value rate base. For sheer clarity and lucidity the Utah opinion best illustrates the proper approach to this problem:

The removal of the constitutional barrier erected by Smyth v. Ames unleashed the power of the Commission and permitted it to expand into fields previously restricted by earlier court decisions.

"Id. at 281, 309 P.2d at 1041.
"The immediately prior decision, State ex rel. Olsen v. Public Service Comm'n, 131 Mont. 104, 308 P.2d 633 (1957), though reaching the same result as the case presently being considered, entered into a more thorough examination of the effect of the Hope decision on the merits and demerits of the fair value theory, though concluding: "This court has held that the value of the property means the present fair value and that reproduction cost new less depreciation is an important factor in determining the value." (Citing Tobacco River Power Co. v. Public Service Comm'n, 109 Mont. 521, 98 P.2d 886 (1940).
"109 Mont. 521, 98 P.2d 886 (1940).
"Utah Code Ann. §§ 54-4-1, -21 (1953).
"107, Utah 155, 152 P.2d 542 (1944).
"152 P.2d at 508.
At the time of Smyth v. Ames a rate could not be just and reasonable in the constitutional sense unless it permitted a fair return on fair value. This concept has... been overruled. It would be contrary to common sense to hold that the legislature meant “just and reasonable” only as defined by the courts at the time of Smyth v. Ames and to hold that the legislature would, in order to authorize the Commission to use prudent investment, be required to re-enact the statute saying that it mean “just and reasonable” as that term is construed today. To the contrary, it must be assumed that the legislature contemplated that the concept of that which is “just and reasonable” might change with social trends. Possibly that is why the legislature did not prescribe a definite formula to be applied to every case without variation. The term “just and reasonable” is not an absolute. The legislature need not amend the statute to permit the Commission to apply the present judicial interpretation of what is “just and reasonable.”

It could be argued in Montana, as it was in Utah, that in 1921 when the legislature passed the Public Service Laws, they intended to embody into those laws the meaning expressed in Smyth v. Ames. It could be argued that the legislature, in its selection of the word value deliberately designed to freeze into the statute law of this state the rate base then currently endorsed by the United States Supreme Court. It therefore becomes important to ascertain the intent of the legislature at the time it enacted this statute. To deduce a deliberate legislative design to compel consideration of reproduction cost estimates in fixing the rates of utilities attributes to the astuteness and mental processes of the draftsmen more than is warranted. First, there is nothing in the legislative history which would indicate that the decision in anyway affected the ideas of the draftsmen of this statute. They did not copy the key term of the Smyth v. Ames decision, i.e., “fair value.” Second, they made no effort whatever to depict “value” in a fluctuating present sale or exchange context. They did not precede it with the word “reproduction,” nor follow it with any qualifying phrase such as “at the time it is being used for the public.” And third, there is no express mandate that the Commission value the property at all. The deliberate selection of words which connote permission strongly indicates that the legislature intended only to place a guide at the disposal of the Commission. The only limitation appended to the delegation of power contained in these statutes is that the rates established by the Commission must be “just and reasonable.”

With the passing of the “fair value” doctrine from the scene the full broad scope of the legislation becomes free for application. It is submitted that should the Public Service Commission in the future desire to abandon completely the discredited reproduction-cost-new rate base it should do so without hesitation. At such time the Montana Supreme Court would then be faced squarely with the proposition decided by the Utah Court above, whose lucid analysis is recommended for consideration.

JAMES V. BOTTOMLY

See Montana House and Senate Journals, 1921.