A Consumer Oriented Approach to Regulation of Public Utility Prices by the Cost of Living Council

Edward Terrar III
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Introduction

During the past several years there has been an ongoing struggle between the utility industry, their regulatory commissions and the Cost of Living Council. The struggle began when Congress mandated that utility prices be included in the economic stabilization program, just as prices in the other industries were included in the program.2

One method after another was attempted by the federal price controllers to bring utility prices under control. Phase IV of the economic stabilization program marked the end of the struggle at least temporarily, with the total surrender of the Cost of Living Council, when it granted an exemption to utilities from further participation in the price control program. The Cost of Living Council was not the only loser in this struggle. Consumers, labor and other industries also lost as they were made to bear the full rigors of the price control program, increased by the uncontrolled utility prices.

† The author acknowledges the encouragement in preparing this article of Professor Roy Schotland, Georgetown University Law Center, in whose administrative law course the idea for this article was formulated.


1. Articles dealing with the utility and carrier industries and the treatment which they have received at the hands of economic stabilization programs are few. D. Toll, Price Commission Regulation of Public Utilities, American Bar Association's Section on Public Utility Law Annual Publication 5 (1972) presents a description of Phase I and the first several months of Phase II, as it applied to the utility industry. V. Hirschberg, Higher Utility Rates Loom as Price Panel Assigns Control Duties to Regulatory Agencies, 4 National Journal 512-524 (1972) offers a consumer oriented criticism of the Price Commission and its treatment of utilities. L. Jourolmon, Wartime Utility Rate Control, 17 Tenn. L. Rev. 915 (1943) offers a discussion of the economic stabilization program as it related to utilities during World War II.

The following will describe the struggle that occurred, the problems which defeated the Cost of Living Council and outline a basic program of reform which would permit control of utility prices, just as prices in other industries are controlled.

**The Economic Stabilization Act and the Price Commission**

The Economic Stabilization Act originated in the House Committee on Banking and Currency, and was approved by Congress on August 15, 1970. The Act was largely the work of Congressional Democrats concerned about the economy and eager to influence President Nixon's economic policies. Nixon opposed the Act and said that he would not exercise the authority which it granted, as such action "simply does not fit the economic conditions which exist today." White House supporters in Congress opposed the grant of presidential power as a political maneuver by Democrats to blame the President with inaction if inflation continued.

However, as a result of continuing inflation, a sluggish recovery from the 1969 recession, a worsening foreign trade balance, and a deepening...
deficit in the nation's balance of international payments, as well as a growing lack of public confidence in his ability to manage the economy, the President changed his mind in mid-1971. On August 15, 1971 the President issued Executive Order No. 11615 which set in motion Phase I of the stabilization program. Its purpose was to freeze the economy, or at least chill it, for ninety days. The Order covered “prices, rents, wages and salaries” and prohibited increases in those categories beyond the levels reached in the thirty-day period preceding the date of the Order. It excluded raw agricultural products from regulation.

The Order created the Cost of Living Council and delegated to it all the powers which the Act had given to the President. The Order also provided that anyone who willfully violated it or any of the regulations issued under its authority, would be fined up to $5,000 for each violation, and would be


9. See Economic Report of the Presidents 1972 3-7, 56-116 for President Nixon’s explanation of his resort to price controls. The President states:

In the Summer of 1971 the American economy was beset by a conflict among four objectives: faster growth, higher employment, greater price stability, and a more balanced external position. The danger was that steps to speed up growth and boost employment by expanding demand would worsen both the inflation and the balance-of-payments deficit. The steps initiated on August 15 greatly increased the possibility of simultaneous progress on all four fronts. The price and wage control system has provided more room for expanding growth and employment even while inflation and inflationary expectations are being reduced.

Id. at 101.


12. Section 204 of the 1970 Act provided that “[W]hoever willfully violates any order or regulation under this title shall be fined not more than $5,000.” The words “for each violation” made their first appearance in Exec. Order No. 11,615, apparently without any statutory authority. 3 C.F.R. 201 (1971). The issue has been mooted by § 208 of the 1971 Amendments which provides for civil penalties ($2,500) and criminal penalties ($5,000) “for each violation.”
subject to appropriate injunctive relief.  

Phase II was born on November 14, 1971. It was conceived by Executive Order No. 11627. This Order created a Pay Board made up of fifteen members, five each from the general public, business, and organized, labor, and a Price Commission composed of seven public members. The Order was subsequently confirmed and refined by Executive Order No. 11640, which was issued on December 22, 1971, concurrently with the President’s signing of the 1971 amendments to the original Act. The 1971 amendments evidenced congressional attempts to furnish standards to guide the President in the exercise of his authority to stabilize the economy. The original Act had failed to establish such standards. However, the amended Act set forth standards that were so vague as to add little that the due process clause had not already impliedly furnished. Thus, among other things, the President was directed to be “fair and equitable,” and to prevent “gross inequities.” The standards called “for generally comparable sacrifices by business and labor as well as other segments of the economy.”

The federal district courts were given exclusive jurisdiction of cases arising under the Act. Appeals from district court decisions were handled ex-
clusively in a newly created Temporary Emergency Court of Appeals, which with one important qualification was granted the powers of a Circuit Court of Appeals.\textsuperscript{20}

approved by Congress and signed by the President on December 22, 1971, elaborated the standards to which the Price Commission actions and decisions had to conform and created a specialized system for judicial review of stabilization measures. The amendments were intended to achieve three primary ends: (1) speed and consistency of decisions in cases arising under the Act, (2) avoidance of any breaks or stays in the operation of the Stabilization Program, and (3) relief for particular persons aggrieved by the operation of the program. \textit{See S. Rep. No. 92-507, 92d Cong., 1st Sess. 10 (1971).} State courts were permitted to consider a defense based on the Act or the regulations, unless the defense questioned the constitutionality of the Act or the validity of the regulations, in which event removal by either party to a federal court was permitted.

In addition, the amendments directed the Price Commission to establish by regulation appropriate procedures, including agency review, “available to any person for the purpose of seeking an interpretation, modification or recision of, or seeking an exception or exemption from . . . rules, regulations, and orders.” Congress exempted the Price Commission from most of the requirements of the Administrative Procedure Act. 1971 Amendments § 207(a). It was felt that these requirements would result in “too cumbersome and dilatory a procedure.” \textit{See S. Rep. No. 92-507, 92d Cong., 1st Sess. 8 (1971).} Congress rejected, however, the Administration's proposal, S. 2712, 92d Cong., 1st Sess. § 207 (1971), that the Price Commission, like that of the Korean period, Defense Production Act of 1950, 50 U.S.C. App. § 2159 (1951), be exempted from all of the Act's requirements. The 1971 Amendments did subject the Price Commission to the section of the APA that governs the rule-making process, the procedures by which generally applicable regulations are formulated. 5 U.S.C. § 553 (1970). The section, when it applied, required that notice of proposed rule-making be published in the Federal Register; interested parties were then given “an opportunity to participate in the rule-making through submission of written data, views, or arguments with or without opportunity for oral presentation.” In most cases, substantive rules must be published at least thirty days before they are to take effect. 5 U.S.C. § 553(d). The Price Commission at first took much advantage of § 553(b)B of the APA, which allows agencies to disregard the prescribed rule-making procedure, “when the agency for good cause finds . . . that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.” The general regulations promulgated at the outset of the Phase II controls were designed to govern nearly all sectors of the economy. Because of the extremely broad scope of these initial regulations and the time pressures under which they were formulated, the APA's rule-making procedures would have been of little utility. The Price Commission also remained subject to §§ 555, and 706 of the APA.

20. 1971 Amendments, §§ 211(b)(1), (2). The Act provided that the Emergency Court was deprived of power to issue interlocutory decrees “staying or restraining in whole or in part any provision of this title, or the effectiveness of any regulation or order issued thereunder.” 1971 Amendments, § 211(b)(1). Similarly, the district court was deprived of its customary power to grant interlocutory relief to stay enforcement of a regulation it considered unlawful, except with regard to a party before it, 1971 Amendments, § 211(d)(1), and then only for the same reasons which authorize the Emergency Court to invalidate the regulations and orders. If a district court concluded that a substantial constitutional question existed, the question had to be certified to the Emergency Court. A regulation was permitted to be set aside by the Emergency Court only after judgement, and then only if the regulation was in excess of the agency's authority, arbitrary or capricious, or otherwise unlawful under 5 U.S.C. § 706(2). Appeals from interlocutory decisions of district courts were permitted to be taken under 28 U.S.C. § 1292(b) to the Emergency Court. 1971 Amendments § 211(d)(2). Further appeal rested on the certiorari jurisdiction of the Supreme Court. 1971 Amendments § 211(g).
The administration of the wage program was simple compared to the fixing of price levels. The truth of this is exhibited by a comparison of the regulations. Whereas wage increases were to be calculated according to a 5.5 percent limit, prices were to be controlled by a formula whose components included allowable costs, productivity gains and profit margins, all of which escaped mathematical precision. There were three broad groups to which price regulations applied: manufacturers, retailers and wholesalers, and service and professional organizations. Each group was treated differently but all were subject to the general rule that prices could not be increased over the base price except when justified by allowable cost increases and not even then if the effect of the price boost was to raise the company's profit margins. The regulation read:

A manufacturer may charge a price in excess of the base price only to reflect increases in allowable costs that it incurred since the last price increase in the item concerned, or that it incurred after January 1, 1971, whichever was later, and that it is continuing to incur, reduced to reflect productivity gains, and only to the extent that the increased price does not result in an increase in its profit margin over that which prevailed during the base period.

As can be seen, Congress gave the regulatory agencies in this area practically unlimited discretion. The vagueness of the standards furnished, coupled with the prohibition against temporary restraints by the district courts, constituted a grant of immense power to the new agencies. During the 16 months of Phase I and Phase II the rate of inflation decreased, total employment rose, the rate of unemployment dropped, and real spendable earnings rose. In general, the program received wide public acceptance and voluntary cooperation.

The Price Commission and the Public Utilities

During the price control programs of World War II and the Korean War,
utilities were exempt from federal price control programs. Leon Henderson, one of the authors of the World War II price control program and the first Price Administrator of that program, gave as reasons for exempting utilities that: they seemed to be under an adequate system of state regulation; this was an area not likely to give difficulty or to cause, so far as then could be seen, any inflationary trend; they had problems peculiar to themselves and no further regulation seemed necessary; and the agencies in control of their rates were found to be just as earnest as the Price Administrator about keeping their costs down.

Henderson's reasoning is generally supported by the Consumer and Retail Price Indexes. These indexes reflect the fact that utility prices were on a decline from before World War I until well into the 1960's. The utility indexes continued to show that utility prices were declining during World War I, World War II, and the Korean War, despite the sharp growth of the

25. In the price control program of World War II, Section 3022(c) of the Emergency Price Control Act of 1942 specifically exempted “regulation of . . . rates charged by any common carrier or other public utility.” Emergency Price Control Act of 1942, ch. 26, § 302, 56 Stat. 23, 36. This total exemption was later curtailed by an amendment to that statute, which prescribed that no public utility or carrier could increase its rates “unless it first gives thirty days notice to the President, or such agency as he may designate, and consents to the timely intervention by such agency before the federal, state or municipal authority having jurisdiction to consider such increase.” Act of October 2, 1942, ch. 578, § 1, 56 Stat. 765. The United States Supreme Court found the Act constitutional and acknowledged that Congress intended that final ratemaking authority should be retained by the various regulatory commissions. Vinson v. Washington Gas Light Co., 321 U.S. 489 (1944). The Court stated that Congress “limited the right of the Executive to notice by the utility and the utility's consent that the Executive might be heard by the regulatory body having final authority in the premises.” Id. at 498. During the Korean War Congress again exempted utilities and carriers from the price controls. The authority conferred by the Defense Production Act of 1950 was not to be exercised with respect to “rates charged by any common carrier or other public utility.” Defense Production Act of 1950, ch. 932 § 402(e)(v), 64 Stat. 798, 806. However, utilities had to again give thirty days notice of any increase and the Executive was allowed timely intervention.

26. Hearings on H.R. 5479 Before the House Committee on Banking and Currency, 77th Cong., 1st Sess., pt. 1, at 444 (1941) where it was said that “. . . public utilities were under what for the time at least seemed to be an adequate system of state regulation, and therefore did not need to be brought into review.”

27. Id. at 54-55.

Now, as to the utilities, there is as the members are aware, an adequate set of regulations as to the charges which utilities can make. These, again, are based upon a long series of judicial determinations, of state regulations and state laws. It seemed to those drafting the bill that this was an area which was not likely to give difficulty or to cause, so far as they could see at that time, any inflationary trend. The bill is designed to control an emergency inflationary situation and has left them out, just as it has transportation rates. There are questions peculiar to utilities and none of them, so far as I see at the present time, would make necessary further regulation by means of a price-control bill.

28. Id. at 445.

I have found that every one of the agencies charged with these particular items of cost are just as earnest as we are about keeping those costs down.
indexes for other items. The reason for the decline was the ever improving technology and efficiency of the utilities, the cost savings of which were passed through to consumers.

<table>
<thead>
<tr>
<th></th>
<th>World War I</th>
<th>World War II</th>
<th>Korean War</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>1915</td>
<td>1920</td>
<td>1940</td>
</tr>
<tr>
<td>All Items, CPI²⁹</td>
<td>43.4</td>
<td>85.7</td>
<td>59.9</td>
</tr>
<tr>
<td>CPI for Gas and Electricity,²⁹</td>
<td>NA</td>
<td>NA</td>
<td>103.9</td>
</tr>
<tr>
<td>RPI for Elect./100 k.w. hrs.³⁰</td>
<td>NA</td>
<td>NA</td>
<td>105.1</td>
</tr>
<tr>
<td>Average Price in Cents/100 k.w. hrs.³¹</td>
<td>8.6</td>
<td>6.9</td>
<td>3.88</td>
</tr>
<tr>
<td>RPI for Natural Gas/10 Therms³²</td>
<td>59.7</td>
<td>77.2</td>
<td>117.2</td>
</tr>
<tr>
<td>Telephone toll rates between N.Y. C. and Denver³³</td>
<td>11.25</td>
<td>10.40</td>
<td>3.25</td>
</tr>
<tr>
<td>S.F.</td>
<td>20.70</td>
<td>16.30</td>
<td>4.00</td>
</tr>
<tr>
<td>CPI for Public Transportation³⁴</td>
<td>NA</td>
<td>NA</td>
<td>81.3</td>
</tr>
<tr>
<td>NA (Not Available)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1947-1949=100</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

There were those, however, who advocated that federal price controls should be applied to utilities. For example, Leon Jourolmon, a commissioner of the Tennessee Railroad and Public Utility Commission, published an article in 1942 citing numerous abuses, inconsistencies, and unjustified price increases in the utility and carrier industry during World War I and World War II.³³ He suggested that utilities should have the same obligation to assume an equitable share of the burdens of war as other citizens, that is, be subject to federal price controls.³⁴

It was not until the Economic Stabilization Act of 1970, however, that utilities were included in federal price controls. A number of factors led to the inclusion of utilities in these controls. First, during the 1960's the utility prices ended their long-term decline and started to inflate. This was due in large measure to the rapid increase in interest rates, and the increase in construction and labor costs, which were suddenly outpacing the cost savings from

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30. Id. at 129, Series E 177-185.
31. Id. at 510, Series 570-80.
32. Id. at 481, Series R 10-13.
33. L. Jourolmon, Wartime Utility Rate Control, 17 Tenn. L. Rev. 915 (1943).
34. Id. at 924.
developments in technology. Utility prices became a victim of demand pull inflation, a plague experienced by almost every industry in the 1960's.\textsuperscript{35}

<table>
<thead>
<tr>
<th>PERCENT INCREASE OR DECREASE IN THE CONSUMER PRICE INDEX</th>
<th>FOR SELECTED UTILITIES AND CARRIERS IN 1968, 1969, and 1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Items CPI</td>
<td>1968 1969 1970</td>
</tr>
<tr>
<td>Utilities and Public Transportation CPI</td>
<td>4.7% 6.1% 5.5%</td>
</tr>
<tr>
<td>Local Transportation Fares CPI</td>
<td>2.9% 3.8% 8.0%</td>
</tr>
<tr>
<td>Railroad Fares CPI</td>
<td>NA 4.3% 20.0%</td>
</tr>
<tr>
<td>Airplane Fares CPI</td>
<td>NA 8.1% 12.2%</td>
</tr>
<tr>
<td>Bus Fares CPI</td>
<td>NA 13.6% 4.7%</td>
</tr>
<tr>
<td>Electric CPI</td>
<td>NA 8.6% 11.5%</td>
</tr>
<tr>
<td>Gas CPI</td>
<td>1.2% 3.2% 5.5%</td>
</tr>
<tr>
<td>Telephone CPI</td>
<td>1.2% 3.6% 5.8%</td>
</tr>
<tr>
<td>Water CPI</td>
<td>NA .9% 2.5%</td>
</tr>
<tr>
<td>NA (Not Available)</td>
<td>4.2% 12.9%</td>
</tr>
</tbody>
</table>

With utility prices in many cases outstripping other consumer items a majority of Henderson's reasons for exempting utilities were no longer valid.

A second factor which made utility prices ripe for non-exemption was the advance in economic theory in this area since the Korean price controls.\textsuperscript{44} For example, Briefs and Means developed a theory to justify


\textsuperscript{37} Id. at 17, Table 8.


\textsuperscript{39} Id. at 21, Table 8.

\textsuperscript{40} Id. at 19, Table 8.


\textsuperscript{42} Id. at 23, Table 8.

\textsuperscript{43} Id. at 21, Table 8.

\textsuperscript{44} In the World War II Korean War period, economic thought was not far removed from the theory of inflation, rooted in the quantity theory of money, that an increase in the quantity of the circulating medium was the common cause and characteristic of inflation. Since governments were responsible for the increase in the quantity of the circulating medium, it was governments that caused inflation. Utility rates according to this theory had no relation to the quantity of the circulating medium, and so could not be the cause of inflation. As a result price controls in this area would be inappropriate. For more on the quantity theory see M. Friedman, \textit{The Quantity Theory of Money, in Studies in the Quantity of Money} (M. Friedman ed. 1956); A. Lerner, \textit{The Inflationary Process: Some Theoretical Aspects}, 31 Rev. Econ. & Stat. 1943 (1949).

Keynesian theory, which won popularity during World War II, put the emphasis on the supply and demand for goods and services. It found inflation was related to ex-
cess demand, the condition which prevailed when the quantity demanded was greater than the quantity which could be supplied at current prices. Demand pull resulted from the existence of an excess demand over supply at current prices. Cost push resulted from the increase in costs in market situations in which producers were able to pass cost increases on to the purchasers in the form of higher prices.

Keynesian theory is more readily applicable to carrier prices than to utility prices. Carriers, like most private firms, consider market (demand) factors as well as cost (supply) factors in determining their rate structures. Rate structures are often a mixture of cost of service and value of service considerations. Where competition is strong, rates tend toward the cost of service; where competition is weak, toward the value of service. C. Phillips in The Economics of Regulation Theory and Practice in the Transportation and Public Industries (1969) at 313 mentions railroad prices as an example of the importance of demand considerations. He writes:

As a result of (a) the difficulty of finding the cost of carrying a specific commodity and (b) the favorable results obtainable through discrimination, there is little attempt to set specific railroad rates on the basis of cost, if cost is used in the sense of including both fixed and variable costs. Railroad rate differentiation is largely based upon demand characteristics or how much the potential buyer of the service values it.


The application of Keynesian theory to utilities requires some modifications as far as demand pull is concerned. Demand pull assumes a free enterprise situation, a system in which individuals are substantially free to sell the product of their labor to the highest bidder and to spend their incomes thus obtained by buying from the cheapest source of supply the goods and services that yield the greatest satisfaction. But demand and supply, it might be argued, are not factors which are considered in the utility rate making situation. Or to say it another way, it is not the market place and free enterprise which determines utility rates, but regulatory commissions. Further, consumers have little choice in buying or not buying utility services. Such services are necessities, and are supplied by monopolies.

A study by F. Fisher, A Study in Econometrics: The Demand for Electricity in the United States (1962) supports this line of reasoning. Fisher found that the price of electricity has no effect on demand. Id. at 5. If such is the case, then following Keynesian analysis, utilities could well argue that they do not cause demand pull inflation. Even if there were an excess of demand over supply, utility and carrier prices would not be driven up, because prices are not related to demand. In A. Boyd, Inflation and Public Utility Regulation, Annual Report of the American Bar Association's Section on Public Utility Law, 1 (1959) the vagueness can be seen that one finds in discussions of demand pull and public utility prices:

Inflation, or a rise in price levels, is considered to be caused by one of two reasons. The first is that any increase in demand in excess of capacity (to meet the demand) will tend to produce price increases. This is the 'demand pull' theory of inflation. The other, known as the 'cost push' theory of inflation, is that trade union pressure can cause prices to rise in circumstances in which the 'demand pull' theory tells us that they ought not to rise. Because of the high demand for new utility plants and the fact that all utility industries are almost completely organized (by unions), it is apparent that whatever theory of inflation you choose to follow the regulated utilities are caught in the web.

Id. at 2.

While demand pull analysis of utility prices has its difficulties, there is no problem with cost push analysis of utility prices. Cost push is always the reason given for rate increase requests. See, e.g., the statements of T. Brophy, President of General
President Kennedy's wage-price guidelines in the early 1960's.\textsuperscript{45} This theory held that no longer is it competition which determines prices and wages in most industries, but discretionary decisions of companies and unions. It is discretionary decisions which cause inflation. This better explains how inflation on the one hand and stable demand, relatively substantial unemployment and unused industrial capacity on the other, once thought incompatible, have managed to co-exist.

A third and perhaps the most significant factor which accounted for utilities non-exemption from the 1970 Stabilization Act was the surprise element. The price controls caught the utilities, their lobby groups, and the Congress by surprise. There were several aspects to the surprise:

First, the Act was opposed by the President, who had stated during the Congressional consideration of the Act that he would not use its authority if it were enacted.\textsuperscript{46} Apparently taking the President at his word, no spokesman for the public utilities industry appeared at the hearings which were held on the Act, nor was any mention of the possible exemption or problems which would be involved in non-exemption ever brought up, either in hearings or floor debate on the Act.\textsuperscript{47}
Second, soon after it became clear in Phase II that the Price Commission was giving up in its attempt to stop inflation in the public utility industry, the Congress was specifically offered an amendment to an act extending the Emergency Stabilization Act which would have forced the President to subject the public utilities to price controls, and this amendment was rejected.\textsuperscript{48}

surprise is pointed up by the fact that the history of the utilities, carriers and their regulators for the last 70 years has been one of constant battle against the federal government's ever expanding power over them. At the mere sign that the federal government, in the form of the Federal Power Commission, the Interstate Commerce Commission, the Securities Exchange Commission, or the Department of the Interior is considering some action which touches on their rights, there is set in motion a flood of lobbying and literature in opposition. There was not a word from the industry about the Economic Stabilization Act, which had the potential of putting the entire industry under federal control for the first time in history. It was not until the President implemented the price freeze that the industry started to react.


For an example of how the industry came to the defense once the Economic Stabilization Act was implemented, see H. Cohn, \textit{The Regulated Electric Utilities and Price Controls}, \textit{89 Pub. Util. Fort.} (April 13, 1972).

\textsuperscript{48} 117 Cong. Rec. 19181 (1971). Senator Metcalf offered the amendment, stating his purpose as being to make clear as a matter of law that all rates and charges of major public utilities shall remain frozen during the stabilization period. . . . The objectives are, first, rate hikes for public utilities and services not only impose a multi-billion-dollar inflationary burden on the Nation, but they hit the consumer especially hard because he has virtually no way to avoid these charges. . . . Second, the many regulatory agencies have neither the resources, the staffing, nor the inclination to generate an aggressive testing of the evidence produced by the utility companies. In addition, they tend to be biased in favor of the businesses they regulate. Third, any rate increases approved by the President or his delegate, should be in accord with the standards set forth under the legislation, but in addition, and most importantly, be not in excess of the price increase levels permitted for other industries and businesses. Utilities should be held at least to the general line with other industries. . . . The Price Commission should establish guidelines for Public Utilities that will hold those companies to a definitive anti-inflationary norm. . . . Thus, what we have here is really a very simple charge to the executive branch. Because of the special impact of regulated public utilities on our economy, and because of the inability of Federal and state regulatory agencies to coordinate a national anti-inflationary policy, we say put the re-
Third, when the Economic Stabilization Act was originally passed, the Congress was told, and many legislators probably believed, that the Act contained the same provisions as did the price control acts of the Second World War and the Korean War.\textsuperscript{49} And finally, even if the President had wanted to control inflation in the public utilities industry, no funds were provided and the authorization period for his authority was only six months. Under these conditions it would be physically impossible to stop inflation in the public utilities industry.\textsuperscript{50}

\textit{Regulation of the Utility Industry by Direct Controls}

The success of the Price Commission in the first effort at federal control of utility prices once the Economic Stabilization Act was implemented on August 15, 1971 was checkered. During the periods of August 15-November 15, 1971 and February 10-March 25, 1972 when the Price Commission imposed a total freeze on utility prices, the Utility and Public Transportation Consumer Price Index reflected a near zero gain.\textsuperscript{51} There

\begin{itemize}
  \item [49] Congressman Reuss stated: "The language is identical with that used in legislation in both World War II and the Korean conflict in order to enable the President to deal with inflation." 116 CONG. REC. 26830 (1970). It is thought however, that Congress was very aware of what it was doing. Far from acting in the dark and merely to harass the President, the initiators of the price control program had a rather sophisticated grasp of the inflation situation and tailored their legislation to fit it. R. Carr, \textit{Administration and Judicial Review of Economic Controls}, 39 U. CHI. L. REV. 566, 569 (1972).
  \item [50] Carr's analysis of the recent price controls makes sense, but it is probably more an after-the-fact rationalization of what did happen than what was planned by either the Congress or the Executive. No such sophisticated analysis of the inflationary economy and the type of price controls needed to heal it was presented at Congressional hearings. The only explanation which the administration gave for the form in which the price controls were implemented involved the desire not to have as large a bureaucracy as was required in earlier programs. Price Commission Chairman C. Jackson Grayson, Jr., made the following statement to the Consumer Federation of America: "Item-by-item controls were rejected by the Price Commission because of the large bureaucracy required to administer such a program and the resulting dislocations to the economy." Price Commission News Release No. 50, at 4 (January 28, 1972). In World War II over 250,000 people were involved in the price control program. In the Korean War the number was 17,000 and a budget of $137,000,000. In the recent program less than 500 people were involved. \textit{See} W. Widnall, \textit{Defense Production Act and Economic Stabilization Act}, H.R. Doc. No. 91-1330, 91st Cong., 2d Sess. (July 27, 1970).
  \item [51] For a fuller development of this point, see Congressman Blackburn's statement, 116 CONG. REC. 26830 (1970).
\end{itemize}
was little inflation and a near total success of the price controls during these periods. But during all other periods, the Utility and Public Transportation Consumer Price Index increased faster, sometimes three and four times faster than the 2.5 point rate set by the President. During the calendar year 1972, a period when the Price Commission had complete authority to control utility prices, the Utility and Public Transportation Consumer Price Index inflated at a rate of 4.8 points. The rest of the economy increased at a rate of 4.2.52 The problem was that, unlike in other industries, the Price Commission could not arrive at an effective system of price controls short of a total freeze.

Following the total freeze on prices during Phase I, August 15- November 15, 1971, the Price Commission tried to control utility prices like the prices in other industry. This commenced on November 17, 1971 when the

| Index of August and November, 1971, reflects the entire month, not just the period during which the price freeze was in effect. During September and October, 1971, the Consumer Price Index for all items increased .1 and .2 points respectively each month. During the second price freeze, February 10-March 25, 1972, which was applied only to utility prices, the Consumer Price Index for Utilities and Public Transportation recorded a -.1 loss in March 1972, despite the fact that the freeze was taken off on March 25, 1972. The Consumer Price Index for Utilities and Public Transportation in February, 1972 recorded a .6 point gain. The reason for the gain is attributable to the price increases allowed in the first ten days of February, 1972, before the freeze was imposed. See BUREAU OF LABOR STATISTICS, CONSUMER PRICE INDEX FOR URBAN WAGE EARNERS AND CLERICAL WORKERS, UNITED STATES CITY AVERAGE (New Series 1967 = 100) for February, 1972 Table I (1972); Id. for March 1972. 52. During December, 1971, the Consumer Price Index for Utilities and Public Transportation rose 1.1 points and during January, 1972, 1.5 points while the Consumer Price Index for all items was .5 points and .1 points respectively. See BUREAU OF LABOR STATISTICS, THE CONSUMER PRICE INDEX FOR DECEMBER 1971, Table 1 (1972); Id. for January 1972. The following table compares monthly point increases in the Consumer Price Index for all items with the Consumer Price Index for Utilities and Public Transportation and the Consumer Price Index for Gas and Electricity during the first 23 months of the economic stabilization program. THE BUREAU OF LABOR STATISTICS, CONSUMER PRICE INDEX: Table 1 (1971-1973). 1971 1972 CPI Aug Sept Oct Nov Dec Jan Feb Mar Apr May June July All Items .4 .1 .2 .2 .5 .1 .6 .2 .3 .4 .3 .5 Utility and Public Transportation .5 0 0 .4 1.1 1.5 .6 -.1 .4 .2 .2 .2 Gas and Electricity .9 0 0 .6 2.0 1.2 .3 .3 .5 .4 -.2 0 1973 CPI All Items .2 .5 .4 .3 .4 .4 .9 1.2 .9 .8 .9 Utility and Public Transportation .1 .3 .3 .8 .3 .6 .3 .4 .2 .2 .1 Gas and Electricity .2 .2 .2 1.3 .3 1.6 .4 .5 .5 2 -3 For more charts and data on utility and carrier prices see: V. Hihschberg, Higher Utility Rates Loom as Price Panel Assigns Control Duties to Regulatory Agencies, 4 NATIONAL JOURNAL 512-518 (1972).
Price Commission issued its first post Phase I regulation affecting utilities. Utilities could charge a price in excess of their existing price if the increase was approved by a state or federal regulatory commission. Utilities which averaged more than $100 million in revenues were required to report to the Price Commission their requests for fare increases, and to inform the Price Commission when that increase was granted. Utilities which averaged between $50 and $100 million were required to inform the Price Commission of any increases. The Price Commission retained the right to review and limit the amount of any increase requested or authorized.

The first regulations issued November 17, 1971 gave no criteria as to what would be considered a permissible price increase. This problem the Price Commission attempted to solve by bringing out new regulations, which became effective January 17, 1972. They directed that price increases in excess of an existing price on January 16, 1972 would be allowed only if, within 10 days, the Price Commission did not make a negative finding on any of the following:

1. The increase was cost-based and did not reflect future inflationary expectations;
2. The increase was the minimum required to assure continued, adequate and safe service or to provide for necessary expansion to meet future requirements; and
3. The increase was the minimum required to attract capital at reasonable costs and not to impair the credit of the public utility.

The regulations were, for the most part, quite familiar to utilities and carriers, as they were the same criteria that state commissions had been using for 70 years. It was standard procedure in rate cases decided by state commissions. See 36 Fed. Reg. 21953 (1971). It was amended the next day. 36 Fed. Reg. 22014 (1971). For a complete history of the relationship between the Price Commission and the utilities up until June, 1972, see D. Toll, Price Commission Regulation of Public Utilities, AMERICAN BAR ASSOCIATION'S SECTION ON PUBLIC UTILITY LAW ANNUAL PUBLICATION 5 (1972).


54. See 37 Fed. Reg. 632 (1972). The Price Commission also had the option of acting if it determined that the increase did not conform with the overall objective of maintaining average price increases across the economy at a rate of no more than 2 1/2 percent a year. The Price Commission attempted to make itself an appellate review board through the use of this check. All utilities and carriers seeking price increases had to obtain certain certifications from their regulatory agencies, or, if not regulated, to self-certify to certain matters. Although the January 17, 1972 regulations had meant to limit the review period to ten days of notice, any increases put in effect after November 15, 1971, until the adoption of the new regulations could still be rescinded or modified. Therefore, on February 8, 1972, the Commission made an announcement concerning price increases which were reported to the Commission before January 17, 1972. The Price Commission ordered February 24, 1972 to be the date those increases would become final. 37 Fed. Reg. 2359 (1972).

55. R. BESSE, SEVENTY-FIVE YEARS OF PUBLIC UTILITY REGULATION IN A COM-
under the Price Commission criteria to make note of this fact. An example is the opinion of the Public Service Commission of the District of Columbia, July 28, 1972, granting a 7.84 percent rate increase to the Potomac Electric Power Co. The Public Service Commission of the District of Columbia had received a certificate of compliance from the Price Commission on July 20, 1972. Its opinion in part read as follows:

... [w]e ... note that we have followed in this proceeding the same regulation policies and procedures that we have followed in the past. We are an original cost jurisdiction, and our normal approach to ratemaking has been to find an original cost rate base; to determine, again on the basis of costs, allowable expenses; to establish, as a matter of judgment on the basis of expert testimony with respect to the cost of equity and senior capital, a fair and reasonable rate of return; to compute, on the basis of the foregoing findings and determinations, the overall revenue requirement to be met through rates for service; and finally, to consider and approve rate schedules which will justly and reasonably produce the computed revenue requirement. We have done precisely that in this case. * * * Clearly, then the increase allowed here is cost-justified. It reflects only experienced cost, contains no additives, and does not take into account future inflationary expectations.

... [i]t would be difficult, if not impossible, to conclude that the increase or the rate we allow here could properly be reduced. There is no persuasive evidence of record on the basis of which we could defensibly determine a lower rate base or a lower total expense allowance. * * * We would have serious concern that any lower rate of return allowance might indeed not only impair Pepco's credit in today's financial markets but also be subject to constitutional challenge. We therefore have no hesitation in finding and determining that the increase and the increased rate of return here allowed are the minimums needed to assure continued, adequate and safe service, to provide for necessary expansion to meet future requirements, to attract capital at reasonable costs and not to impair the credit of Pepco.

Walker, writing in the Public Utility Fortnightly, is representative of the utility and carrier reaction to the regulations:

We interpret the Hope case to mean that the utility is to be allowed the minimum rate necessary to cover its prudent operating costs and allow it a rate of return on invested capital comparable with that earned in the competitive sector, after appropriate adjust-
Regulation of Utility Prices

ment for risk differentials. This will assure that the utility is able to compete effectively for capital and thus expand as required. . . . It would seem that the new standards imposed by the Price Commission are in large measure fully compatible with the Hope criteria.57

Walker goes on to say that the one criteria which might possibly be unfamiliar is that prohibiting increases reflecting inflationary expectations. But if the criteria is unfamiliar, it is because utility prices simply do not reflect inflationary expectations. Herbert B. Cohn made this clear in his statement during the Price Commission hearings in February, 1972. While he was speaking in behalf of the electric utilities, Cohn's statement is applicable to other utilities.

Speculation reflecting future inflation is prohibited by existing rate-making process. The rates allowed by a regulated electric utility almost are always based upon costs already incurred. There is a 12 month test period; only costs incurred during the test period are used, adjusted for any changes that are known and measurable. No speculation as to future inflation can enter this process.58

Being little more than a restatement at the federal level of traditional utility regulatory principles, the guidelines fell subject to the traditional criticism of such guidelines. Koontz and Gable in their study of utility rate making summarize this criticism: "Analysis of these rules of rate making will show how broad they are. Essentially, they set no formula or standard for commission action."59 Vermont Attorney General Jeffards brought this problem before the Price Commission in February, 1972. "State agencies are in the dark as to what to do. The effect is to do nothing. . . . The guidelines are without substance."60

The enforcement of the guidelines reflected the fact that the Price Commission itself admitted the guidelines were without substance. For example, price increases, according to the guidelines, had to be cost based. Yet the Price Commission never asked for any cost data from the regulatory agencies.61 The Price Commission had only two lawyers and their secretaries to look after guideline enforcement. Neither lawyer had had previous experience in the utility rate making area. Less than a month after the

58. See H. Cohn, Statement Before the Price Commission 373 (February 24, 1972).
60. M. Jeffords, Statement Before the Price Commission, 2 Price Comm'n Hearings on Public Utilities 803 (February 24, 1972). See also F. Heinimann, Issues and Alternatives in Economic Stabilization Phase II, 18 PRAC. LAWYER 39, 47 (1972) which notes in general the lack of standards in Phase II.
guidelines were issued there were 9000 pending utility and carrier rate increase cases for these two lawyers to handle, and 40 percent of the Price Commission's mail involved utility rate increases.\textsuperscript{62}

As might be expected, considering all their shortcomings, the guidelines of January 17, 1972, did little to abate the utility industry's ever mounting prices. The Consumer Price Index for Utilities and Transportation of January, 1972 rose 1.2 percent.\textsuperscript{63} This was 12 times faster growth than the general Consumer Price Index for all items during the same month. Following the consumer price index for utilities and transportation increase of 1 percent in December, 1971, the Price Commission was under intense pressure to do something to stop utility price increases. On February 10, 1972, the Price Commission turned to the one method which had been effective against utility prices. The Price Commission called for a total freeze of all utility prices not legally in effect February 9, 1972.\textsuperscript{64} This freeze was to last one month, until March 10, 1972, but was extended to March 25, 1972.\textsuperscript{65} Four days of public hearings on how utility prices should be handled were held in late February, 1972.

\textit{Regulation of the Utility Industry by Indirect Controls}

The solution which the Price Commission imposed after the second price freeze was politically effective. It took the pressure off the Price Commission to control utility prices. Unfortunately the solution did not consist of solving the utility price increase problem. The solution, in essence, was that the Price Commission would give full authority to the utility regulatory commissions to apply the January 17, 1972, guidelines. Once the regulatory commissions promised to apply them, the Price Commission would forego any

\begin{table}[h]
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\begin{tabular}{|l|c|c|c|}
\hline
Type of Utility & Number of Applications & Applicant Revenues (millions) & Amount of Revenue Increase (millions) & Percent of Revenue Increase \\
\hline
Communications & 73 & $19,063.3 & $1,963.7 & 10.30 \\
Electric & 48 & 10,986.7 & 1,125.3 & 10.24 \\
Gas & 35 & 5,558.3 & 437.2 & 7.87 \\
Gas and electric & 23 & 5,431.0 & 325.5 & 6.49 \\
Transportation & 8 & 12,791.7 & 269.4 & 2.11 \\
Water and sewage & 11 & 2.9 & 1.2 & 42.47 \\
\hline
Totals & 198 & $53,833.9 & $4,149.4 & 7.71 \\
\hline
\end{tabular}
\caption{Amount of Revenue Increase by Type of Utility}
\end{table}

\textsuperscript{62} According to V. Hirschberg, \textit{Higher Utility Rates Loom as Price Panel Assigns Control Duties to Regulatory Agencies}, \textit{4 Nat'l J.} 512, 515 (1972), the utility and carrier price controller's previous experience had been in the area of selling computers to the utility and carrier industry. Id. at 513 gives the following breakdown of pending applications by type of utility that were before the Price Commission:

\begin{table}[h]
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\begin{tabular}{|l|c|c|c|}
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\end{table}

\textsuperscript{63} See note 51 supra.

\textsuperscript{64} 37 Fed. Reg. 3094 (1972).

review of price increases. Any future increases in utility and carrier prices would be blamed on the regulatory commissions, not the Price Commission.

The new regulations were published on March 18, 1972. Chairman Grayson of the Price Commission described the new regulations as establishing "a new procedure which permits the Price Commission to regulate utilities through the regulators." Under section 300.004 of the March 18, 1972, regulations, each existing regulatory agency was required to submit to the Price Commission a proposed set of rules for use by that regulatory agency in considering requests for price increases for each kind of utility service under its jurisdiction. The proposed rules had to encompass the guidelines of January 17, 1972. Section 300.004 provided in part:

If the Price Commission approves a set of proposed rules and the proposed reporting procedure relating to those rules, it shall give the regulatory agency a certificate of compliance with the Economic Stabilization Act pertaining to those rules. A set of proposed rules to which the Price Commission makes no response within 30 working days after receiving them shall be considered as approved, and the Commission shall issue a certificate of compliance to the regulatory agency. If the regulatory agency theretofore has, or thereafter does, take appropriate binding action to adopt the rules as approved by the Price Commission as rules the regulatory agency will use in the determination of cases, all price increases which the regulatory agency approves thereunder shall be considered to be in compliance with the Economic Stabilization Program. The decisions of a regulatory agency pursuant to those rules are not subject to review by the Price Commission, or by any judicial or other body which would not be authorized to review the decisions of the regulatory agency in the absence of the Economic Stabilization Program.

67. 37 Fed. Reg. 18894 (1972) renumbered the regulations. The renumbered regulations are used throughout this paper.
68. In addition several additional guidelines were included, all of which were more or less familiar to the utility and carrier commissioners. The additional guidelines were: (1) The increase does not reflect labor costs in excess of those allowed by Price Commission policies; (2) The increase takes into account expected and obtainable productivity gains, as determined under Price Commission policies; and (3) The procedures of the regulatory agency provide for reasonable opportunity for participation by all interested persons, or their representatives, in its proceedings.
69. The proposed rules which were submitted by the Wisconsin Public Service Commission on June 27, 1972, and which were certified on October 10, 1972, are typical. See Wisconsin Public Service Commission, Rules Within the Meaning of and Pursuant to § 300.004 of the Regulations of the Price Commission for Use by the Public Service Commission of Wisconsin in Considering Requests for Price Increases for Each Kind of Public Utility Service Under Its Jurisdiction, Pursuant to Authority Granted in §§ 196.02(1), 227.014 and 227.02(1)(b), Wisconsin Statutes at 1-2 (1972). § I is a statement of purpose: "The purpose of these rules is to meet all requirements specified..."
The regulatory commissions were quick to obtain certificates of compliance from the Price Commission. When the Price Commission was terminated on January 11, 1973, thirty-one commissions had obtained certificates of compliance.\(^7\)

Being generally one and the same with the guidelines of January 17, 1972, and the traditional guidelines used by commissions to regulate prices, the March 18, 1972 guidelines suffered the same defect of being broad to the point of giving the commissions no guidance in setting prices.\(^7\) But the regulatory commissions were at an even greater disadvantage, in applying the guidelines than the Price Commission. The point is well made by Senator Fred Harris:

The public utility commissions have neither the resources, staffing nor inclination to generate an aggressive testing of the evidence produced by the companies. To rest with these agencies the additional role of enforcing a coordinated, national economic policy installs the rabbits as guardians of the public's lettuce.\(^2\)

In different words, Vermont Attorney General Jeffords says the same thing.

The primary duty and concern of the regulatory agencies is to insure adequate utility service by a financially healthy company
and not to adjust for and visualize the anti-inflationary impact upon either the economy or the consumer of their allowance of rate increases.\textsuperscript{73}

The purpose of the regulatory agencies is two-fold. They must protect the consumer against the price demands of monopolies, but they must also set rates high enough to enable the utility to be sufficiently profitable not only to stay in business but to attract capital for improvements at fairly reasonable rates of interest. These dual responsibilities, to be low on the one side and high on the other, are actually in conflict and the task is to strike a balance between the two. The regulatory commissions have limited jurisdiction, operate within specialized areas, and are governed by law that do not allow them to determine and assess the broad national economic impact of a particular rate increase. The function and responsibility of the Price Commission was quite different. According to section 202 of the Economic Stabilization Act, the Price Commission had to endeavor “to stabilize the economy, reduce inflation, minimize unemployment, improve the nation's competitive position in world trade, and protect the purchasing power of the dollar.”

The inherent inconsistency in the type and purpose of regulating engaged in by utility commissions, as compared with price control programs, is perhaps best understood by an analysis of the historical origins of the systems of regulation. Judge Leventhal offers the following analysis:

The different situations which gave rise to these programs [utility regulation on the one hand, price controls on the other] led to differences in the content and underlying standards governing prices and rates. Thus the concept of 'just and reasonable' in the public utility statutes oriented against extortion by a monopoly is typically construed in terms of limiting the utility to a 'fair return' on utility property, whether determined by book value or a current valuation process. But the 'generally fair and equitable' standard of wartime maximum price regulation, aimed at price stability in the face of abnormal inflationary pressures, was administered in terms of an industry profits standard defined as the profit levels prevailing during the years prior to the onset of World War II, with the result that in terms of return on investment there were material differences between industries.\textsuperscript{74}

Partly in response to such problems, partly because regulatory commissions continued to grant rate increases in much the same manner as in pre-Price Commission days, and partly because utility prices continued to

\textsuperscript{73} M. Jeffords, Statement Before the Price Commission, 2 Price Comm'n Hearings on Public Utilities 803 (February 24, 1972).

inflate, the Price Commission took a step in the direction of regaining direct control. On December 20, 1972, the Price Commission proposed amending its regulation 300.305 to prescribe reporting requirements for agencies holding a certificate of compliance from the Price Commission.\textsuperscript{75} It was proposed that rule 300.305 would require quarterly reports of price increases pending, total annual revenues, and revenue increases applied for; and would require quarterly reports of increases granted, annual revenues and amounts increased. In addition such other information as would allow the Price Commission to determine if regulatory agencies were acting in conformity with terms of their certificates of compliance had to be supplied. This included the following information: type of utility, total revenue, rate of return, operating ratio, and equity rate of return.

However, before the regulation change became effective, the President announced the end of Phase II of the economic stabilization program on January 11, 1973.\textsuperscript{76} As a result, no experience under the new reporting regul-

\textsuperscript{75} 37 Fed. Reg. 28080-81 (December 20, 1972). All agencies, when issued certificates of compliance, had agreed to submit whatever information was requested in the future by the Price Commission. Proposed regulation 300.305 amendment would not become effective until January 20, 1973. Up until this point comments on the proposed rule were to be accepted.

\textsuperscript{76} Exec. Order No. 11,695, 38 Fed. Reg. 1477 (January 12, 1973) in part reads:

\begin{quote}
The Pay Board and Price Commission established by sections 7 and 8 of Executive Order 11,627 are hereby abolished effective not more than 90 days from the date of this order or such earlier date as the Chairman of the Cost of Living Council may designate.
\end{quote}

The Phase III program was intended to be applied voluntarily and/or self-administered basis. See sec. 130.11, 38 Fed. Reg. 1480 (January 12, 1973). The Phase III program was intended to reduce the rate of inflation by setting a general price standard which it was hoped would guide industry in its pricing policy. The general standard for price adjustments was that

a person may increase prices above those authorized or lawfully in effect on January 10, 1973, to reflect increased costs so long as his profit margin does not increase over that which prevailed during the base period as modified herein. Alternatively, a person may increase prices by a weighted annual average of 1.5 percent over prices authorized or lawfully in effect on January 10, 1973, to reflect increased costs without limitation as to profit margin. Adjustments in excess of the standards may be made only as necessary for efficient allocation of resources or to maintain adequate levels of supply. The principles and policies contained in the Price Commission's regulations in effect on January 10, 1973, can be used in applying the standard. No price increase should be placed into effect which is unreasonably inconsistent with the standard or the goals of the Economic Stabilization Program.


The Phase III approach was similar to the jawboning policy practiced during the years 1962 to 1968, but reinforced by sanctions that were not available during those years. The basic theory was that by concentrating on selective wage and price decisions considered to be especially important, all other wage and price decisions could be left to be determined by example and market forces. For a discussion of the philosophy of Phase III see Statement of H. Houthakker, Professor of Economics, Harvard University, Hearings on S. 398: A Bill to Extend and Amend the Economic Stabilization Act of 1970 Before the Senate Committee on Banking, Housing and Urban Af-
lation was logged by the Price Commission. While the Price Commission was heading in the right direction, rule 300.305 would have been of little use in coping with utility prices as long as utilities were not required to follow a uniform system of valuation, rate making and accounting. Without a uniform method of determining rates of return, operation ratios and equity rate of returns, such figures could not be meaningfully compared. The proposed suggestion of price control regulations, which will follow, elaborates on this point.

Phase III was an attempt to begin the exit from controls before control inducted distortions in the economy became severe. The six months of Phase III, from January 11, 1973 to July 13, 1973, brought no change as far as utilities were concerned. Utility prices had long since exited from controls. The Cost of Living Council, which had been the parent agency for the Price Commission, absorbed the functions of the Price Commission when it was abolished. The Cost of Living Council abandoned the certification procedure and issued new regulations for utilities.

In keeping with the general Phase II policy, the prices of utilities were not subjected to the same standard which was used for other industries. The new regulations merely restated the guidelines of January 17, 1972, and admonished utilities and their regulatory commissions to abide by them in adopting price increases. While the Cost of Living Council set up special programs to keep pressure on prices in the food, health service and construction industries, the utility industries went unchecked. During the six months of Phase III, the Utility and Public Transportation Consumer Price Index increased at an annual rate of 3.6 points. That is, 1.1 points above the 2.5 point goal set by the President.

fairs, 93d Cong. 1st Sess. 270 (1973). Houthakker makes the following criticism of this approach: "In practice the jawboning of the 1960's was directed at very few industries, particularly metals, automobiles and rubber. Although these are very visible industries, they do not account for more than a few percent of our total GNP. It is therefore not surprising that whatever success was achieved in those industries had little significance for the economy as a whole. The same danger is clearly present in Phase III, which also appears to reflect the idea that there are a few key sectors where price and wage decisions have an importance extending beyond the sector immediately affected. It is true that the increase in the price of steel, for instance, makes the headlines in the newspapers, and that a decision by the undertakers in Omaha to raise the price of funerals does not. In the aggregate, the many thousands of decisions similar to that of the Omaha undertakers are far more important than the decisions made by a few steel companies or the wage contracts reached in a few visible industries. In our highly complicated and diversified economy there simply is no small group of wage and price decisions that sets the standard for the rest."

78. 6 C.F.R. §§ 130.80-130.81 (1973).
79. See n.73, supra for the general price increase standard for Phase III.
80. See the text accompanying nn.53, 67, supra for these guidelines.
Consumer Price Index for Gas and Electricity increased at an annual rate of 5.8 points.81

President Nixon ended Phase III on June 13, 1973 when he ordered prices frozen at levels in effect the week of June 1-8, 1973.82 For utilities the freeze continued until August 12, 1973.83 During the freeze period the Cost of Living Council members and staff engaged in consultations with businessmen, Congressional and government officials and consumer representatives in order to draw up regulations for Phase IV. The proposed Phase IV regulations, which were released July 18, 1973, became effective August 12, 1973.84

While the regulations greatly tightened price control standards and involved more mandatory compliance procedures than had been seen in Phase III,85 public utility prices were totally exempted from Phase IV controls. Even the fiction of regulation, the January 17, 1972 guidelines, were abandoned.86

A Suggested Method of Control of Utility Prices

The Cost of Living Council could not come up with a simple, speedy and exact system of price controls for utilities, short of total price freeze.87

81. See n.51, supra.
82. Exec. Order No. 11,723, 38 Fed. Reg. 15765 (June 15, 1973). The failure of Phase III has been attributed to at least three principle forces. First, prices at the end of Phase II were below what they otherwise would have been. There resulted the catch-up phenomenon. Second, aggregate economic activity had been rising very strongly, creating demand pressure in an increasing number of sectors. Third, since the Phase III decontrol was not unequivocal, some price increases were motivated by anticipations of the imposition of a new set of tight controls. See B. Bosworth, The Current Inflation: Malign Neglect?, BROOKINGS PUBLICATIONS ON ECONOMIC ACTIVITY 263-283 (1973); Congressional Quarterly Weekly Reports 1483 (June 16, 1973).
85. The new regulations required prenotification by all firms with annual sales of more than $100 million, quarterly reporting by firms with annual sales or revenues of over $50 million, and annual reporting by non-exempt firms with annual sales less than $50 million and over 60 employees. Cost of Living Phase IV Regulations §§ 150.60.62, 150.151, 38 Fed. Reg. 19,476 (July 20, 1973). The new regulations established a new base period for both prices and costs of the last fiscal quarter before January 11, 1973. § 150.101. The new regulations prohibited use of costs incurred prior to the new Phase IV base period as justification for price increases. Finally, the new regulations permitted costs to be passed-through only on a dollar-for-dollar basis.
87. The typical method by which rates were reviewed by the Price Commission is illustrated by the New York Telephone Company's 7.16 percent rate increase of February 3, 1972. On February 15, 1972, consumer protests forced the Price Commission to suspend the rate increase until it could be "investigated." See Price Commission Release #58 (February 15, 1972). On March 30, 1972, without explanation, without public hearings, and without any type of supporting evidence, the Price
This is the reason the Cost of Living Council failed to control utility prices, both when it attempted direct controls and when it attempted indirect controls through delegation of its authority. It is the contention of this paper that if such had been done, it would have taken little effort to arrive at a fairly simple and speedy control of utility prices. The following outlines at least one method by which a simple and speedy set of utility price controls could be obtained. The particular approach suggested here, follows closely the philosophy of John Bauer's *Updating Public Utility Regulation*.88

Three steps would be required. These steps would only be temporary, to last as long as the price controls in other industries. However, once these steps were initiated, it is likely that utility regulatory commissions would continue to follow them, at least in large part. This is because the method of regulation to be suggested here is far easier to apply and more fair to all concerned, than present systems of regulation.

The first step would involve the establishment of a uniform national system of accounting for all utilities. At present each regulatory commission has its own separate method of accounting. The result, as experienced by the Price Commission, is that each time a rate increase is reviewed, a whole new system of accounting must be mastered. Each system is highly complex and there are numerous rate increase requests waiting for review at any given time, so that even during the period when the Price Commission attempted to regulate utility prices, rate increases were allowed to take effect largely by default.

The second step in obtaining effective price controls would be to set a fixed annual national rate of revenue return that would be allowed utility

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Commission declared that the increase met the Price Commission standards. Price Commission Decision List 72-60 (March 30, 1972). The company had been granted a $160 million increase in July 1971. The February 1972 increase amounted to $190 million in increased prices. M. Musicus in testimony before the Price Commission stated:

The New York consumer, asked to pay 26 percent more for telephone service within six months, is interested in knowing that the Price Commission reviewed the record and took some affirmative action. After having adjudged 7.875 percent rate of return on total capital as being necessary in 1970, the New York State Public Service Commission's decision to authorize at this time a rate of return of 8.23 percent on total capital and 10.9 percent profit on sales appears to warrant further examination as to its inflationary implications.


*United States News and World Report* 38 (February 21, 1972) mentions that of a sample of the 9000 applications for rate increases filed with the Price Commission up to February, 1972, the increases ranged from 10 to more than 30 percent, despite the 2.5 percent guideline of the Price Commission.

investors on their investment dollar.\textsuperscript{89} The actual cost-of-money would be the measure of the annual dividend. As Bauer states:

Each [regulatory] commission should fix . . . for each company under its jurisdiction a fair dividend rate on the existing stock outstanding, and subsequently require all further stocks to be issued on the basis of the dividend rate as fixed. It should further provide definite and continuous protection so that the investors will actually get the dividend payments according to underlying agreements and expectations.\textsuperscript{90}

The rate would be the same for all utilities throughout the country during the period of the price controls. Such would lead to certainty in rate making and end the problem of case by case review of multitudes of rate increases by the price control authorities. Because all utilities would follow the same uniform accounting procedures, all investors would be treated equally as to their rate of return.

The third step that would be needed in this suggested method of price controls involves the means by which the investor's annual return is protected. Each utility would be required to establish a "mandatory rate equalization reserve," as Bauer calls it.

\textit{Step One: Uniform System of Accounting}

The lack of a unified accounting system in the utility industry was a prime reason why controls over utility prices were so difficult to maintain.\textsuperscript{91} A majority of federal and state regulatory commissions require some sort of uniform system of accounts.\textsuperscript{92} However, such uniformity applies only to the particular type of industry regulated, in the case of federal commissions, or to the particular state, in the case of state commissions. Jay Price, \textit{et al}, in considering why national uniform accounting standards have not been

\textsuperscript{89} An alternative to a fixed dividend would be a fixed annual percentage price increase that would be allowed all utilities and carriers, perhaps 2.5 percent. If steps one and three were not adopted, that is, if there was no uniform system of accounting for utilities and carriers, and no method by which utility and carrier investors could be assured an annual fixed return, then the above mentioned alternative might well be preferable. However, the above mentioned alternative is much less precise than the suggested method. Some utilities and carriers would profit more than others from it. It would simply continue present inequalities and there would be no method of determining if some utility and carrier investors were receiving more than a fair return on their investment. But the alternative would put a concrete hold on inflation in utility and carrier prices, just as the suggested method would. \textit{See n. 97 infra, especially the discussion regarding Fifteen Percent Case, 226 I.C.C. 41 (1938).}

\textsuperscript{90} \textit{BAUER} at 119-20.

\textsuperscript{91} For a history of attempts to establish a uniform system of accounting see J. Price, \textit{Accounting Uniformity in The Regulated Industries}, 30 LAW & CONTEMP. PROB. 824 (1965).

\textsuperscript{92} \textit{Id.} at 828-830.
adopted by regulatory agencies, and thus failing to produce uniformity except on an agency-by-agency or jurisdiction-by-jurisdiction basis, give two reasons:

(1) The purposes of regulation have not included the achievement of uniformity except in so far as effective regulation of rates and services requires it, and

(2) The accounting profession has not provided guidelines, consisting of sound accounting principles and standards, upon which conscientious regulators could base a uniform system of accounts.93

Grady's Inventory of Generally Accepted Accounting Principles for Business Enterprises states that an accounting practice becomes a "generally accepted accounting principle" when there is "authoritative support" for it, and lists as one of several sources of such authoritative support the various uniform systems of accounts set forth by regulatory commissions.94 This amounts to a delegation of professional judgment to determine what is sound accounting, with the result that the AICPA would be bound by the decisions of regulatory agencies on accounting matters. With such circularity of reasoning, the Institute would have little claim to standing before any agency, and the agencies could hardly be expected to look to the profession for meaningful guidance in the determination of sound, objective accounting principles.

Price, et al, in concluding their article, make the following observation:

The over-all experience of the regulated industries would indicate that comparability in financial reporting could readily be obtained on major matters of principle if an organizational form could be developed to arbitrate disputes concerning principles that should be employed in all public financial reporting. . . . The ultimate objective must be comparability in financial reporting both among companies within a single industry and among companies in different industries, so that substantial factual matters are not hidden from the public view by accounting flexibility. These goals should and can be reached without incurring a costly burden of detailed or straitjacket uniformity. Existing regulatory commissions have a built-in bias springing from their historic statutory goals that may disqualify them as objective prescribers of sound accounting principles that are fair to all segments of the population. Unfortunately the AICPA seems also to have disqualified itself from achieving this objective by knowingly acquiescing in multiple standards of accounting both through a lack of independence from outside pressures and through an unwillingness

93. Id. at 847.
to seek, through professional action, required accounting principles that produce comparable financial statements in many obvious instances where this is possible.  

The Price Commission and Cost of Living Council would have been the logical organization to cure the utility industry of its accounting disunity. Such is absolutely essential if the Cost of Living Council is to regulate utility prices in the future and if investors, creditors, consumers, labor, management and the public at large are to be given fair and impartial treatment.

The most significant of the differences in accounting methods resulting from the lack of uniformity are in the following areas: income tax expense, plant, related depreciation, and valuation, items to be charged or credited to income or surplus, current assets and current liabilities, capitalization of construction overheads, charitable contributions and capital stock expense.  

Number two above, "plant, related depreciation and valuation," will serve as an example of the problems created by disunity of accounting methods. Utility rate-making follows two basic steps: first, the utility's cost of service under prudent management is determined; second, the utility is authorized to charge for its services under schedules of rates which, on an anticipated volume of business, will produce total revenues expected to cover the cost of service.  

The cost of service is the sum of operating expenses, depreciation expense, taxes, and a reasonable return on the net valuation of the property devoted to the public service. The total net value of the company's tangible and intangible capital is called the "rate base" or the valuation for rate-making purposes. The rate base is composed principally of the net (or depreciated) valuation of the public utility's tangible property, comprising the plant and equipment used and useful in serving the public. In addition, the rate base includes an allowance for working capital and, depending on the circumstances, may also include amounts for the overhead costs of organizing the business, intangibles, and going-concern value.

The key issue in the determination of the rate base is the valuation of the public utility's plant and equipment. This is because the valuation of plant and equipment is the largest component part of the rate base and the particular valuation method employed can affect the size of this principal com-
ponent. The greater the valuation of public utility tangible property, the
greater will be the rate base and, therefore, the total cost of service, other
things remaining equal.

The principal valuation methods which are applied to a public utility's
tangible property in order to measure that component of the rate base are:
(1) actual cost less depreciation; (2) reproduction cost new less depreciation;
and (3) "fair value". Variations in each of these approaches are found.

Actual cost methods include: historical cost, prudent investment, and
original cost. Generally speaking, historical cost includes both the con-
struction and acquisition costs of the properties serving the public, including
additions and betterments, less depreciation. Where accounting records
have been inadequate, historical cost has been found by estimating the cost
of the present plant on the basis of costs of materials and labor at the time
each property unit was constructed or acquired, less depreciation. A sec-
ond actual cost method, prudent investment, may be taken as historical cost,
as defined, less any amounts found to be dishonest or obviously wasteful.

Under the prudent investment standard, every investment is assumed to be
prudent unless the contrary is shown. A third measure of actual cost, called
original cost, has acquired a specialized accounting definition since the
1930's. This definition holds that original cost is the total investment
cost of constructed and acquired property when first devoted to public serv-
vice, less depreciation.

Reproduction cost new is the cost of duplicating plant and equipment at
recent average prices, less depreciation. Sometimes used as a substitute for
reproduction cost is an approach called trended original cost. Valuation
by this method is found by multiplying the actual cost of each property

98. There are 29 jurisdictions that use some form of the actual cost method of
valuation. These include the Federal Power Commission, Arkansas, California, Colo-
rado, Connecticut, District of Columbia, Florida, Georgia, Hawaii, Idaho, Kansas,
Louisiana, Massachusetts, Michigan, Nebraska, Nevada, New York, Oklahoma, Oregon,
Puerto Rico, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Virginia, Washing-
ton, West Virginia, and Wyoming. For a complete listing of the appropriate code
sections involving actual cost valuation, and the state court and administrative agency
interpretations of them, see Note, Confusion in Valuation for Public Utility Rate Making,
47 MINN. L. REV. 1 (1962); FEDERAL POWER COMMISSION, FEDERAL AND STATE COM-
MISSION JURISDICTION AND REGULATION: ELECTRIC, GAS AND TELEPHONE UTILITIES
11 (1967).

99. See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262
U.S. 276, 289 (1923) (historical cost is an estimate of prudent investment when ac-
counting records do not show original cost).

100. Id. (prudent investment resembles cost when first devoted to public use, but,
as explained by Mr. Justice Brandeis in his separate opinion, the investment must have
been made prudently).

101. See 47 C.F.R. § 31-01-3(x) (1971); American Tel. & Tel. Co. v. United
unit or class of units by the ratio of the cost index number for the present year to the cost index number for the year property was installed, less depreciation.\footnote{102}

Another approach to valuation, which originated in \textit{Smyth v. Ames}, is \textit{fair value} method.\footnote{103} Fair value is a composite method which considers

\footnote{102. The traditional concept of reproduction cost assumes that the existing property is reconstructed as a whole in a single continuous operation. An engineering inventory is made, a period of construction is estimated, and current prices are applied to the units of property. These may be spot prices as of a given date or average prices for one, two, three or five years. Wage rates and labor performance are also estimated. Pittsburgh v. Public Util. Comm'n, 169 Pa. Super. 400, 82 A.2d 515 (1951).

Since World War II trended original cost has largely replaced estimates of reproduction cost. The practice first developed in the application of price indices to an estimate of a reproduction cost already in existence in order to avoid the expense of making another such estimate. Scranton-Spring Brook Water Serv. Co. v. Public Serv. Comm'n, 119 Pa. Super. 117, 146,181 A. 77, 89 (1935). Trending has been extended to original cost by constructing index numbers for labor and materials and applying them to the original cost of the property as reflected in the primary accounts. The trending is brought down to the cut-off date of the rate proceedings. Bell Tel Co., 16 P.U.R.3d 207 (Pa. Pub. Util. Comm'n 1956). There are important differences between a traditional estimate of reproduction cost and trended original cost. One is that the former assumes that the property is reconstructed in a single operation and takes account of the economics of scale, whereas the latter does not give consideration to such economies because it is predicted on piecemeal construction. Sometimes used as a substitute for reproduction cost is an approach called "trended original cost." Valuation by this method is found by multiplying the actual cost of each property unit or class of units by the ratio of the cost index number for the present year to the cost index number for the year property was installed, less depreciation.

103. 169 U.S. 466 (1898). The Supreme Court defined fair value as a judgment figure to be derived by the regulatory authority after giving consideration to, \textit{inter alia}, original cost of construction, amount and market value of bonds and stock, and the earning capacity of the property under particular rates prescribed by statute. This concept of fair value was soon modified. In 1909 the Supreme Court held in City of Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909), that accrued depreciation must be deducted from original and reproduction cost in establishing fair value. In addition it was early realized that market value of securities and earnings could not properly serve as the basis of determining earnings. The Minnesota Rate Cases, 230 U.S. 352, 461 (1913). Consequently, "fair value" has been often re-interpreted as a judgement figure predicated principally upon original and reproduction costs, both depreciated.

Prior to FDC v. Hope Natural Gas Co., 320 U.S. 591 (1944) the fair value method as a result of Smith v. Ames, 169 U.S. 466 (1898) was followed in almost all jurisdictions. St. Louis & O'Fallen Ry. v. United States, 279 U.S. 461, 487 (1929). This meant that valuation for rate making was substantially uniform throughout the country, at least in principle, despite incessant and unremitting opposition to fair value as the rate base by advocates of original cost. After Hope, regulatory agencies proceeded to re-examine law and policy in the light of past experience and contemporary conditions. Consequently, uniformity in valuation has been succeeded by the application of a variety of valuation methods to rate-making, although fair value has demonstrated remarkable vitality.

Fair value in some form governs the rate making in 19 jurisdictions. They include Alabama, Alaska, Arizona, Delaware, Illinois, Indiana, Iowa, Kentucky, Maryland, Mississippi, Missouri, Montana, New Jersey, Pennsylvania, New Mexico, New Hampshire, North Carolina, Texas and the Virgin Islands. For a complete listing of the appropriate code sections involving fair valuation and the court and administrative cases interpreting these sections, see: Note, \textit{Confusion in Valuation for Public Utility}}
both depreciated actual cost and reproduction cost new less depreciation, and other factors affecting value, with each factor given the weight judged appropriate to the individual case.

The main idea behind the current reproduction cost and fair value methods of valuation is that the investor is compensated for inflation by having his original cost converted into dollars of the current year. This results in increased rates to the consumer. The actual cost system of valuation also compensates the investor for inflation, but in a different way. The actual cost method compensates by adjusting the rate of return. It has been stated that of the two techniques, the utilities prefer the current reproduction cost-fair value method of compensation for inflation, as “the public does not complain when the same effect (increasing charges) is achieved through revaluation. For here it does not realize what is going on. The companies center their attention on the rate base rather than the rate of return because valuation is a mystery and earnings can thus be boosted with greater

Rate Making, 47 MINN. L. REV. 1-11 (1962); FEDERAL POWER COMMISSION, FEDERAL AND STATE COMMISSION JURISDICTION AND REGULATIONS: ELECTRIC, GAS AND TELEPHONE UTILITIES 11 (1967). BAUER, 56-57 (1966), in discussing a Delaware rate case, gives an example of how fair value valuation works. The Delaware statute gives the commission power to determine:

. . . the fair value of the property . . . and in determining such fair value, the commission may determine every fact, matter or thing which, in its judgment, does or may have any bearing on such value; and may take into consideration, among other things, the original cost of construction . . .; the reproduction costs of the property . . .; and these, and any other elements of value, shall be given such weight by the commission as may be just and right in each case.

Bauer cites a 1957 rate case involving the Delaware Telephone that was before the commission. 104. This assumes that the index of construction costs, which should be used in reproduction cost valuation, and the living cost index, which measures the investors’ purchasing power, are the same. While they usually move in the same direction, the construction cost index has been considerably above the cost of living index lately, resulting in utility rates inflating even faster than the cost of living. More importantly, the use of the cost of construction index overcompensates a company’s common stockholders when prices rise. As interest on bonds and dividends on preferred stock are fixed or subject to a limited return, they do not change with the price level. Earnings on a common stock, therefore, will change by more than the price level. See C. PHILLIPS, THE ECONOMICS OF REGULATION 236 (1965). The actual cost method also includes historical cost and prudent investment. Generally speaking, historical cost includes both the construction and acquisition costs of the properties serving the public, including additions and betterments, less depreciation. Where accounting records have been inadequate, historical cost has been found by estimating the cost of the present plant on the basis of costs of materials and labor at the time each property unit was constructed or acquired, less depreciation. See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm’n, 262 U.S. 276, 289 (1923) (historical cost is an estimate of prudent investment when accounting records do not show original cost). A second actual cost method, prudent investment, may be taken as historical cost, as defined, less any amounts found to be dishonest or obviously wasteful.

ease."106 It can be well contended that the public is not the only one fooled. While the Cost of Living Council did at times express concern about a percentage increase in the rate of return, it never took notice of revaluations.107 Yet either method increases prices, and is inflationary.

107. It might well be argued that under guideline number one of the Price Commission guidelines of January 17, 1972, "the increase must be cost-based and not reflect future inflationary expectations," only the original cost method of valuation for rate making would be permissible. There is an inconsistency in trying to stabilize inflation, and on the other hand, allowing increased prices because property valuation has been inflated to make up for inflation. See note 53 supra. The Price Commission missed a grand opportunity to solve once and for all the problem of what to do about inflation in the valuation of utility plant and equipment. This question has plagued state courts, legislatures and regulatory commissions for 70 years. In 1930, after many years of controversy, the Supreme Court appeared to have resolved in favor of giving great weight to compensating investors for inflation. In United Railways v. West, 280 U.S. 234 (1930) the Supreme Court said:

It is the settled rule of this Court that the rate base is present value and it would be wholly illogical to adopt a different rule for depreciation. . . . One of the items of expense to be ascertained and deducted [in computing the annual return on property] is the amount necessary to restore property worn out or impaired, so as continuously to maintain it as nearly as practicable at the same level of efficiency for the public service. The amount set aside periodically for this purpose is the so-called depreciation allowance. Manifestly, this allowance cannot be limited by the original cost, because, if values have advanced, the allowance is not sufficient to maintain the level of efficiency. Id. at 254, 253.

They then went on to quote from the Court's earlier decision, Knoxville v. Knoxville Water Co., 212 U.S. 13-14 (1909) to the following effect:

. . . . [The utility] is entitled to see that from earnings the value of the property is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. 280 U.S. at 254.

* * * This naturally calls for expenditures equal to the cost of worn out equipment at the time of replacement; and this, for all practical purposes, means present value.

There were two significant dissents from the majority opinion of the Supreme Court in the United Railways case, referring particularly to the computation of the provisions for depreciation or capital exhaustion: one by Mr. Justice Brandeis and the other by Mr. Justice Stone. Both urged that the annual provision for depreciation should be based solely on original cost. Mr. Justice Brandeis argued that the purpose of depreciation was to preserve "the integrity of the investment" and that basing the annual provisions on original cost would best accomplish this end. A footnote in his opinion may suggest his reasoning:

In part, costs and values in the several future years will depend upon the general price level. As to this, even the economist can know nothing, save how the general price level has heretofore fluctuated from year to year; and that periods of rising prices have ever been followed by periods of falling prices. Id. at 278 n.49.

Mr. Justice Stone's reason for urging original cost was clearer. He said:

I will assume, for present purposes, that as a result of Smyth v. Ames, 169 U.S. 466 (1898), the function of a depreciation account for rate making purposes must be taken to be the establishment of a fund for the replacement of plant rather than the restoration of cost or value of the original plant investment. Id. at 289.

He then argued that

[a] depreciation reserve, calculated on the basis of cost, has proved to be the
Probably the greatest single change that a unified system of accounting would bring would be the requirement that all utilities that are not currently required to employ the original cost method of valuation, would be so required. This would involve some twenty commissions.\(^{108}\)

Even if step two and three were never taken, simply standardizing utility accounting would solve many of the problems which the Price Commission could not handle during the earlier price controls. The most important advantage would be that the price increases of the various utilities and carriers could be compared with each other in a meaningful way. With the present systems of valuation, the significance of increases in valuation is hidden from regulatory authorities.

most trustworthy guide in determining the amount required to replace, at the end of their useful life, the constantly shifting elements of a property. . . .

\(^{108}\) Id. at 290.

But the *United Railways* case did not conclude the matter. With the great depression of the early 1930's and the decline in price levels, the difference between original costs and replacement or reproduction costs became less pronounced. It appeared that Stone's and Brandeis' observations might prove correct and that in the long run the average of the general price level would be somewhere between the low costs of the pre-World War I period and the relatively high costs of the early 1920's. And by 1934, when a question of depreciation was again before the Supreme Court on a controversy regarding the estimated useful life of certain utility properties, the Court approved the utility company's voluntary use of original cost as the basis for depreciation. Lindheimer v. Illinois Bell Tel. Co., 292 U.S. 151 (1934).

Then in 1944, in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) an issue was presented to the Court whether the Commission had acted arbitrarily in failing to give any weight to present fair values of the properties devoted to public service and in effect making original cost the controlling factor. The Court refused to disturb the holding of the Commission on the ground that in view of all the circumstances the Commission had not acted arbitrarily in its determinaton of rates. The Court referred to its holding in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942), "that the Commission was not bound to the use of any single formula or combination of formulae in determining rates." 320 U.S. at 602.

In upholding the Commission's use of original cost as the basis for depreciation the Court reversed its former stand, specifically disapproving "the contrary holding of United Railways Co. v. West." \(^{108}\) Id. at 606-607. It might at first appear that this decision of the Supreme Court in the *Hope* case rules out any possibility of determining provision for capital exhaustion on any basis other than original cost, at least as far as jurisdictions which have rejected present "fair value" for the rate bases are concerned. But the *Hope* case did not say that original cost alone was necessarily controlling or that original cost could not be adjusted to reflect seemingly permanent changes in price levels. The departure from the holding of the *United Railways* case was that replacement or reproduction cost need not necessarily be given weight. The holding in the *Hope* case was simply that in view of all the circumstances then present the action of the regulatory body in using original cost could not be said to be unjust or unreasonable.

Under these circumstances [price fluctuation between 1939 and 1944] the arguments of Mr. Justice Brandeis and Mr. Justice Stone in their dissents in the *United Railways* case still seemed applicable. The future still gave promise that price fluctuations would average out at about the same level as they had in the past; and original cost still seemed the most reliable test of average original purchasing power of the capital invested.

\(^{108}\) See note 90 supra.
Step Two: The Establishment of a Fixed Annual Rate of Return on Utility Common Stock

Step two in obtaining an effective system of price controls involves the establishment of a fixed annual rate of return for utility investors. The second step would have a favorable impact on stabilizing utility rate levels. Such would indirectly help to stabilize rate structures. One could object that the fact that utility investors assume a risk, just as investors in other industries, indicates that they should be compensated just as investors in other industries. Furthermore, fixed returns will mean no compensation for the loss in buying power of the investment due to inflation and will hamper capital fund raising efforts of utilities.

The first objection is answered by the fact that investor risks in most utility enterprises are different than risks borne by investors in ordinary competitive enterprises. Utilities are engaged in a natural monopoly and in essential public services. They are protected from competition by regulation as well as by inherent monopoly.

109. J. HERING & J. HUMPHREY, UTILITY REGULATION DURING INFLATION 34 (1971) states: "Arguments about the proper rate base or an adequate rate of return are mere legislative tempests in teapots; all a utility seeks is sufficient cash flow adequately to meet all of its costs. The only reasonable variable is the earnings necessary to compensate its equity investors and prevent flight of capital." He suggests an approach in which commissions would change their regulations so as to provide automatic adjustments to the return on equity allowed, to the rate base, and/or to the allowable rate of return. Such adjustments could be linked to an agreed-upon index, such as the prime rate, the annual rate of inflation, or other equitable measures of the financial market place. Such a suggestion is midway between present freely fluctuating rates of return, and the fixed return advocated here. For other suggested methods of improving the method of reaching the annual rate of return, see H. Somers, Rate of Interest and Rate of Return: Cost of Money in Public Utility Rate-Making, THE NEW ECONOMICS OF REGULATED INDUSTRY: RATE-MAKING IN A DYNAMIC ECONOMY 69-111 (J. Herin ed. 1968); Comment, Cost of Capital as a Rate Base Substitute, 80 PUB. UTIL. FORT. 74-77 (November 9, 1967); J. Nelson, Reassessment of Economic Standards for the Rate of Return Under Regulation, RATE OF RETURN UNDER REGULATION: NEW DIRECTIONS AND PERSPECTIVES 3-25 (H. Trebing & R. Howard eds. 1969); Note, An Earnings-Price Approach to Fair Rate of Return in Regulated Industries, 20 STAN. L. REV. 287 (1968).

110. Rate regulation is not separated completely into that of levels and that of structures. As a matter of fact, as H. KOONTZ AND R. GABLE, PUBLIC CONTROL OF ECONOMIC ENTERPRISE 98 (1956) point out:

These two aspects are closely related. Very seldom can a shift in the rate level be undertaken without upsetting many of the individual rate adjustments. For example, when the Interstate Commerce Commission allowed a general increase in the level of railroad rates in 1938, it recognized that competition with other forms of transportation, as well as possible discrimination against localities, made in blanket increases of a certain percentage applied to all rates impracticable. Fifteen Percent Case, 226 I.C.C. 41 (1938).

It would not be necessary, nor would it be fruitful, for a national price control program to attempt to make rate structures. Such structures depend on many variables, depending on the utility or the carrier. At least at present, there is no simple way to reduce the process to a uniform, nationwide procedure.
The basic risk borne by the utility common stock investors results from two uncertainties. Will a fair-return be obtained under regulation, and will losses of return and capital investment be incurred because rates cannot be fixed high enough or otherwise adjusted so that the total revenues of the company will equal the total cost of service, including a return on investment.\textsuperscript{111} Such risks would be eliminated by step three, which will assure a fixed return, and relieve utilities of their justification for unlimited speculative returns.

The second objection concerns the problem of inflation and changes in the original dollar value basis of the investment as of the time when the investment was made. The risk is that, in time, the purchasing power of the dollar will decline, and the investor will not be compensated for this loss. It is true that investors in the ordinary nonregulated concern adjust their dollar-returns to offset rising price levels. They increase the prices charged for their own products.

In answer, it can be said that in the utility industry public policy has never provided clearly and explicitly for the price level risks that have prevailed.

There has been no outright economic and legal requirement for price level adjustments in the regulatory process; nor has there been clear and explicit contrary provision. The matter has been

\textsuperscript{111} Bauer 116-19 states:
Practically all the risks borne by investors have been due to the indefiniteness and conflicts of interest that have pervaded the standards and procedures of regulation. Stockholders have been subjected particularly to regulatory uncertainties and risks. . . . The regulatory risks have been the result of the undefined and imprecise considerations that have applied to rate base and rate of return findings; they have embraced also the uncertainties as to the price level factor in the determination of fair returns. The stockholders have never known what dollar returns they will get under prevalent regulation. Between the spasms of rate cases, the stockholders would normally get increasingly more than fair . . . returns; the extent would be uncertain, and the date of interruption by another rate case indefinite. These . . . are . . . the regulatory risks, risky not because of intrinsic industry and price level risks, but because of the indefiniteness of regulatory standards and the irregular, uncertain impacts of regulation. . . . So great has been the default in regulation of certain commissions, that many utility stocks have been at times considered growth stocks.

* * *

From the regulatory standpoint, utility stocks do not belong inherently with the recognized growth grouping as to realizable returns per share. While they do, or should, represent growth in demand for services and growth in efficiency, they reflect more often poor regulation and insecure finance when they are taken as growth stocks in regard to increasing earnings per share. When capital funds are supplied for public use, the investors should know exactly what returns in dollars they will receive. This has been the standard for debts and preferred stock financing. It should be adopted for common stock,
shrouded in indefiniteness and vagueness. . . . 112

Direct cost-of-money, at actual-dollar amounts, has been adopted as the measure of fair-return for about 60 percent of total utility investments (bonds and debt financing). There is no fundamental economic or constitutional grounds why the other 40 percent should not be exposed to the same treatment. 113 If the annual dividend rate as fixed were fair to existing shareholders, it would automatically be fair to future investors who would supply new capital funds as needed for efficient public service.

The third objection is concerned with the possible harmful effect which fixed returns would have in raising capital. Capital funds can be obtained as needed with common stock, just as it is now obtained for bonds and preferred stock which is subjected to fixed dividend provisions. At any given time, the company would issue new common stock or bonds, or preferred stock, or a combination, as may best fit the particular situation, subject to commission approval. The variations in return requirements from time to time would be automatically provided for by the successive issue prices of the capital securities. This would apply to common stocks as to bonds and preferred stocks.

Step Three: Rate Equalization Reserve

The third step would be to establish "a rate equalization reserve." 114 Such a reserve would be the method by which investors would be assured of a fixed annual rate of return. The reserve would also guarantee that consumers were never overcharged, and would bring to an end rate making litigation.

Since rates apply to the future, they cannot be fixed so that for each year total revenues will equal total costs. For precise price control, there must be annual equalization between total revenues and total costs, for the purpose of exact accounting between consumers and investors. In general, the

112. Id. at 114.
113. W. Vickrey in Utility Regulation During Inflation 56 (J. Haring et al., eds., 1971) points out that in its extreme form the historical-cost school treats the investor in a public utility the same way as a bondholder, entitled only to a specified return in terms of nominal monetary units. If, due to a rise in prices, an accumulated depreciation fund proves insufficient to replace a piece of equipment when it is worn out, then additional outside financing must be sought.
114. See Bauer at 121-134 for a complete discussion of the rate equalization reserve. The reserve would stand as a company liability in the balance sheet. This operating reserve would not constitute past company income accumulated as surplus. It would not represent stockholders' equity like the conventional statement of surplus. Instead, as a consumer prepayment, it would stand distinct and would be definitely conserved for the consumers. In the course of rate-making, it would not be embodied directly or indirectly in the total investment on which required returns were predicated.
rate equalization reserve would have the same make up as other operating reserves that involve equalization or adjustment of charges from period to period. In the beginning, after the initial determination of the required returns to the investors and the establishment of fixed dividends as outlined in step two, the Cost of Living Council would set rates as a whole at a level high enough to provide, according to best appearing estimates, total revenues moderately in excess of total costs, subject to periodic balancing through the revised regular income statements. This would be modified so as to include in the income deductions not only interest and other fixed charges but also payments or accruals of preferred and common stock dividends. These would be obligations of the company, no different essentially from interest, and would thus be charged regularly to the income account. The common stock dividends would be a fixed percentage on par value or dollars per share and would be charged accordingly to the income account.

If the proposed system were followed, the excess of total revenues, including non-operating income, over total costs, as shown by the modified income statement, would be transferred and credited to the rate equalization reserve at the end of each accounting period, presumably at the close of each calendar or fiscal year.

The excesses would be accumulated year by year in the reserve. Its balance at the close of any year would show the extent that total prior years revenues had exceeded total prior costs under the new exact return accounting. When in any year total revenues were less than total costs, the year's revenue deficiency will be made good through an equal transfer from the reserve. It would be charged to, or deducted from, the reserves and concurrently added or credited to the income account for its annual equalization. There will thus be exact balancing each year between total revenues and total cost, through the means of the reserve. The net total income of the company would be shown regularly as the total net requirements for fixed interest and dividend payments (plus or minus related credits or debits for proper amortization).116

What the normal standard of the reserve or its maximum and minimum would be could not be stated in absolute terms.116 The Cost of Living Coun-

115. Id. at 122.

116. The extent that the reserve should be built up or accumulated would be subject to Cost of Living Council control under flexible rules for standard, maximum and minimum provisions. If the maximum was reached or approached and if total revenues still appeared substantially in excess of total costs, rates would be reduced to a level which in prospect would result in current equalization of total revenues and total costs. If, however, through greater cost increases than expected, or through unpredicted declines in revenues, there were annual deficiencies, these would be charged year by year to the reserve until its minimum authorized level had been reached or approached; then rates would be revised upward to again provide estimated total revenues equal to total costs and to rebuild the revenue to its normal standard.
cil could of course, adopt general rules, but it would have to act largely upon judgment in dealing specifically with each company and the prospects ahead. It would base its judgments on the combination of functions that are involved in the long-range balancing of total revenues and total costs. As a rough suggestion, it might place the general standard at the total fixed return requirements for two years, with the maximum at three years, and the minimum at one year, subject to such modifications as might be reasonable to attain the purposes of the reserve.

The advantages to the rate equalization reserve are threefold: it would end frequent rate changes and litigation, investors would be assured of a constant and reliable return, and consumers would never over pay.

With such an equalization reserve there would be no need for frequent rate changes. Minor adjustments might prove desirable from time to time, the schedule as a whole would be left unchanged, unless revision, upward or downward, became necessary or reasonable because of fundamental and extensive changes in the relation of total annual revenues and costs. Between such basic changes, the moderate fluctuations in revenues and costs would be equalized annually through the reserve. Because the Price Commission would apply exact and systematic regulation to an exact showing of facts, there would be an end to rate cases. Regulation would be freed from litigation. Instead of being bogged down with rate cases and their cumbersome involvements, the Price Commission and regulatory commissions could devote their energies and staff to the constructive aspects of controlling prices and improving service. They could investigate what improvements should be made; what technological advances have been made and can be applied; what improvements in efficiency and economy could be attained; and how, in general, cost could be kept to economic minimums, consistent with proper service.

These constructive phases of regulation are largely precluded by the confusions encouraged under existing standards and procedures of rate making. In rate case proceedings, the Cost of Living Council was inevitably mired by indefiniteness and conflicts of interests between investors and consumers, and regulation went largely by default. This is the unavoidable result if the returns to which the investors, particularly the stockholders, are entitled, are not made explicit and protected by appropriate accounting methods.

Protection of both the investor and the consumer is another advantage of the rate equalization reserve. The return of investors would be protected; in the ordinary unregulated business stockholders have to go without dividends or stand investment losses during depression periods. Consumers would be protected against payment of higher rates. While the investors will get the
benefit of exact annual protection, the consumers would get longer-range protection. In any year, they would pay more or less than the required terms, but in the long run they would pay only the required amounts, plus the accumulated reserve balance. This balance would be accurately safeguarded for them. It would not be available to the stockholders except to make up deficiencies in later annual earnings for the payment of the required returns. The consumers would have accurate continuous accounting in regard to their total past revenue payments. Their basic gain would consist of exact protection against excessive return payments.

To summarize, the justification of the reserve is based

In the simple and elementary economic and legal principle that investors are entitled to fair-returns and no more, that consumers should pay fair-returns and no more, that the rights and duties of investors and consumers are reciprocal, and that they should jointly be equalized. But, under past and prevalent regulation, there has been, and is, a wide gap between providing fair-returns and "no more."\(^{117}\)

While the Price Commission would have only been concerned that the reserve be continued during its term of existence, it is likely that many regulatory bodies would continue to make use of it voluntarily. If such were the case, the benefits of the Price Commission's improvements would have continued long after the actual price control program.

**Conclusion**

The delegation to the Cost of Living Council of power over utility prices is unique in the history of utility regulation. Never before has a federal agency been granted such powers. The reason for this grant is well expressed by the Honorable Mary Hanuelton, who at the time was a Commissioner of the Price Commission.

The reason for price controls on regulated industry was simply that in an era of clamoring consumerism it was the intent of Congress that all component of the economy be treated evenly and equitably under the stabilization program.\(^{118}\)

Initially the Cost of Living Council exercised its power, but with little success. This led to a complete abandonment of price controls. The three steps outlined here would assure success of utility price control. Even if only the first step, promulgation of a uniform system of accounting, were adopted, the Cost of Living Council could expect better results.

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117. **BAuER** at 125.
Steps two and three involve the establishment, respectively, of a national rate of revenue return and the establishment of a mandatory rate equalization reserve. Developed by John Bauer with no thought of an economic stabilization program, steps two and three nevertheless might well fit the purposes of the Cost of Living Council. In Bauer's scheme they represent a compromise between public ownership of utilities and reconstituted regulation.

As for my own thinking, I have more or less wobbled between the public ownership view and the reconstituted regulation view. The first was outlined in Public Organization of Electric Power (1949) and the second in Transforming Public Utility Regulation (1950). The present book (Updating Public Utility Regulation) submits my end conclusion on how best to protect and promote the public interest in public utilities.¹¹⁹

Bauer's scheme, applied to the economic stabilization efforts, is at least one way in which the Cost of Living Council's power over utility prices could be returned, and the Congressional mandate to restrict inflation could be achieved.

¹¹⁹. BAUER at VIII.