

IPU RESEARCH NOTE

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CORE CASE LAW IN U.S. PUBLIC UTILITY REGULATION

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CONSTITUTIONAL BASIS

- Commerce Clause (Article I, Section 8, Clause 3) of the [U.S. Constitution](#): Congress shall have the power "To regulate Commerce with foreign nations, and among the several States, and with the Indian tribes." Establishes a strong *federal role* in interstate, wholesale markets; important and some controversy as to interpretation.
- Contract Clause (Article 1, Section 10, Clause 1): "No State shall... pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts..."
- Fifth Amendment: "...nor shall private property be taken for public use, without just compensation" ("takings").
- Tenth Amendment: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."
- Fourteenth Amendment: "...nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."
- States regulate pursuant to their constitutions and/or police powers.

JUDICIAL PRECEDENTS

Authority of the legislature to grant charters and franchises

[Charles River Bridge v. Warren Bridge 36 U.S. 420 \(1837\).](#)

- The Charles River Bridge, having been granted a charter in 1785 to operate a bridge and charge a toll for service, sued a new bridge company. The court sided with the legislature in finding that a monopoly had not been granted and that economic development interests took priority over the private interest of the company.

[New Orleans Water-Works Company v. Rivers 115 U.S. 674 \(1885\).](#)

- The granting by the state of an exclusive water service franchise established constitutionally protected property rights.

Authority to regulate in the public interest

[Munn v. State of Illinois 94 U.S. 113 \(1876\).](#)

- Illinois established a commission that set maximum rates for grain storage.
- Chief Justice Waite echoed the common law heritage: “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 created. He may withdraw his grant by discontinuing the use; but, so long as he maintains the use, he must submit to the control.”
- [Dissent in Munn \(Justice Field\)](#): “It requires no comment to point out the radical differences between the cases of public mills and interest on money, and that of the warehouses in Chicago. No prerogative or privilege of the crown to establish warehouses was ever asserted at the common law... The business of a warehouseman was, at common law, a private business, and is so in its nature. It has no special privileges connected with it, nor did the law ever extend to it any greater protection than it extended to all other private business... No reason can be assigned to justify legislation interfering with the legitimate profits of that business, that would not equally justify an intermeddling with the business of every man in the community, so soon, at least, as his business became generally useful.”
- Regarding early judicial review of the authority of the legislature to grant charters, see [Charles River Bridge v. Warren Bridge 36 U.S. 420 \(1837\)](#).
- Regarding regulation of rates in the public interest, see also [German Alliance Insurance Co. v. Lewis 233 U.S. 389 \(1914\)](#).
- Regarding what the public interest is *not* (i.e., impairing, burdensome, or discriminatory), see [United Gas Pipe Line Co. v. Mobile Gas Service Corp. 350 U.S. 332 \(1956\)](#) and [Federal Power Commission v. Sierra Pacific Co. 350 U.S. 348 \(1956\)](#).

Narrowing of the public-interest doctrine

[Williams V. Standard Oil Co. 278 U.S. 235 \(1929\).](#)

- State cannot fix commodity prices (in this case gasoline) absent a public interest justification without violating due process.
- “By repeated decisions of this court, beginning with [Munn v. Illinois](#)... that phrase, however it may be characterized, has become the established test by which the legislative power to fix prices of commodities, use of property, or services, must be measured. As applied in particular instances, its meaning may be considered both from an affirmative and a negative point of view. Affirmatively, it means that a business or property, in order to be affected with a public interest, must be such or be so employed as to justify the conclusion that it has been devoted to a public use and its use thereby in effect granted to the public... Negatively, it does not mean that a business is affected with a public interest merely because it is large or because the public are warranted in having a feeling of concern in respect of its maintenance.”

Expansion of the public-interest doctrine

[Nebbia v. New York 291 U.S. 502 \(1934\).](#)

- Expansion of the concept of “a business affected with a public interest” beyond the narrower concept of a public utility.
- Expansion of regulation to serve appropriate and nonarbitrary legislative purposes (i.e., vital economic interests).
- “Plainly the activities of the railroads, their charges and practices, so nearly touch the vital economic interests of society that the police power may be invoked to regulate their charges, and no additional formula of affection or clothing with a public interest is needed to justify the regulation. And this is evidently true of all business units supplying transportation, light, heat, power and water to communities, irrespective of how they obtain their powers.”
- Dissenting opinion in [New York State Ice Co. v. Liebmann 285 U.S. 262 \(1932\)](#) argued further that public welfare—even without monopoly or emergency—may demand regulation.
- Dissenting opinion in [Davies Warehouse v. Bowles 321 U.S. 144 \(1944\)](#) defined public utilities.

Barriers to entry and exit

- Barriers to entry.
 - ▶ [Idaho Power & Light v. Blomquist, 26 Idaho 222, 141 P. 1083 \(1914\).](#)
- Barriers to exit (subject to overall profitability).
 - ▶ [New York and Queens Gas v. McCall 245 U.S. 345 \(1917\).](#)
 - ▶ [Puget Sound Traction, Light and Power v. Reynolds 244 U.S. 574 \(1917\).](#)

Protection of investors

- Reasonable opportunity to earn a return.
 - ▶ Fifth and Fourteenth Amendments (non-confiscatory, “takings”).
 - ▶ [Georgia Railroad and Banking v. Smith 128 U.S. 174 \(1888\).](#)
- Reasonable rates are based on the “fair value” of the ratebase and returns are not guaranteed: “The public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends... If a corporation cannot... earn dividends for stockholders, it is a misfortune for it and them which the Constitution does not require to be remedied by imposing unjust burdens upon the public.”
 - ▶ [Smyth v. Ames 169 U.S. 466 \(1898\).](#) (*Overtaken by FPC v. Natural Gas Pipeline, 1942*).
- The power to regulate is “null” if the 14th Amendment is protective of “the most profitable return,” but withdrawing the 14th Amendment renders property “nought”; a “midway” must be hit. The case upheld a State Supreme Court decision.
 - ▶ [Cedar Rapids Gas Light Co. v. City of Cedar Rapids 223 U.S. 655 \(1912\).](#)

- Fair rate of return: "The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."
 - ▶ [Bluefield Waterworks v. PSC of WV 262 U.S. 679 \(1923\).](#)
- "By longstanding usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense... But regulation does not insure that the business shall produce net revenues, nor does the Constitution require that the losses of the business in one year shall be restored from future earnings..."
 - ▶ [Federal Power Commission v. Natural Gas Pipeline Co. 315 U.S. 575, 585 \(1942\).](#)
- Due process does not protect utilities from losses due to business risk associated with economic forces.
 - ▶ [Market St. Ry. Co. v. Railroad Commission of California 324 U.S. 548 \(1945\).](#)

Standards of review for investment

- Allowance of cost recovery for expenditures and avoidance of substituting commission judgment for management.
 - ▶ [State of Missouri, ex rel. Southwestern Bell v. PSC 262 U.S. 276 \(1923\).](#)
- Prudence of utility investments.
 - ▶ [West Ohio Gas Co. v. PUCO 294 U.S. 63 \(1935\).](#)
- The "fair value" of utility assets is based on whether they are both "used" (in service during the test year) and "useful" (in service to utility customers).
 - ▶ [Denver Union Stock Yard Co. v. U.S. 304 U.S. 470 \(1938\).](#)
- ▶ Overturning *Smyth v. Ames* with regard to "the fallacious 'fair-value' theory of rate making": "While the opinion of the Court erases much which has been written in rate cases during the last half century, we think this is an appropriate occasion to lay the ghost of *Smyth v. Ames*... which has haunted utility regulation since 1898.... [T]he Commission is now freed from the compulsion of admitting evidence on reproduction cost or of giving any weight to that element of 'fair value'. The Commission may now adopt, if it chooses, prudent investment as a rate base..."
 - ▶ [Federal Power Commission v. Natural Gas Pipeline Co. 315 U.S. 575, 585 \(1942\).](#)
- Protection of consumers by disallowance of "unnecessary or illegitimate costs."
 - ▶ [National Association for the Advancement of Colored People v. FPC 425 U.S. 662 \(1976\).](#)
- A prudent investment may be disallowed if it is not used and useful (i.e., the disallowance is not a "taking"). Also, "The Constitution, within broad limits, leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public."
 - ▶ [Duquesne Light v. Barasch 488 U.S. 299 \(1989\).](#)
- Utilities are obligated "to operate with all reasonable economies."
 - ▶ [El Paso Natural Gas Co. v. FPC 281 F.2d 567 \(1960\).](#)
- Government, having 20-20 hindsight, should avoid usurping managerial discretion when reviewing abuse of that discretion. Investments should be "prudent" based on what is known and knowable to managers at the time

(protects utilities from uncontrollable or systemic risks). "...the issue is not whether the company acted lawfully but whether it acted prudently-- a higher standard..." [Trans World Airlines v. Civil Aeronautics Board, 385 F.2d 648 \(1967\)](#).

- Regulators must ensure that all costs are "necessary and prudent."
 - ▶ [Midwestern Gas Transmission Co. 36 F.P.C. 61 \(1966\)](#), affirmed, by [Midwestern Gas Transmission Co. v. Federal Power Commission 388 F.2d 444 \(7th Cir.\)](#), *cert. denied*, 392 U.S. 928 (1968).

Reasonable and nondiscriminatory rates

- A rate is unjustly low if it destroys "the value of [the] property for all the purposes for which it was acquired."
 - ▶ [Covington & Lexington Turnpike Road Co. v. Sandford 164 U.S. 578, 597 \(1896\)](#).
- Railroads began to bear the burden of proof for just and reasonable rates before the Interstate Commerce Commission.
 - ▶ [Hepburn Act, 1906](#).
- Rates must be just and reasonable; the result reached not the method employed is controlling; historical costs are appropriately used in ratemaking; and regulation "must draw a balance between wealth and welfare."
 - ▶ [Federal Power Commission v. Hope Natural Gas Co. 320 U.S. 591 \(1944\)](#).
- Freely-negotiated contract rates for wholesale electricity are just and reasonable and can only be revised by FERC to protect the public interest based on a finding that the result would "impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory" (*Mobile-Sierra Doctrine*).
 - ▶ [United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332 \(1956\)](#).
 - ▶ [Federal Power Commission v. Sierra Pacific Co., 350 U.S. 348 \(1956\)](#).
- Rates must be nondiscriminatory, as well as just and reasonable.
 - ▶ [Public Service Company of Indiana, Inc. v. FERC 575 F.2d 1204 \(1978\)](#).
- Proof of market manipulation would eliminate the premise on which the *Mobile-Sierra* presumption rests.
 - ▶ [Morgan Stanley Capital Group Inc. v. Public Utility District No. 1 of Snohomish County et al. 06-1457 \(2008\)](#). Also decided 06-1462.

Commission jurisdiction and discretion

- "The ratemaking power is a legislative power, and necessarily implies a range of legislative discretion... The question involved is whether... There is no formula for the ascertainment of the fair value of property used for convenience of the public, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts."
 - [Minnesota Rate Case, 230 U.S. 352 \(1913\)](#).
- Commission has authority to issue interim orders and grant interim rate relief.
 - ▶ [FPC v. Tennessee Gas Company \(1962\)](#).

- Per constitutional and statutory law, "Courts are without authority to set aside any rate selected by the Commission which is within a zone of reasonableness" (i.e., courts will not second guess); "[N]either law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders."
 - ▶ [Permian Basin Area Rate Cases 390 U.S. 747, 790 \(1968\).](#)
- Federal jurisdiction for wholesale power is exclusive, preempting state authority.
 - ▶ [Narragansett Elec. Co. v. Burke 119 R.I. 559, 381 A.2d 1358 \(1977\).](#)
- Federal jurisdiction for wholesale rates *does not* pre-empt the states with respect to associated prudence.
 - ▶ [Pike County Light and Power Co. v. Pennsylvania Public Utility Commission 465 A.2d 735 \(PA 1983\).](#)
 - ▶ [Kentucky West Virginia Gas Company v. Pennsylvania Public Utility Commission 837 F.2d 600 \(3rd Cir. 1988\).](#) [Writ of certiorari denied.](#)
- Federal jurisdiction for wholesale rates *does* pre-empt the states with respect to associated prudence (*Nantahala Power & Light, 1986; Mississippi Power, 1988*).
 - ▶ [Nantahala Power & Light v. Thornburg 476 U.S. 953 \(1986\).](#)
 - ▶ [Mississippi Power & Light Co. v. Mississippi ex rel. Moore 487 U.S. 354 \(1988\).](#)
- "Chevron deference" principle in administrative law holds that a reasonable interpretation of an ambiguous statute by an agency with subject matter jurisdiction prevails.
 - ▶ [Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc. 467 U.S. 837 \(1984\).](#)
- Commissions are creatures of the legislature, possessing only powers specifically conferred by the law (i.e., ratemaking authority): "The relevant acts do contain specific grants of "managerial" authority to the Public Service Commission, although the very specificity of these grants indicates that general managerial authority has never been conferred upon the PSC."
 - ▶ [Union Carbide v. \[MI\] Public Service Commission 431 Mich 135, 147 \(1988\).](#)
- States may have authority for holding companies without preemption by the commerce clause or the Public Utility Holding Company Act.
 - ▶ [Baltimore Gas and Electric Company v. Public Service Commission of Maryland 760 F.2d 1408 \(4th Cir. 1985\).](#)
- "The Constitution within broad limits leaves the States free to decide what rate-setting methodology best meets their needs in balancing the interests of the utility and the public."
 - ▶ [Duquesne Light v. Barasch 488 U.S. 299 \(1989\).](#)
- Federal telecom act allows states to prevent municipalities from providing telecommunications services.
 - ▶ [Nixon v. Missouri Municipal League et al. 541 U.S. 125 \(2004\).](#)
- Pursuant to Chevron, the courts should defer to the FCC's reasonable interpretation of the federal telecom act by deciding that broadband cable companies did not provide a "telecommunications service."
 - ▶ [National Cable and Telecomm. Assn v. Brand X Internet Services 545 U.S. \(2005\).](#)