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STATE OF OREGON
LEGISLATIVE COUNSEL COMMITTEE

February 12, 2018

Senator Lee Beyer
900 Court Street NE S411
Salem OR 97301

Re: Public Utility Right to Recovery of Costs Through Rate of Return

Dear Senator Beyer:

You asked whether section 2 of Senate Bill 1552 is an unconstitutional restriction on a public utility's right to recover costs associated with making sales of electricity. As you know, that section restricts a public utility's rate of return to 4.5 percent:

> A public utility that makes sales of electricity may not establish a rate for any service performed, controlled or operated by the public utility in this state, and related to making sales of electricity, that provides the public utility with a rate of return that exceeds 4.5 percent.

As a practical matter the answer to your question is yes. A public utility is a highly regulated private company providing services to customers as part of a state-granted monopoly. A public utility benefits from the privilege of being the exclusive provider of services within the public utility's service territory. However, a public utility is limited to establishing rates for services only as approved by the state. This governance model puts public utilities at risk of being deprived by a state of the ability to pay for services rendered, which is why courts have held that a state may not limit a public utility's ability to establish rates beyond that which provides the public utility a reasonable rate of return. A limitation of that nature would violate the Takings Clause of the Fifth Amendment to the United States Constitution, as applied to the states through the Fourteenth Amendment.[1]

In general, rate regulation by the states serves two purposes. The first purpose is to ensure that customers within a public utility's service territory are provided with essential services at an affordable cost. The second purpose is to ensure that the public utility providing the services earns enough income to remain in business. States attempt to achieve these goals by approving rates that allow a public utility to recover the cost of providing the service, including a fair rate of return. These principals were first articulated in the landmark United States Supreme Court decision, *Smyth v. Ames*:

[1] If public utility rates do not "afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments." *Duquesne Light Company v. Barasch*, 488 U.S. 299, 308 (1989). The Takings Clause of the Fifth Amendment provides: "nor shall private property be taken for public use, without just compensation." The Takings Clause of the Fifth Amendment was first applied to the states through the Fourteenth Amendment in *Chicago B & Q Railroad v. Chicago*, 166 U.S. 226, 238-239 (1897).

> A corporation maintaining a public highway, although it owns the property it employs for accomplishing public objects, must be held to have accepted its rights, privileges and franchises subject to the condition that the government creating it, or the government within whose limits it conducts its business, may by legislation protect the people against unreasonable charges for the services rendered by it . . . But it is equally true that the Corporation performing such public services and the people financially interested in its business and affairs have rights that may not be invaded by legislative enactment in disregard of the fundamental guarantees for the protection of property.[2]

Originally, the United States Supreme Court held that a public utility only had a constitutionally guaranteed right to a rate of return for the property that the public utility was currently using to provide services to customers.[3] However, the jurisprudence has changed to reflect that a public utility has a constitutionally guaranteed right to a rate of return on investment as well. This new standard is set forth in the landmark United States Supreme Court decision, *Federal Power Commission v. Hope Natural Gas Company*.[4] In *Hope*, when deciding whether a rate was reasonable, the court considered the competing interests of the customers of a public utility and the investors in the public utility, a stark contrast to previous courts that primarily had considered the competing interests of the customers of a public utility and the public utility itself.[5] The court asserted that the investors in the public utility had "a legitimate concern with the financial integrity of the [public utility]."[6] The court further asserted that the investors' return "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain [the public utility's] credit and to attract capital."[7] The court held that securing a rate of return on investment is essential to the viability of a public utility, and that depriving a public utility of a rate of return on investment would deprive the public utility of its constitutionally guaranteed rights.

The calculation of rate of return reflects the accrued value of the money invested by a public utility's investors and, because public utility investments are financed over long periods of time, that accrued value can be substantial. Another way of looking at it is that securing a rate of return on an investment requires payment equal to a public utility's cost of capital, or the opportunity that the public utility foregoes by using capital to provide public utility services rather than engage in a more profitable activity. Cost of capital includes (1) money that a public utility borrows on both a long-term and short-term basis, also known as "debt"; and (2) money that a public utility receives in exchange for its stock, also known as "equity."

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[2] 169 U.S. 466, 545-546 (1898). *Smyth v. Ames* is no longer good law for two reasons. First, the *Smyth* court used the due process clause of the Fourteenth Amendment as the basis for its decision, not the Takings Clause of the Fifth Amendment as applied to the states through the Fourteenth Amendment. Second, the *Smyth* court concluded that the public utility at issue was entitled to ask for "a fair return upon the value of that which it employs for the public convenience." *Id.* at 547. In other words, the public utility was constitutionally guaranteed to earn a rate of return only on the property that the public utility was currently using to provide service to customers. However, the basic explanation of the purposes of public utility law described in *Smyth* are just as illustrative today as they were 120 years ago.

[3] *Id.* at 547.

[4] 320 U.S. 591 (1944).

[5] *Id.* at 603.

[6] *Id.*

[7] *Id., citing Missouri ex. rel. S.W. Bell Telephone Company v. Public Service Commission,* 262 U.S. 276, 291 (1923) (Brandeis, J., concurring).

Debt is easy for states to compensate. It is a fixed amount, the payment of which can easily be incorporated into rates. If debt were the only factor to consider, it is conceivable that a statutorily fixed rate of return, such as that proposed by section 2 of Senate Bill 1552, would pass constitutional muster, so long as the public utilities were allowed to pay off any debt accrued before the law took effect that necessitated a rate of return in excess of the statutorily fixed rate, and so long as the legislature did not require the public utilities to provide additional services and fulfill additional duties that necessitated a rate of return in excess of the statutorily fixed rate.

Equity is much more difficult for states to compensate. Equity is rarely a fixed amount. Dividend rates fluctuate, reflecting the value of stock in response to a variety of economic, social, political and other factors, including, perhaps most importantly, the approval of rates by the state:

> Investors' decisions are largely based on a utility's expected earnings and upon their stability, as well as upon alternative uses of investment funds. Yet, since the allowable amount of earnings is the object of a rate case, a [state's] decision, in turn, will affect investors' decisions.[8]

Or, as articulated by the court in *Hope*:

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business.[9]

Given the constitutional right to a rate of return on investment, the court in *Hope* articulated three conditions on a state's regulation of rate of return to ensure that the rate of return on investment for a public utility is "just and reasonable."[10] The court held that the rate of return must be (1) sufficient to maintain the financial integrity of the public utility; (2) sufficient to compensate the public utility's investors for the risks assumed in investing in the public utility; and (3) sufficient to enable the public utility to attract needed new capital.[11]

The law is far from settled in what constitutes a "just and reasonable" rate of return. There are no bright lines to be drawn. Even the approach by courts to whether a public utility's guaranteed rate of return is limited to investments that are "used and useful" is not consistent. Whereas some courts have held that an investor's interest should be measured by public utility property that is used and useful,[12] other courts have held that an investor's interest is properly measured by the amount of prudently invested capital.[13] However, even regarded in the most

[8] Charles F. Phillips, Jr., *The Regulation of Public Utilities*, at 393 (3d ed., 1993).
[9] 320 U.S. at 603.
[10] *Id.*
[11] *Id.*
[12] *See Pennsylvania Electric Company v. Pennsylvania Public Utility Commission*, 509 Pa. 324, 334 (1985) ("the *Hope* decision is to be interpreted as recognizing a constitutional requirement of 'just and reasonable' utility rates, providing a return on used and useful property").
[13] *See Washington Gas Light Company v. Baker*, 188 F.2d 11, 18-19 (D.C. Cir. 1950) (used and useful no longer part of the constitutional standard), *cert. denied,* 340 U.S. 952 (1951).

positive light, restricting a public utility's rate of return to 4.5 percent will inevitably violate a public utility's constitutional right to a reasonable rate of return on investment. For some investments, the 4.5 percent cap may be sufficient for a public utility to continue operations. For others, it would create a risk for the public utility on grounds that it would damage the financial integrity of the public utility, or on grounds that it would inadequately compensate investors in the public utility. The most significant problem with a 4.5 percent cap, though, is that such a low rate of return is insufficient to encourage the type of long-term investment in a public utility that is crucial to public utility operations.

In conclusion, we believe section 2 of Senate Bill 1552, if enacted into law, would create a statutory standard that would be held unconstitutional as applied in a variety of circumstances. The rigidity of the standard, as well as the comparably low rate of return, provides no assurances to potential investors in the public utilities of this state that make sales of electricity.

If you have any other questions or concerns, do not hesitate to contact our office.

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Very truly yours,

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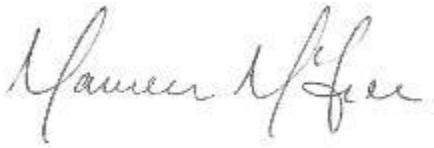

By
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