Judicial Review of Rate of Return Calculations

Samuel L. Hanson
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JUDICIAL REVIEW OF RATE OF RETURN CALCULATIONS

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&

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"I have one last question. Is rate of return traditionally called the black magic of the regulatory ring?"

Chairman, South Dakota Public Utilities Commission

I. INTRODUCTION

In times of judicial overload, courts are understandably less than enthusiastic about receiving appeals from complex administrative proceedings. Certainly this is true of utility rate cases, which present voluminous materials to review (a typical transcript is 4,000 pages) and come infrequently enough to leave the court with the uneasy feeling that it has fallen into wonderland, where all language and customs are foreign. Yet, as this paper will develop, it is precisely these cases—highly charged with confrontation of customer against company, customer class against customer class, and even government agency against government agency—which critically require the ongoing development and application of judicial standards. Though sorely tempted, courts dare not shrink back from an active, participative role in the sound and unbiased development of utility law.

This article focuses upon the application of judicial standards to the critical issue of rate of return on common equity. Those judicial standards are of two basic types: (1) administrative appeal standards governing both the quality of the process and the quality of the evidence supporting an administrative determination; and (2) constitutional standards governing both the quality of the process and the quality of the result. We demonstrate that these standards are not static, but must evolve dynamically, synchronized to the changing realities of the utility industry. We also demonstrate that the decisions of the Minnesota Supreme Court, while necessarily piecemeal, represent an integrated and, for the most part, progressive application of judicial standards to rate case review. Finally, we urge as the next logical step, the appropriate extension
of those standards to resolve major dilemmas produced by current changes in the industry.

II. THE REGULATORY FRAMEWORK

Before addressing the issue of judicial review we will describe the place of rate of return in the ratemaking process, summarize typical rate of return approaches, and review relevant changes in the industry to which regulation must respond.

A. The Ratemaking Process

It is often said that regulation takes the place of competition; that is, since the utility is granted a monopoly in its service territory it is necessary to impose some limits upon the utility's prices because the normal limits imposed by competition are absent. Under regulation, the utility's prices are limited to the recovery of the costs incurred in providing service. Recognized costs include labor, materials and supplies, taxes, insurance, and depreciation. They also include the financing costs for dollars invested in utility plant, office buildings, and equipment.

A utility cannot automatically raise its prices to recover cost increases. Instead, it must file a rate case and prove the increases, as measured for a particular test year. Thus, the function of a rate case is, first, to determine the revenue required by the utility to recover its costs—the "Revenue" section of the case—and, then, to design the rate schedules to generate revenue equal to that requirement and to spread it among the various customer classes—the "Rate Design" portion of the case.

The process of determining revenues was succinctly stated in Southern Bell Telephone & Telegraph Co. v. Public Service Commission:1

First, the investment of the utility is calculated in a set of figures known as the rate base. Next, the revenues and expenses are analyzed to determine the net operating income of the company. When that net operating income is divided by the rate base, the rate of return on rate base is derived, a critical item in any rate proceeding.

In judging the fairness and adequacy of this rate of return, the cost of the utility company's invested capital must be considered. A utility company's capital will generally consist of fixed obligations, such as bonds, preferred stock and short-term debt, and the investment of its stockholders which is the com-

1. 270 S.C. 590, 244 S.E.2d 278 (1978) (Ness, J., concurring and dissenting).
common equity of the company. To determine the cost of this capital, the cost of fixed obligations (bonds, preferred stock and short-term debt) is calculated and a reasonable return on the investment of the company’s stockholders (common equity) must be established. These costs are combined to determine the company’s overall cost of capital. The rate of return on rate base is then compared to the cost of capital which has been established. If the rate of return on rate base is lower than the cost of capital, the rates must be adjusted upward by the Commission. It is on this basis that the general determination is made as to what rates are appropriate for utility service.2

B. Rate of Return Approaches

Rate of return is an element of the revenue side of the case. The commission determines what return would be earned under current rates—the income earned at current rates for test year sales, less test year expenses—; calculates what percentage rate of return this represents in respect to the utility’s total investment or rate base; and then compares this rate of return to that which it determines to be the reasonable rate of return to be allowed. The deficiency or excess in that comparison then becomes the basis for any increase or decrease in revenues to be reflected in the new rates. In this broad sense, the rate of return is generally called the “overall rate of return” and includes several elements—the overall capital structure and the individual components of debt (long and short term), preferred stock, and common equity.

The prevailing practice is to develop an overall rate of return that is the product of the weighted cost of capital. For example, if we assume the composite cost rate for debt is 9.0%, for preferred stock is 10.0%, and for equity is 16.0%, the overall cost of capital would be 11.9% with the following capitalization ratios:

<table>
<thead>
<tr>
<th>Type of Capital</th>
<th>Ratio</th>
<th>Cost Rate</th>
<th>Weighted Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>50.0%</td>
<td>9.0%</td>
<td>4.50%</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>10.0</td>
<td>10.0</td>
<td>1.00</td>
</tr>
<tr>
<td>Common Equity</td>
<td>40.0</td>
<td>16.0</td>
<td>6.40</td>
</tr>
<tr>
<td>TOTALS</td>
<td>100.0%</td>
<td></td>
<td>11.90%</td>
</tr>
</tbody>
</table>

While issues can arise on the other elements, litigation focuses pri-

2. Id. at 606-07, 244 S.E.2d at 286.
The general question to be determined relative to return on equity is always the same: what rate of return on equity will permit the utility to earn the return required by equity investors, and thereby allow it to attract on fair terms the equity capital necessary to provide service to the public. Over the years, several approaches to estimating the rate of return on equity have been developed. It is recognized that the appropriate equity return simply cannot be derived by the mechanical application of any mathematical formula and, because each of the approaches must be based on underlying assumptions or theories, expert judgment is required in their application.

For present purposes, we will summarize three common approaches.

1. The Comparable Earnings Approach

The comparable earnings approach is based on a review of the returns achieved by other investments—including both regulated and unregulated companies—having “comparable” investment risk. The analyst defines the criteria for selecting a set of companies viewed by investors as having risks comparable to the subject company. Many measures of risk are available and comparable earnings studies have utilized a myriad of them. Once the set of companies is selected, the actual earned returns of those companies, as a percentage of their book equity, are examined as being indicative of the required return for the subject company. Frequently, adjustments are made to those earnings if it is perceived that the companies are earning below or above their cost of equity,
as indicated by market-to-book ratios below or above one. This method, as all others, has its shortcomings. Its validity depends upon the difficult task of finding true risk comparability. Advocates of the comparable earnings approach acknowledge that there are no perfect measures of risk. Further, the question whether the actual returns earned by these companies are equal to their cost of equity is always problematic. 7

2. The Risk Premium Approach 8

The risk premium approach is based upon the premise that investors demand a greater return for equity than debt to compensate for the greater risks of equity ownership. The risk premium is the amount of additional return required by investors to compensate for this added risk of equity investment. Risk premium can be measured by viewing the historical differential between what equity returns investors anticipated for equity investment and what bond yields were required for the same companies over the same time period. This differential, the “premium,” is then added to the current interest rate on the subject company’s bonds to determine the required market return on equity. The risk premium approach is similarly not capable of producing precise, judgment-free results, since it cannot be shown that the relationship between the cost of debt and the cost of equity is constant over time. 9

3. The Discounted Cash Flow (DCF) Approach 10

Discounted cash flow (DCF) is a formula approach that assumes an investor in common stock equity seeks a return on investment composed of (1) current income to the investor—the dividend yield—plus (2) anticipated growth in future dividends. The term “discounted” stems from the fact that money has a time value in considering an investment. The expected future cash payments

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8. The risk premium approach is a more indirect approach and addresses the other criteria set forth in Hope—that the return should be sufficient to enable the enterprise to “attract capital.” Hope, 320 U.S. at 603.
10. The discounted cash flow approach is a market-based approach that attempts to determine directly what investors are requiring to place their investment in the subject company. The assumption is made that the market evidence with respect to the subject company can be used to discern what return is necessary to attract capital.
can be discounted to their present worth in order to determine the “real” value of a stock as estimated by the potential investor. Investors then decide whether or not to buy a stock by comparing their own estimate of the stock’s real value with the actual market price of the stock. A simplified version of the DCF formula for expected market return is set forth as follows:

$$K = \frac{D}{P + G}$$

$K$ is the required rate of return on equity, $D$ is the sum of the dividends to be paid in the coming year, $P$ is the current market price of the stock, and $G$ is the expected long term growth rate of dividends and ultimately of the stock.

A major difficulty with the DCF formula lies in predicting $G$, the investor’s expectations as to the future growth rate in dividends. DCF results can also be biased by changing the time frame for determining $D/P$, since the price of the stock is dynamic. Further, the return required by investors, as measured by DCF, is a return in relationship to the market price. Since the rate of return to be allowed in regulation will be applied to the rate base (more akin to the book value of common equity), the use of DCF will tend to maintain the market price at or below book value.11

Many other approaches, usually variations or combinations of the above approaches, are presented to regulators. Computers led to the development of sophisticated models, such as price-book statistical models. These models are conceptually similar to the DCF formula. They attempt to predict what rate of return, if actually earned, would tend to induce the investor to bid the price of the stock to a level where new shares could be issued for net proceeds, after deducting the cost of issuance and allowing for market pressures, at least equal to book value.

C. Changes in the Utility Industry

In addition to consideration of the regulatory framework, intelligent development of judicial standards must be responsive to real changes in the regulated industry. For example, few industries have changed as radically as the energy industry. With those changes, pressures developed which made it difficult, if not impossible, for a utility to actually earn the allowed rate of return. This,

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in turn, places pressure upon judicial standards designed to protect the utility's opportunity to earn a fair rate of return.

Electric and gas utilities began as small, local enterprises. After the initial capacity was installed, there were decades of steady demand growth, with additions to plant being infrequent and manageable. Construction programs were small, construction financing was easily attainable, and construction schedules were short. When construction was necessary, it produced economies of scale. As recently as the late 1960's, economies of scale sufficiently offset the mild inflation being experienced and there was a trend of decreasing unit costs of service. Rate cases were infrequent and the rate of return allowance was just another fact within a narrow range of debate.

The decade of the 1960's witnessed unprecedented increases in demand for electrical services. Utilities, by now large enterprises resulting from the merger of many smaller systems, began enormous construction programs which extended over five-year, and then ten-year, periods. These programs required vast amounts of both internal and external funds. In addition, environmental requirements and inflationary pressures increased the costs at an unprecedented rate. All of these combined to greatly increase the need for raising equity capital, and the importance of the rate of return determination in relation to the attractiveness of that capital to investors rose commensurately.

The last two decades have also witnessed radical changes in the financial world. From the utilities' standpoint, these changes have dealt a dual blow of rapidly rising interest rates on debt and rapidly declining investor attraction for utility stocks. For example, the 1970's, interest rates on utility long-term bonds had more than doubled since the early 1960's. By 1980, they were triple the mid-1960's level. While the Dow Jones Industrial Average declined by 2% from 1965 to 1980, the Dow Jones Utility Average declined by 30% for the same period.

Finally, the last two decades also witnessed a dramatic change in the public interest in utility rates. A fundamental change in

12. For example, Minnesota Power & Light Company's most recent coal-fired unit, Clay Boswell No. 4, cost $786 per kilowatt. The portion of that cost attributable to compliance with environmental regulations accounted for $397 per kilowatt, or over one-half of the total.

13. The secular trend in interest rates for single-A utility bonds shows increases from 4.5% in the mid-1960's, to 6% in the late 1960's, to 7.2-9.5% in the 1970's, to 10.2% in 1980, to over 15% in 1981.
public policy concerning gas and electric utilities began to occur at the end of the 1960's and perhaps culminated in the Arab oil embargo in 1973. Prior to that time, the public was either silent or actually favored the expansion of utility services to promote development and to improve the quality of life. Expansion meant economies of scale that reduced the utilities' cost per unit. Today, inflation and the added cost of environmental protection have reversed the economics of expansion. Public interest shifted attention from the demand for expanded utility service to the impact upon customers of increasing utility costs. Rate cases became far more partisan and increasingly complex. They involved not only the determination of issues between the utility and its customers at large, but saw intense conflicts between customer classes. There are many issues raised by customer intervenors as to which the utility is nearly indifferent, or at least not the primary responding party. Perhaps even more surprising, intervening parties representing public bodies do not evidence a cohesive "public policy" and commonly take completely opposing positions on certain issues.

In proceedings under the Minnesota Public Utilities Act, concepts of social welfare and consumer protection have permeated the economic principles that stand at the core of the ratemaking discipline. The question of fairness, even when defined in terms of the public interest, must involve a reasonable resolution of the so-called conflict of interest between investor and consumer. Nowhere does the balancing of this conflict become more critical than in determining the utilities' fair rate of return. The courts must be vigilant to correct any unreasonable imbalance and ensure that fundamental fairness has been observed.

The following sections of this paper examine the courts' role, first from the standpoint of inherent judicial review, and then from the constitutional framework of confiscation.


Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable. Rates shall not be unreasonably preferential, unreasonably prejudicial or discriminatory, but shall be sufficient, equitable and consistent in application to a class of consumers. Any doubt as to reasonableness should be resolved in favor of the consumer. For rate making purposes a public utility may treat two or more municipalities served by it as a single class wherever the populations are comparable in size or the conditions of service are similar.
III. Administrative Appeal Standards

Beyond Ghor there was a city. All its inhabitants were blind. A king with his entourage arrived nearby. He had a mighty elephant, which he used in attack and to increase the people's awe. The populace became anxious to learn about the elephant, and some sightless from among the blind community ran like fools to find it. Since they did not know even the form or shape of the elephant, they groped sightlessly, gathering information by touching some part of it. Each thought that he knew something, because he could feel a part. When they returned to their fellow-citizens, eager groups clustered around them, anxious, misguidedly, to learn the truth from those who were themselves astray. They asked about the form, the shape, of the elephant. The man who had reached an ear said, "It is a large, rough thing, wide and broad, like a rug." The one who had felt the trunk said: "I have the real facts about it. It is like a straight and hollow pipe, awful and destructive." One who had felt its feet and legs said: "It is mighty and firm, like a pillar."

The Blind Men and the Elephant (An Ancient Tale)

In exercising its mandate to protect the public interest, we believe that we should choose the lowest acceptable recommendation (adjusted as appropriate) which falls within the range of reasonableness. We will first review the testimony of all the witnesses to determine a range of reasonableness. We will then focus on the testimony of the witness who recommends the lowest rate of return to determine if it is reasonable and has withstood the tests of cross examination and rebuttal testimony. If we are satisfied that it is sound, we will adopt it. If the testimony has been shown to be deficient in certain respects but is nevertheless basically sound, we will adjust it to remedy the deficiencies and adopt it as adjusted. If we conclude that the testimony is basically unsound, we will reject it and consider the next lowest recommendation.

North Central Public Service Co.,
Docket No. G-101/GR-77-221
(Minn. P.S.C. Dec. 30, 1978)

By administrative appeal standards we wish to identify that aspect of the scope of judicial review defined by statute and by consideration of separation of powers. Generally, a state's administrative procedure act specifies the scope of judicial review on appeal from administrative decisions. For example, many provide that administrative findings may be reversed if not supported by "substantial evidence." To this standard there is a court declared exception, arising from constitutional separation of powers, which suggests that administrative decisions that are purely, and appropriately, legislative in character are not reviewable at all by the courts, except for abuse of discretion or constitutional viola-
tion, since any greater review would interfere with the legislative function. The critical questions reviewed in this section, thus, are (1) whether rate of return determinations are legislative or judicial in quality and (2) if judicial, how the substantial evidence standard is properly applied to them.

A. The Legislative, Quasi-Judicial Distinction

There are marked differences, both in origin and function, between the judicial and the administrative process. Where the rights of private parties are adjudicated by decision of administrative agencies, however, both the substance and the procedure of that process must be subject to judicial review to ensure the rudimentary requirements of fair play.16

In Minnesota, utility rate regulation is accomplished by the Minnesota Public Utilities Commission through the administrative procedures of the Public Utilities Act17 and the contested case

17. MINN. STAT. ch. 216B (1982). The relevant provisions are found at section 216B.08:

The commission is hereby vested with the powers, rights, functions, and jurisdiction to regulate in accordance with the provisions of Laws 1974, Chapter 429 every public utility as defined herein. The exercise of such powers, rights, functions, and jurisdiction is prescribed as a duty of the commission. The commission is authorized to make rules and regulations in furtherance of the purposes of Laws 1974, Chapter 429;

and section 216B.16;

Subdivision 1. Unless the commission otherwise orders, no public utility shall change any rate which has been duly established under this chapter, except upon 60 days notice to the commission. The notice shall include statements of facts, expert opinions, substantiating documents, and exhibits, supporting the change requested, and state the change proposed to be made in the rates then in force and the time when the modified rates will go into effect. The filing utility shall give written notice, as approved by the commission, of the proposed change to the governing body of each municipality and county in the area affected. All proposed changes shall be shown by filing new schedules or shall be plainly indicated upon schedules on file and in force at the time.

Subd. 2. Whenever there is filed with the commission any schedule modifying or resulting in a change in any rates then in force as provided in subdivision 1, the commission may suspend the operation of the schedule by filing with the schedule of rates and delivering to the affected utility a statement in writing of its reasons for the suspension at any time before the rates become effective. The suspension shall not be for a longer period than ten months beyond the initial filing date. During the suspension the commission shall determine whether all questions of the reasonableness of the rates requested raised by persons deemed interested or by the administrative division of the department of public service can be resolved to the satisfaction of the commission. If the commission finds that all significant issues raised have not been resolved to its satisfaction, or upon petition by ten percent of the affected customers or 250 affected customers, whichever is less, it shall refer the matter to the office of administrative hearings with instructions for a public hearing as a contested case pursuant to chapter 14, except as otherwise provided in this
procedures of the Minnesota Administrative Procedure Act. While judicial review is guaranteed by both statutes, the Administrative Procedure Act was adopted "to make uniform the scope

section. . . . If the commission does not make a final determination concerning a schedule of rates within ten months after the initial filing date, the schedule shall be deemed to have been approved by the commission. For the purposes of this section, "final determination" means the initial decision of the commission and not any order which may be entered by the commission in response to a petition for rehearing or other further relief. The commission may further suspend rates until it determines all those petitions.

Id. § 216B.16 (emphasis added).

18. Id. §§ 14.02(3), 14.60. A contested case is statutorily defined:

Subd. 4. "Contested case" means a proceeding before an agency in which the legal rights, duties, or privileges of specific parties are required by law or constitutional right to be determined after an agency hearing. "Contested case" does not include hearings held by the department of corrections involving the discipline or transfer of inmates or other hearings related solely to inmate management.

Id. §§ 14.02(3), 15.0411(4).

19. MINN. STAT. § 216B.52 (1982) (emphasis added) provides:

Subdivision 1. Any party to a proceeding before the commission or any other person, aggrieved by a decision and order and directly affected thereby, shall be entitled to appeal from such decision and order of the commission. The proceedings shall be instituted by serving a notice of appeal personally or by certified mail upon the commission or one of its members or upon its secretary, and by filing the notice in the office of the clerk of the district court of Ramsey or of the county in which the appellant resides or maintains his principal place of business, all within 30 days after the service of the order and decision of the commission or in cases where a rehearing is requested within 30 days after service of the order finally disposing of the application for the rehearing or within 30 days after the final disposition by operation of law of the application for rehearing. The notice shall state the nature of the appellant's interest, the facts showing that the appellant is aggrieved and directly affected by the decision, and the grounds upon which the appellant contends that the decision should be reversed or modified. Copies of the notice shall be served, personally or by certified mail, not later than 30 days after the institution of the appeal, upon all parties who appeared before the commission in the proceeding in which the order sought to be reviewed was made. The commission and all parties to the proceeding before it, shall have the right to participate in the appeal. The court, in its discretion, may permit other interested parties to intervene.

Subd. 4. The appeal shall be conducted by the court without a jury and shall be confined to the record, arguments and brief, except that in cases of alleged irregularities in procedure before the commission testimony thereon may be taken in the court. The court may affirm the decision of the commission or may reverse or modify it.

Subd. 5. Any party, including the commission, may secure a review of the final judgment of the district court by appeal to the supreme court. The appeal shall be taken in the manner provided by law for appeals from the district court in other civil cases, except that the time for appeal shall be limited to 30 days from the notice of entry of the judgment.

MINN. STAT. § 14.63 (1982) provides:

Any person aggrieved by a final decision in a contested case is entitled to judicial review of the decision under the provisions of sections 14.63 to 14.68, but nothing in sections 14.63 to 14.68 shall be deemed to prevent resort to other means of review, redress, relief, or trial de novo provided by law now or hereafter enacted. A petition by an aggrieved person for judicial review under sections 14.63 to 14.68 must be filed with the district court and served on the agency not
of judicial review of the decisions of all administrative factfinding agencies. Its purpose is to afford the affected party an independent judicial analysis of whether the administrative process offered the basic fairness and propriety required in determining the parties' rights and obligations. The scope of review is established by Minnesota Statutes, section 14.69, which provides that the reviewing court may affirm the decision of the agency or remand the case for further proceedings; or it may reverse or modify the decision if the substantial rights of the petitioners may have been prejudiced because the administrative finding, inferences, conclusion, or decisions are:

(a) In violation of constitutional provisions; or
(b) In excess of the statutory authority or jurisdiction of the agency; or
(c) Made upon unlawful procedure; or
(d) Affected by other error of law; or
(e) Unsupported by substantial evidence in view of the entire record as submitted; or
(f) Arbitrary or capricious.

Which of the cited standards will form the basis for the court's review turns, in the first instance, on what function the administrative agency performed. A general statement of the governing standard can be found in this pronouncement in Reserve Mining Co. v. Herbst:

We said in Minneapolis Van that the provisions of Minn. St. [14.69] of the Administrative Procedure Act, adopted by the legislature following the Dahlen case, evidenced an intent "to make uniform the scope of judicial review of the decisions of all administrative factfinding agencies," including those expressly more than 30 days after the party receives the final decision and order of the agency.

MINN. STAT. § 14.68 (1982) provides:

The review shall be conducted by a court without a jury and shall be confined to the record, except that in cases of alleged irregularities in procedure, not shown in the record, testimony thereon may be taken in the court. The court shall, upon request, hear oral argument and receive written briefs. Except as otherwise provided all proceedings shall be conducted according to the rules of civil procedure.

23. 256 N.W.2d 808 (Minn. 1977).
excluded from the definition of "agency" by Minn. St. [14.02, subd. 2]. However, even that definition does not exclude either the DNR or PCA. Our subsequent decisions have uniformly applied the "substantial evidence" rule with respect to findings of fact by administrative agencies. In the St. Paul Area Chamber of Commerce decision, which was a rate case decided by the Public Service Commission, we reiterated with approval what we said in Minneapolis Van, distinguishing between judicial functions in reviewing factual matters and the more limited latitude allowed in reviewing legislative decisions of administrative agencies where social policy is involved.24

The distinction between matters of social policy, inherently legislative, and the quasi-judicial factfinding process alluded to in Reserve Mining Co., is the key determinant of scope of review and was clearly designated as the line of demarcation for commission decisions. In St. Paul Area Chamber of Commerce v. Minnesota Public Service Commission,25 the court said:

Combining this rule with that adopted above for factual determinations, we may summarize as follows:

(a) When the Public Service Commission acts in a judicial capacity as a factfinder, receives evidence in order to make factual conclusions, and weighs that evidence as would a judge in a court trial, it will be held on review to the substantial-evidence standard.

(b) When the Public Service Commission acts in a legislative capacity as in rate increase allocations, balancing both cost and noncost factors and making choices among public policy alternatives, its decisions will be upheld unless shown to be in excess of statutory authority or resulting in unjust, unreasonable, or discriminatory rates by clear and convincing evidence.26

B. Application to Rate of Return Calculations

1. Pre-Hibbing Taconite

Prior to Hibbing Taconite Co. v. Minnesota Public Service Commission,27 the question of the application of these standards to rate of return on equity determinations had not been directly addressed by the Minnesota Supreme Court. In fact, the commission evi-

24. Id. at 826 (emphasis added).
25. 312 Minn. 250, 251 N.W.2d 350 (1977).
26. Id. at 262, 251 N.W.2d at 358.
27. 302 N.W.2d 5 (Minn. 1980).
dently perceived indirect references by the court to endorse a legislative standard.

Those indirect references were drawn by the commission from two earlier cases where the determination of rate of return on common equity was not before the court. The first was *Northwestern Bell Telephone Co. v. State*,\(^{28}\) where the court, in the same breath as its discussion of the fair rate of return, made the general statement:

> We have previously noted that the fixing of a fair rate of return cannot be determined with precision, since it is not derived from a formula, but must be reached through the exercise of a reasonable judgment, applying the criteria to which we have referred. *Ratemaking is a legislative and not a judicial function*. In complex cases such as this, the court should, and does, accord the commission great deference in reviewing its decision. The rates fixed by the commission are presumed to be reasonable and just until the contrary is shown by clear and convincing evidence. In this area, the court's only function is to protect constitutional rights and not to substitute its own judgment for that of the commission.\(^{29}\)

This language was embellished in *St. Paul Area Chamber of Commerce v. Minnesota Public Service Commission*,\(^{30}\) when the court, in an appeal that considered rate design, not rate of return, stated, "As we have said in previous cases of this kind, ratemaking is an inherent legislative function not to be exercised by the courts. . . . We recently reaffirmed this principle in *Northwestern Bell Telephone Co. v. State*."\(^{31}\) The court went on to reconcile *Northwestern Bell* with *Minneapolis Van & Warehouse v. St. Paul Terminal Warehouse*,\(^{32}\) as follows:

Taken together, these two decisions made the substantial-evidence test of § [14.69] applicable to commission decisions only when it is acting in a quasi-judicial manner, in a role similar to that of a trial judge sitting without a jury. *In cases where the commission acts primarily in a judicial capacity, that is, hearing the views of opposing sides presented in the form of written and oral testimony, examining the record, and making findings of fact, the administrative process is best served by allowing the district court to apply the substantial evidence standard on review*. This is so because in such a case the district judge is able to review all of the evidence as he would in any trial and can, within the knowledge parameters of

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28. 299 Minn. 1, 216 N.W.2d 841 (1974).
29. *Id.* at 27-28, 216 N.W.2d at 857 (emphasis added).
30. 312 Minn. 250, 251 N.W.2d 350 (1977).
31. *Id.* at 254, 251 N.W.2d at 353-54 (citations omitted).
32. 288 Minn. 294, 180 N.W.2d 175 (1970).
his own expertise, determine whether or not each finding is supported by substantial evidence. There is no policy reason why the commission's finding should not be required to satisfy the substantial-evidence test on this issue. The absence of challenge to this aspect of the commission's decision indicates the parties are satisfied it was supported by substantial evidence.

As to rate allocations, the teaching of *Northwestern Bell Telephone Co. v. State* remains the law: "The rates fixed by the commission are presumed to be reasonable and just until the contrary is shown by clear and convincing evidence." The function of the district court is not to "substitute its own judgment for that of the commission," but is only to ensure that the rate structure adopted by the commission is not "unjust, unreasonable, or discriminatory."33

2. The North Central Doctrine

Seizing upon its perception of the implied license granted by *Northwestern Bell* and *St. Paul Area*, the commission, within months of the *St. Paul Area* opinion, made a decisive move to sweep rate of return on equity determinations under the legislative umbrella. In an effort to standardize this complex rate case procedure, the commission announced a new approach in 1977 for determining the appropriate return on common equity in *North Central Public Service Co.*:34

"Fixing the rate of return on common equity is a legislative process. In the ideal sense the Commission's obligation is to insure that a Company has the opportunity to earn as much as it needs to maintain its financial integrity and provide adequate service and not a penny more. In exercising its mandate to protect the public interest, we believe that we should choose the lowest acceptable recommendation (adjusted as appropriate) which falls within the range of reasonableness. We will first review the testimony of all the witnesses to determine a range of reasonableness. We will then focus on the testimony of the witness who recommends the lowest rate of return to determine if it is reasonable and has withstood the tests of cross examination and rebuttal testimony. If we are satisfied that it is sound, we will adopt it. If the testimony has been shown to be deficient in certain respects but is nevertheless basically sound, we will ad-

just it to remedy the deficiencies and adopt it as adjusted. If we conclude that the testimony is basically unsound we will reject it and consider the next lowest recommendation, etc.\textsuperscript{35}

Casting the rate of return as legislative, whether done to avoid in-depth judicial scrutiny or to make its decision process easier, was a fundamental mistake that had a costly impact on utilities. While formulated in the context of a rate case, this doctrine attained the status of a rule and was consistently followed in all cases.\textsuperscript{36} In fact, by the time the commission heard the 1977 \textit{Minnesota Power & Light Co.} case, it had become so confident in the viability of its \textit{North Central} doctrine that it fashioned a sporting context for its application:

We shall continue to follow the \textit{North Central} method here. We turn then to the question of whether either [company witness] Mr. Benderly or [Staff witness] Mr. Miller were so badly pummeled in cross-examination or through rebuttal testimony that a knockout was scored. After reviewing their testimony in its entirety, we conclude that, while each suffered several punishing blows, neither was incapacitated.

Accordingly, we will analyze Mr. Miller's discounted cash flow analysis in some detail to explain why we think we can accept it with certain adjustments.\textsuperscript{37}

Running parallel to the \textit{North Central} doctrine was the commission's increased reliance upon and progressively narrower application of the Discounted Cash Flow formula.\textsuperscript{38} Beginning in June 1977, with \textit{Interstate Power Co.},\textsuperscript{39} the commission announced its intention to rely more heavily on DCF and, in the process, to look more narrowly at the usual adjustment for market pressure and the costs of issuing new common stock.

\textsuperscript{35} \textit{Id.} at 31 (emphasis added).

\textsuperscript{36} Typical language found in commission orders was as follows: "In accordance with our approach for determining the appropriate cost of equity as set forth in the \textit{North Central} case, we will first focus our attention upon the testimony of the witness recommending the lowest return." \textit{Minnesota Power & Light Co.}, Docket No. E-015/GR-78-514 (Minn. P.S.C. Apr. 9, 1979), at 53 (footnote omitted).


3. A Case Study Impact

The combination of these policies had a dramatic impact upon rate of return determinations. The experience of at least one utility under this doctrine is illuminating.

Minnesota Power and Light Company (MP&L) is a Duluth-based, investor-owned electric utility with a service area which extends over 26,000 square miles in fifteen counties in central and northeastern Minnesota. It serves Minnesota's famous Iron Range, vast forested and recreational areas, and active freshwater and ocean shipping port facilities on Lake Superior. This area has a concentration of industrial facilities engaged in iron ore and taconite extraction and processing, manufacture of paper and pulp products, and manufacture of iron and steel products, with lake shipping and associated storage of grain and ore. All of these industries use substantial amounts of electrical energy, thus giving the company a unique predominance of sales of energy to large industrial users.

Simultaneous with the advent of commission regulation in 1975, the predominance of consumption of electrical energy by taconite processing facilities was accelerating. Beginning in 1973, a number of planned expansions of taconite processing facilities in the service area were announced, with additional announcements in 1974. From a peak load of approximately 700,000 kilowatts in 1975, the committed and anticipated demand for additional energy pushed the projected 1980-81 system peak to 1.5 million kilowatts, a 100% increase during a five-year period. This increase required MP&L to undertake a massive construction program with attendant needs for huge amounts of capital. Rate cases filed in 1976, 1977, and 1978 reflected these conditions. A comparison of the 1976 MP&L rate case, decided prior to the adoption of the North Central doctrine, with the 1977 and 1978 cases illustrates the detrimental impact of the doctrine on rate of return.

Two primary expert witnesses testified in all three proceedings—Mr. Miller on behalf of the Staff and Mr. Benderly on behalf of MP&L. When not bound by the narrow process of North Central, the commission expressed some restraint concerning its rate of return function, stating, "Within established legal constraints, the Commission has a certain degree of latitude to exercise its judgment and discretion in determining an appropriate
rate of return to common equity."40

Since it had not yet restricted itself to focus on the testimony of the witness with the lowest recommendation, the commission was free to find Mr. Benderly's testimony more persuasive:

The Examiner found Mr. Benderly's [MP&L's witness] analysis most convincing and found MP&L entitled to 13.5 percent rate of return on common equity allowing for a market price 10 percent in excess of book value and also allowing 0.5 percent rate of return for the perceived risks of Square Butte. The Commission is also inclined to accept the rate of return analysis of Mr. Benderly as most convincing and notes that its results do not conflict entirely with those of Mr. Hong and are only slightly above the range established by Mr. Miller. The Commission however is not convinced of the wisdom of placing MP&L on the thin edge of being forced to realize net proceeds from sales of common equity below book value and thus finds 13.25 percent rather than 13.05 percent to be the appropriate cost of common equity.41

The order in the 1977 case came only fourteen months later. Despite similar testimony from the same two rate of return witnesses—both showing that the cost of equity had increased—the commission reduced the allowance, illustrating the practical effect of its self-imposed bondage to North Central. No longer observing "established legal constraints," it flatly stated that "[f]ixing the rate of return on common equity is a legislative process."42 Without permitting itself the opportunity to find Mr. Benderly's analysis the most convincing, it limited its review to the testimony of Mr. Miller, solely because it presented the lowest recommendation. The process, it stated, was to analyze Mr. Miller's discounted cash flow analysis in order to "explain why we think we can accept it with certain adjustments."43

Not surprisingly, the result of this radically altered process was a reduction in return on common equity from 13.25% to 13%, in spite of the fact that the uncontradicted testimony showed that the cost of capital had increased since 1976 because MP&L's need for external funds had increased; new common offerings were planned at greater frequency; the portion of Construction Work In Progress

41. Id. at 35.
43. Id.
CWIP) in rate base had quadrupled; the percentage of Allowance for Funds Used During Construction (AFUDC) in income had quadrupled; MP&L's coverage ratios were declining; and even Mr. Miller's cost of equity findings had come up between the two years. No logical factor could explain the decrease except blind adherence to North Central.

MP&L sought judicial review and the Minnesota Supreme Court, in Hibbing Taconite Co. v. Minnesota Public Service Commission \(^44\) and Minnesota Power & Light Co. v. Minnesota Public Service Commission \(^45\) focused for the first time on the precise question of the scope of administrative review of a rate of return on equity determination. These decisions judicially clarified that fixing the rate of return placed the commission in a quasi-judicial capacity as a fact finder and properly subjected that role to review on the substantial evidence standard.

4. Fixing the Rate of Return on Common Equity is a Quasi-Judicial Function

The commission's reading of Northwestern Bell and St. Paul Area had been mistaken. The court in Northwestern Bell did not rule that fixing the rate of return was a legislative function. More closely examined, it stated two separate propositions: one, that fixing the return must be accomplished through the exercise of reasonable judgment and, two, that "ratemaking" is a legislative function. While the latter proposition is generally accepted, it does not mean that all parts of the ratemaking process are legislative.

Professor Davis had earlier provided a more precise analysis:

Any proceeding, whether judicial or legislative and whether adjudication or rule making, may involve a plurality of tasks, such as finding adjudicative facts, finding legislative facts, interpreting law, creating law, making policy, or exercising discretion, and the proper procedure has to reflect each one of those tasks, not the whole proceeding.

Letting the choice of procedure depend upon characterization of a whole proceeding as "judicial," "legislative," "adjudication," or "rulemaking" involves crude thinking that fails even to begin to reach the true reasons that should control the selection of the appropriate procedure.\(^46\)

\(^44\) 302 N.W.2d 5 (Minn. 1980).
\(^45\) 310 N.W.2d 686 (Minn. 1981).
\(^46\) 2 K. Davis, Administrative Law Treatise § 10.5, at 321-22 (1979). A more
Within this context, determinations of rate of return on equity are quasi-judicial. They are determinations of a "cost" to be allowed. A determination of the cost cannot, by definition, be influenced by non-cost, policy factors. There are no public policy alternatives involved in the process of determining what a cost is. Fixing the rate of return, like determining the cost of labor or fuel, is based on evidence and is determined by a process akin to that followed by a judge sitting without a jury; establishing the weight of expert recommendation according to its own merits and persuasiveness and arriving at the court's independent judgment of the truth.

This conclusion is easily reconciled with *St. Paul Area* by critical focus on the following language:

> As our previous discussion makes clear, however, rate allocation is not a judicial or quasi-judicial function. Once revenue requirements have been determined it remains to decide how, and from whom, the additional revenue is to be obtained. It is at this point that many countervailing considerations come into play.\(^{47}\)

The language, "Once revenue requirements have been determined," is the line of demarcation. Following such determination the commission must understandably exercise its legislative judgment in carefully distributing the increased revenue requirement among the various customer classes and in the process resolve difficult social policy questions such as senior-citizen and fixed-income ratemaking.

In contrast, a proper concept of a rate of return on equity is that it is one of the unavoidable "costs" of doing business—comparable with operating expenses, depreciation, and taxes. It provides for the costs of obtaining capital, just as operating expenses provide for the costs of obtaining materials and supplies, labor, and government services (through taxes).

In short, the rate of return on equity is a fact, albeit a complex fact. It is susceptible of evidentiary proof and requires the regulator to hear the testimony of economic witnesses on the state of the economy, the attitudes of investors, the cost of attracting capital, the relative risk of the investment, and other related factors. These

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matters are legal and evidentiary determinations and fall squarely within the language in *St. Paul Area*:

In cases where the commission acts primarily in a judicial capacity, that is, hearing the views of the opposing sides presented in the form of written and oral testimony, examining the record, and making findings of fact, the administrative process is best served by allowing the district court to apply the substantial evidence standard on review. This is so because in such a case the district judge is able to review all of the evidence as he would be in any trial and can, within the knowledge parameters of his own expertise, determine whether or not each finding is supported by substantial evidence. 48

The *North Central* doctrine had created a process whereby the commission systematically and intentionally ignored major segments of the testimony. While designed to look to *all testimony* to establish a range of reasonable rates of return, that step was meaningless since the testimony which supported the high end of the range was, for that sole reason, excluded from further consideration unless all other testimony in the record was “so badly pummeled in cross examination or through rebuttal testimony that a knockout was scored.” 49 In analyzing the lowest recommendation under this “knockout” standard, no consideration was given to the direct testimony of other witnesses—only “cross examination” and “rebuttal testimony.” The commission, by de facto rule, had effectively prevented itself from giving reasoned consideration to any data or opinions provided by the company’s witnesses.

This procedure denied the company’s right to a fair hearing—it made a mockery of the company’s nominal opportunity to present evidence and argument and it deprived the commission of the opportunity to reach a reasoned judgment based upon all of the facts. It was tantamount to instructing a jury, in a condemnation case, that while the plaintiff is permitted to put expert appraisals on record, the jury may only consider the evidence which tends to prove the lowest value. It, in essence, institutionalized a process whereby the truth about an elephant would be adjudicated conclusively upon the basis of the description of one blind man who had reached an ear.

In reviewing these principles in *Hibbing Taconite*, the court recog-

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48. *Id.* at 259-60, 51 N.W.2d at 356.
nized that clarification was necessary and that it must apply two different scopes of review:

Although the court has set forth these general principles, when considering rate cases the court has not been precise in its use of terminology. The single term "ratemaking" has been used to describe what is really two separate functions—(1) the establishment of a rate of return, which is a quasi-judicial function, and (2) the allocation of rates among various classes of utility customers, which is a legislative function. The court's failure to be more precise when discussing the two phases of ratemaking has led to the inappropriate statement that "ratemaking is a legislative process."

The St. Paul Chamber case enunciated the PSC's two functions and the related standards of review. In applying those standards, we now hold that the establishment of a rate of return involves a factual determination which the courts will review under the substantial evidence standard. When the PSC allocates rates among classes of customers, it acts in a legislative capacity and the courts will uphold the PSC's decision unless it exceeds the PSC's statutory authority or results in unjust, unreasonable, or discriminatory rates by clear and convincing evidence. Here, the trial court correctly concluded that it should apply the substantial evidence test when reviewing the PSC's determination of MPL's rate of return.50

Having recognized the substantial evidence standard, it became readily apparent that the North Central doctrine must fall. Its "knockout" test applied to the low ball testimony did not satisfy the "substantial evidence" requirement. Clearly, a witness's testimony could withstand a "knockout"—implying a burden to eliminate it beyond a reasonable doubt—and yet fall far short of "substantial evidence in view of the entire record," as required by Minnesota Statutes, section 14.69(e).

The attempt to standardize complex rate case procedures had failed the fairness concepts embodied in the Minnesota Administrative Procedure Act and was properly dismantled by the court:

We note that this policy is no doubt designed to comply with the statutory requirement that the PSC ensure that utility rates are just and reasonable and that "[a]ny doubt as to the reasonableness should be resolved in favor of the consumer." Minn. Stat. § 216B.03 (1978). The North Central doctrine is, however, not an adequate method to achieve that goal. Chapter 216B

50. 302 N.W.2d at 9.
gives to the PSC the duty as well as the power to set a just and reasonable rate after a full review of evidence and testimony. To peg an established rate to a rate advocated by any one of several expert witnesses is an arbitrary delegation of that duty. The use of the North Central doctrine is impermissible. Nonetheless, a review of the record satisfies us that the PSC did not apply the doctrine in this case, even though it announced that it was following the doctrine. Reversal on this ground is not required.  

In effect, Hibbing Taconite merely recognized that the North Central doctrine disregarded the first half of the mandate to the commission, set forth in Minneapolis Street Railway Co. v. City of Minneapolis:  

The order of the commission should be recognized as the product of expert judgment which carries a presumption of validity. Such an order will not be disturbed where it appears that the commission has (1) fairly considered the investor's interest with concern for the financial integrity of the company whose rates are being regulated so as to provide a return commensurate with returns or investments of other enterprises having corresponding risks, so as to assure confidence in the financial integrity of the enterprise and to maintain its credit and attract capital; and (2) has fairly balanced those considerations against the just interests of the public who are required to pay the fares imposed. 

Any lingering doubt was dispelled in the 1978 MP&L case, Minnesota Power & Light Co. v. Minnesota Public Service Commission, which involved a commission decision made before the court's ruling in Hibbing Taconite had been announced. On appeal the commission no longer urged the validity of North Central, but in fact defended its order upon the ground that, while it had announced adherence to North Central, it had not in fact applied it. 

5. Related Precedent 

The result in Hibbing Taconite is consistent with federal decisions in analogous areas and with quasi-judicial legislative distinctions in other areas of Minnesota law. A more precise distinction is often drawn in federal cases between “adjudicative facts” and “legislative facts.” For example, in Patagonia Corp. v. Board of Gover-

51. Id. at 11. 
52. 251 Minn. 43, 86 N.W.2d 657 (1957). 
53. Id. at 72-73, 86 N.W.2d at 676. 
nors, the court stated:

Patagonia’s application for a section 1841(d)(3) controlling influence determination confronts the Board with a question of “adjudicative,” not “legislative,” fact. In the context of administrative law, legislative facts are those that affect an industry as a whole. An agency may resolve legislative questions through rule-making, relying on generalized data concerning an industry, the agency’s special expertise, and policy considerations. The rules thereby evolved may be applied to particularized situations without formal hearings. Adjudicative facts are those that immediately affect only specific litigants. Questions of adjudicative fact must be resolved on the basis of the evidentiary submissions of the parties. They are the types of questions that in a trial would normally be submitted to a jury, or to a judge as the finder of facts.

It is also consistent with other pronouncements of the Minnesota Supreme Court on commission authority. In In re Signal Delivery Service, Inc., the court stated:

The substantial evidence test is applicable to commission decisions when it is acting in a quasi-judicial manner; that is, when the commission hears the view of opposing sides presented in the form of written and oral testimony, examines the record and makes findings of fact.

In land use law, where analogous issues arise during judicial review of municipal proceedings, the court has long enforced a similar standard. When acting in a legislative capacity, a municipal council may consider facts within its expertise and common knowledge and is not limited to considering only matters on which substantial evidence has been presented.

Thus, when a city council adopts or amends a zoning ordinance, its actions affect an open class of individuals and it therefore is acting in a legislative capacity. When a council considers whether to grant or deny a permit, its actions no longer bear upon an open class but directly on the particular interests of the applicant and the council is acting in a judicial capacity. The distinction was

55. 517 F.2d 803 (9th Cir. 1975).
56. Id. at 816, citing 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 7.02 (1958).
58. 288 N.W.2d 707 (Minn. 1980).
59. Id. at 710.
60. Barton Contracting Co. v. City of Afton, 268 N.W.2d 712, 715 (Minn. 1978); Sun Oil Co. v. Village of New Hope, 300 Minn. 326, 333, 200 N.W.2d 256, 260-61 (1974).
recently reaffirmed in *Honn v. City of Coon Rapids*.\(^{61}\)

Nevertheless, while the reasonableness standard is the same for all zoning matters, the nature of the matter under review has a bearing on what is reasonable. In enacting a zoning ordinance or in amending an ordinance to rezone, the approach is legislative; what is involved is a kind of municipal planning in which a wide range of value judgments is considered. On the other hand, in granting or denying a special use permit, the inquiry is more judicial in character since the zoning authority is applying specific use standards set by the zoning ordinance to a particular individual use.\(^{62}\)

6. The Substantial Evidence Rule

Since the determination of rate of return on equity is a quasi-judicial function, it is subject to judicial review under the normal scope provided by the Administrative Procedures Act:

[T]he Court may . . . reverse or modify the decision if the substantial rights of the petitioners may have been prejudiced because the administrative finding, inferences, conclusion, or decisions are:

. . . .

(e) Unsupported by substantial evidence in view of the entire record as submitted.\(^{63}\)

The determination that substantial evidence is required does not, obviously, automatically resolve all issues. Since every determination is, hopefully, based upon some evidence, it remains to determine what quality of evidence is sufficient to constitute substantial.

While *Hibbing Taconite* clearly established the applicability of the substantial evidence standard, it gave no definition of that standard. Earlier decisions do provide some direction, however. The most complete statement appeared in *Minneapolis Van & Warehouse Co. v. St. Paul Terminal Warehouse Co.*\(^{64}\)

The statutory rule also settles any doubt of our conformity with the majority of courts, both state and Federal, in accepting the substantial-evidence rule as the rule governing the scope of all judicial review of evidence supporting factual findings of administrative agencies. 4 Davis, Administrative Law Treatise,

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61. 313 N.W.2d 409 (Minn. 1981).
62. Id. at 417.
64. 288 Minn. 294, 180 N.W.2d 175 (1970).
§ 29.11. As Professor Davis points out in chapter 29 of his comprehensive treatment of this subject matter, substantial evidence is more than "a scintilla" and is "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." § 29.02. The main inquiry by the district court is "whether on the record * * * [the commission] could reasonably make the finding." § 29.01. While the test is "vague, rather than precise" and the "intensity of review" may vary from case to case, § 29.11, the "test is the same as the test on review of a jury verdict, but the review is narrower than the review of the findings of a judge sitting without a jury," § 29.01, the latter being governed by the "clearly erroneous" test. § 29.11. The burden is upon the appellant to establish that the findings of the commission are not supported by the evidence in the record, considered in its entirety. If the evidence is conflicting or the undisputed facts permit more than one inference to be drawn, the findings of the commission may not be upset and the district court may not substitute its judgment for that of the commission.65

Notably, the substantial evidence rule requires a review of the "whole record." This requirement means that the court, and therefore the commission, may not look exclusively to the testimony of one party or one witness and ignore other evidence which may weaken or destroy that testimony. Thus, in Hibbing Taconite, the court found that the commission's total reliance on the rate of return recommendation of one witness, dictated by the commission's adherence to its North Central rule, did not satisfy the substantial evidence rule since that recommendation was not credible in light of other evidence in the record.66

The Minnesota view appears consistent with the scope of review of decisions under the Federal Administrative Procedure Act, reviewed by Professor Davis as follows:

The Administrative Procedure Act provides in section 10(e) that "the court shall review the whole record or such portions thereof as may be cited by any party." The Senate and House committees explained: "The requirement of review 'upon the whole record' means that courts may not look only to the case presented by one party, since other evidence may weaken or even indisputably destroy that case." The Supreme Court made clear in the Universal Camera opinion that it takes liter-

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65. Id. at 298-99, 180 N.W.2d at 177-78 (footnote omitted).
ally both the words of the statute and the words of the committee reports. The law of review on the whole record is thus entirely free from doubt in the federal courts.

The only federal problem about review on the whole record is the curiously cluttered one of what was the law before enactment of the APA in 1946. *It is hard to see how sensible judges could conceivably appraise the substantiality of evidence in a record without looking at the evidence on both sides, for evidence has significance only in a context, not in the abstract.* As Professor Jaffee wrote as long ago as 1943: "Obviously responsible men would not exercise their judgment on only that part of the evidence that looks in one direction, the rationality or substantiality of a conclusion can only be evaluated in the light of the whole fact situation or so much of it as appears. Evidence which may be logically substantial in isolation may be deprived of much of its character or its claim to credibility when considered with other evidence."67

C. Conclusion: Administrative Review

The substantial evidence rule is clearly established in Minnesota as the appropriate scope of judicial review of administrative determinations of rate of return on equity. The *North Central* doctrine is clearly and appropriately outlawed.

Unlike the approach of the City of Ghor, utilizing the blind men to describe the elephant, the commission’s determination of the rate of return on equity must search for the whole truth. It should fulfill the criteria endorsed in the Massachusetts case of *Boston Edison Co. v. Department of Public Utilities*: 68

The Department did not base its decision on the testimony of any one witness. Rather, the Department’s written decision evaluates the strengths and weaknesses of each witness’s testimony, *culling from the mass of evidence those elements which, we agree, are worthy of weight.* In so doing, the Department based its cost of equity judgment on a reasoned composite of all the evidence. *That is a process which this court has strongly encouraged.*69

This requirement for an exercise of regulatory judgment of multiple factors is clearly consistent with the spirit of the constitutional standards discussed next. In *Bluefield Water Works & Improvement Co. v. Public Service Commission*,70 the United States

67. 4 K. Davis, *supra* note 56, § 29.03, at 127 (emphasis added) (footnotes omitted).
69. Id. at 12, 375 N.E.2d at 314-15 (emphasis added) (citations omitted).
70. 262 U.S. 679 (1923).
Supreme Court said that "[w]hat annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." We will next discuss what information is necessary for "fair and enlightened judgment."

IV. CONSTITUTIONAL STANDARDS

A certain man was believed to have died and was being prepared for burial, when he revived. He sat up, but was so shocked at the scene around him that he fainted. He was put in a coffin and the funeral party set off for the cemetery. Just as they arrived at the grave, he regained consciousness, lifted the coffin lid and cried out for help. 'It is not possible that he has revived,' said the mourners, 'because he was certified dead by competent experts.' 'But I am alive,' shouted the man. He appealed to a well-known and impartial scientist and jurisprudent who was present. 'Just a moment,' said the expert. He then turned to the mourners, counting them, 'Now we have heard what the alleged deceased has had to say. You fifty witnesses tell me what you regard as the truth.' 'He is dead,' said the witnesses. 'Bury him,' said the expert. And so he was buried.

[An Ancient Tale—]

The Commission's order does not become suspect by reason of the fact it is challenged. It is the product of expert judgment which carries a presumption of validity and he who would upset the rate order under the Act, carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

320 U.S. 591 (1944)

If the rate of return on equity fixed by the commission is inadequate, the result is unconstitutional confiscation of the utility's property. What is adequate? The Bluefield decision of the United States Supreme Court, cited hundred of times on this subject, stated the broad test as follows:

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties;

71. Id. at 692 (emphasis added).
but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises for speculative venture. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business condition generally.\textsuperscript{72}

This test appears simple and dispositive. In application, it is abstract and subjective. Further, as a result of the apparent pulling back by the Court in \textit{Federal Power Commission v. Hope Natural Gas Co.},\textsuperscript{73} by approving any method so long as the “end result” is not unjust,\textsuperscript{74} many a utility has felt itself “buried alive” because of inability to obtain objective review of the “expert judgment” of the administrative body. Further, the radical changes in the utility industry and the national economy since the last major judicial pronouncements on confiscation—pre-1945—make these broad standards insufficiently focused to address the complexity of the 1980’s. The development of more detailed criteria and some identifying marks of confiscation is critically needed.

The discussion is launched by reviewing some of the underlying principles that surround the question of confiscation. Next, we trace the journey of the confiscation standard to test the adequacy of its depth and breadth. Finally, some identifying marks by which confiscation can and should be judged in the real world of today are proposed.

\subsection*{A. General Principles}

The enforcement of rates which are unreasonably low or confiscatory is a violation of the constitutional requirements of due process—no rate may be enforced by public authority which compels the utility to operate its property for public convenience without just compensation.\textsuperscript{75} A return may become confiscatory for any

\begin{footnotesize}
\item[72] \textit{Id.} at 692-93.
\item[73] 320 U.S. 591 (1944).
\item[74] \textit{Id.} at 602.
\item[75] Some early cases also found violation of constitutional requirements of equal protection of the laws where a regulated company was not permitted to earn “reasonable profits” while other industries were permitted to do so. \textit{See}, e.g., \textit{Chicago, M. & St. P. Ry. v. Minnesota}, 134 U.S. 418, 459 (1890). Generally, however, constitutional review is based upon the due process clause.
\end{footnotesize}
one of several reasons—such as:

(1) non-recognition—and thus non-recovery—of some item of necessary expenses, such as taxes or depreciation;

(2) improper exclusion from rate base of some item of investment which is required for utility operation;

(3) miscalculation of the company's capital structure so as to give incorrect weighting to the debt, preferred stock, and equity components;

(4) understatement of debt costs; or

(5) inadequate allowance for the return on common equity.

The focus of this article is, of course, the last item: confiscation which occurs because the rate of return fixed by the commission is too low.

No rule as to what constitutes a nonconfiscatory rate may be laid down to be applied uniformly to all utilities under all circumstances. Each utility presents an individual situation which requires review of all relevant facts in light of that situation and the utility's requirements and opportunities. It is also frequently said that what will constitute a fair return in a given case is not capable of exact mathematical demonstration, but is a matter of judgment. Of course, the utility is never guaranteed that it will actually earn the fair return allowed, but rather is entitled to have its rates established to give it the opportunity to actually earn that fair return.

There has been considerable debate over the years as to whether a nonconfiscatory rate equals a "reasonable" rate. For example, when a statute requires a "fair" or "reasonable" rate of return, does it impose a higher standard than simply a rate which is not constitutionally confiscatory? A body of cases distinguishes between the absolute minimum of a confiscatory standard and the standard of reasonableness. On the other hand, many courts and commissions use the two terms interchangeably, such as in Bluefield, where the Court stated, "Rates which are not sufficient to

78. See Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 692 (1923) ("A public utility is entitled to such rate as will permit it to earn a fair return." (emphasis added)).
yield a reasonable return on the value of the property used at the
time it is being used to render the service are unjust, unreasonable,
and confiscatory." 80

In the turn of the century cases, this debate centered on whether
confiscation existed when the rates provided some earnings above
expenses, albeit modest. Clearly, rates that required the utility to
operate at a loss were confiscatory. The absence of any further
objective criteria, however, led some courts to infer from this that
any earnings above cost, no matter how slight, were not confisca-
tory. A fallacy exists in this reasoning; it fails to comprehend that
the rate of return on common equity is a cost which, like taxes or
wages, should be recovered in full from ratepayers.

Generally, the proposition that a rate could not be set aside as
confiscatory if it produced some return, even though less than a
reasonable return, has not been given credence in recent years by
either regulatory authorities or the courts. Obviously, a utility
would not be able to compete for the attraction of capital if it had
no opportunity to obtain adequate earnings. Thus, for example,
the Texas Supreme Court referred to the distinction between "con-
fiscation" and "unreasonableness" as largely academic, stating
that once it is acknowledged that the return is unreasonable, it is
"overly metaphysical if we add that there is no constitutional ques-
tion involved, or no right to judicial review without a statute, un-
less the rate actually produces red figures on a financial
statement." 81

This appears to be the settled doctrine in the federal courts.
Rates must produce an adequate return rather than merely some-
thing above an operating loss:

The character of the rate has always been determined, in our
law, by its relationship to the sum of a number of components.
Those components, principally, are the expenses of the opera-
tion, and allowance for depreciation or depletion, and a proper
return to the company.

A rate order which does not provide for proper allowable ex-
penses, taxes, depreciation and return, is unfair, unreasonable

80. 262 U.S. at 690.
81. General Tel. Co. of the Southwest v. City of Wellington, 156 Tex. 238, 244, 292
S.W.2d 385, 389 (1956); see also Central Maine Power Co. v. Public Util. Comm'n, 156
Me. 295, 163 A.2d 762 (1960); Southern Bell Tel. & Tel. Co. v. Tennessee Pub. Serv.
Comm'n, 202 Tenn. 465, 304 S.W.2d 640 (1957); Southern Bell Tel. & Tel. Co. v. Louisi-
and confiscatory. We thought it unnecessary to recite that obvious basic premise.\textsuperscript{82}

Minnesota cases support the view that the constitutionally protected return equals a fair and reasonable return. In \textit{Northern States Power Co. v. City of St. Paul},\textsuperscript{83} the court observed:

\begin{quote}
It is equally well settled that some form of judicial review of the reasonableness of rates fixed by the ratemaking body is an essential requirement in the exercise of due process.
\end{quote}

\begin{quote}
\ldots
\end{quote}

Denial of an application for increased rates, where existing conditions require it, has the same effect as fixing unreasonably low rates.\textsuperscript{84}

\textbf{B. United States Supreme Court Decisions}

The history of the participation of the United States Supreme Court in the development of confiscation standards is brief and not current. It is characterized by pronouncements of the fair return or fair profit standard with little instruction as to the criteria for fairness. The story of rate regulation in this country could well be told in terms of the efforts by legislatures, commissions, expert witnesses and, sometimes, courts to supply these criteria.

Beginning in \textit{Munn v. Illinois},\textsuperscript{85} decided in 1876, the United States Supreme Court recognized the need for and constitutionality of legislative control of public utility rates. The Court held that public service businesses were subject to special statutory price-fixing regulations. There followed a considerable period of rate setting by legislative bodies, state or municipal, without the benefit of administrative agencies.

It later became apparent that state legislatures had neither the special competence nor adequate procedures for making fine economic adjustments in rate regulations, and the judiciary intervened in the process. In \textit{Smyth v. Ames},\textsuperscript{86} a landmark rate case decided in 1898, the United States Supreme Court established guidelines that legislatures must follow in making rate determinations. \textit{Smyth} indicated that failure to adhere to the guidelines would result in a judicial denial of a legislated rate order. The

\begin{itemize}
\item \textsuperscript{82} Mississippi River Fuel Corp. v. Federal Power Comm'n, 163 F.2d 433, 450-51 (D.C. Cir. 1947).
\item \textsuperscript{83} 256 Minn. 489, 99 N.W.2d 207 (1959).
\item \textsuperscript{84} \textit{id.} at 493-95, 99 N.W.2d at 211.
\item \textsuperscript{85} 90 U.S. 113 (1876).
\item \textsuperscript{86} 169 U.S. 466 (1898).
\end{itemize}
Court introduced the confiscation standard, establishing the "fair value" rule as setting the normal limit below which rates imposed by a legislative body would be held "confiscatory."

The creation of state regulatory agencies in the early 1900's facilitated more efficient implementation of the Smyth guidelines. By the nature of their specialized function, regulatory agencies proved better able than courts at making the continuous adjustments necessary to conform rates to changing economic conditions. Yet, the constitutional standards continued to require certain minimum criteria for rate of return to avoid confiscation.

After some experience, the Court, in Bluefield, established three standards for determining a "reasonable rate of return." First, the return must be "equal to that generally being made . . . on investments in other business undertakings which are attended by corresponding risks and uncertainties." Second, it must be "reasonably sufficient to assure confidence in the financial soundness of the utility." Finally, the return must be "adequate, under efficient and economical management, [to allow the company] to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."87

Finally, in Hope, the Court indicated that "fair value," as espoused in Smyth v. Ames, was the end result of ratemaking, not the starting point. In discussing the concept of fair return the Hope Court stated:

[I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.88

With Hope, the Court appeared to retreat from its earlier, broader, pronouncements on the subject.89 Since that time it has not granted certiorari on a single case arising from a state commission order and has not directly considered the issue of return on

87. 262 U.S. at 692-93.
88. 320 U.S. at 603 (citations omitted).
89. See Welch, Status of Regulatory Commissions Under the Hope Natural Gas Decision, 32 GEO. L.J. 136, 142, 148-49 (1944).
common equity.90 According to one authority:

[T]he dicta in the court’s opinion as to the broad “end result” test of the adequacy of the return, together with the earlier opinion expressed in Federal Power Commission v. Natural Gas Pipeline Co., (1942) 315 U.S. 572, 42 PUR. N.S. 129, left little doubt that the U.S. Supreme Court would refuse to examine the methods employed by a state commission in a rate case, where the alleged confiscation under the Fourteenth Amendment was the only basis for federal court review.91

The Court had considered and decided several cases between Smyth and Hope besides Bluefield. The others may be only a historical curiosity, but a brief review of them does dramatize the shallowness of the Supreme Court’s exposure to this issue and the radical changes which have taken place since the confiscation standard was last articulated. Indirectly, it may suggest some areas where the identifying marks of confiscation could be located.

Five rarely cited cases, dealing directly with the return on equity component, will be reviewed. All five involved petitions for federal injunctive relief for municipal rate setting ordinances. As a group, they can be said to be discouraging of judicial review, though for reasons which have lost their vitality with the passage of time.

The first, City of Knoxville v. Knoxville Water Co.,92 involved a decree obtained in federal court enjoining the enforcement of a municipal ordinance fixing maximum water rates in 1901.93 Net income under the maximum rates was shown to be less than six percent of the value of the property employed in the business. The Court paid excessive, and inappropriate, deference to legislative discretion of the municipality,94 but recognized its duty to safeguard against abuse.95 Yet, on the basis that the company was certain to obtain some net revenue from the rates, the Court held that the confiscation was not “clearly apparent.”

Willcox v. Consolidated Gas Co.,96 decided on the same day, simi-
larly reviewed a federal injunction against rates established by the City of New York for gas service. As a precursor of the *Bluefield* test, the Court stated:

There is no particular rate of compensation which must in all cases and in all parts of the country be regarded as sufficient for capital invested in business enterprises. Such compensation must depend greatly upon circumstances and locality; among other things, the amount of risk in the business is a most important factor, as well as the locality where the business is conducted and the rate expected and usually realized there upon investments of a somewhat similar nature with regard to the risk attending them. There may be other matters which in some cases might also be properly taken into account in determining the rate which an investor might properly expect or hope to receive and which he would be entitled to without legislative interference. The less risk, the less right to any unusual returns upon the investments. One who invests his money in a business of a somewhat hazardous character is very properly held to have the right to a larger return without legislative interference, than can be obtained from an investment in Government bonds or other perfectly safe security. The man that invested in gas stock in 1823 had a right to look for and obtain, if possible, a much greater rate upon his investment than he who invested in such property in the city of New York years after the risk and danger involved had been almost entirely eliminated.97

The Court determined that an investment in a gas company involves a risk that "is reduced almost to a minimum"

since, so far as it is given us to look into the future, it seems as certain as anything of such a nature can be, that the demand for gas will increase, and, at the reduced price, increased to a considerable extent. An interest in such a business is as near a safe and secure investment as can be imagined with regard to any private manufacturing business.98

The Court reversed the lower court's confiscation finding.

*Cedar Rapids Gas Light Co. v. City of Cedar Rapids*99 followed in 1912 and similarly affirmed the maximum rates set for gas by the municipality. The Court approved the state court's decision to defer action on the issue until the rates had actually been placed into effect, so their impact on earnings could be precisely measured.

97. *Id.* at 48-49.
98. *Id.*
99. 223 U.S. 655 (1912).
Des Moines Gas Co. v. City of Des Moines\textsuperscript{100} also determined that the rates must first be tested by actual experience before confiscation could be determined. While the master had reported that the company ought to earn 8\%, the allowed return of 6\% would produce a lower price, which would increase sales and thus conceivably produce greater profitability.

Finally, Brush Electric Co. v. City of Galveston\textsuperscript{101} similarly ruled that the rates cannot be determined to be confiscatory until tested.\textsuperscript{102} The district court had further noted a difficulty in dealing with the impact of inflation:

The district judge did not agree with the master’s findings, but substituted no base value of his own, because of his conclusion that the injunction should be denied—

on the ground that the ordinance has had no test, and that in my view, taking the master’s base, the ordinance is still not confiscatory, it will not be necessary for me to hazard a guess as to what value ought to be taken, since I feel sure that before the precise valuation of the plant by me can become important, conditions of prices and values will have settled down to such a definite and permanent basis as that there will be no difficulty in reaching a proper price basis to apply on any future adjustment in or out of court.\textsuperscript{103}

With these rather narrow cases under its belt, a watershed of sorts was reached with the Bluefield decision coming just one year later in 1923. In Bluefield, the Court expanded and deepened its analysis and set down broad standards which remain the “last word” on the subject. Hope represented a change in mood, more accurately, an announcement that the Court was calling a moratorium on the review of utility confiscation cases. It did not alter the basic standard set forth in Bluefield, but rather perpetuated them before walking off stage.

The task was left unfinished. As the Court itself acknowledged in a more recent decade:

Although neither law nor economics has yet devised generally accepted standards for the evaluation of rate making orders, it must, nonetheless, be obvious that reviewing courts will require criteria more discriminating than justice and arbitrariness if

\begin{itemize}
  \item \textsuperscript{100} 238 U.S. 153 (1915).
  \item \textsuperscript{101} 262 U.S. 443 (1923).
  \item \textsuperscript{102} \textit{Id.} at 446 ("An actual test of these rates may result in a larger return, by bringing about an increase of business.").
  \item \textsuperscript{103} \textit{Id.} at 445 (quoting the district court) (emphasis added).
\end{itemize}
they are sensibly to appraise the Commission's orders. The court in *Hope* found appropriate criteria by inquiring whether "the return to the equity owner [is] commensurate with returns on investments in other enterprises having corresponding risks" and whether the return was "sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital." . . . These criteria, suitably modified to reflect the special circumstances of area regulation, remain pertinent, but they scarcely exhaust the relevant considerations.104

C. Relevant Considerations

The Court's constitutional review of state rate of return allowances was performed against a backdrop which no longer exists, or exists in a radically altered form. From our earlier discussion of the pre-*Bluefield* cases, it was seen that strong emphasis was given to such factors as:

*Locality*—Since utilities were then small, local enterprises, whose stock was traded locally, specific analysis of the cost of equity for comparable investments in that locality had to be made. This presented a practical obstacle to the development of consistent national standards and likely was part of the reason for the Court's retreat from this field. The locality of comparable earnings is of reduced significance today. The stock and bonds of most major utilities trade nationally and the investors' perception of those securities can be analyzed from national market information.

*Price Elasticity*—Since a lower price could stimulate higher demand, the Court was evidently unwilling to say that a reduction in rates would, *per se*, be confiscatory—speculating that it might induce sufficient growth in sales to produce greater net earnings. This consideration is inapplicable today in the energy field for at least two reasons. First, it runs counter to the national policy of conservation of scarce resources, which has proscribed the ability of utilities to undertake efforts to increase earnings by promoting an increase in sales. Second, it ignores the magnitude of inflation which no longer provides the luxury of a wait-and-see approach—the stakes are just too high to make a decision based on the chance that it might work out.

*Stable Dollar Values*—Since inflation was seen as transient, not

the long-term norm, little concern had to be paid to time lags or "temporary" changes in the value of money. Today, high levels of inflation are the norm. The time value of money is a major concern among financial institutions. Delays caused by environmental requirements, when coupled with inflation, produce astronomical capital requirements for utilities.

**Minimum Risk**—Since the opportunity to earn an allowed return is protected by law, little effort was made to grant utility returns comparable to non-regulated industries, whose risks were far greater. Today's investors may perceive this risk comparison quite differently, recognizing that the so-called safe returns from utility investments have not come close to compensating for the inflation risk.

With nearly fifty years of additional experience since *Hope*, it is possible to suggest some identifying marks of confiscation which, as guidelines, would give judicial review better focus than the extremely broad criteria of *Bluefield* and *Hope*. While these marks are interrelated and may exist in combination, they are offered as individual and independent tests, any one of which would be indicative of confiscation unless insubstantial or counterbalanced.

### 1. Market Price Below Book Value

The first, and perhaps most significant, single indicator is a market price below book value. We speak here not of a brief excursion into a negative market-to-book ratio, which may be produced by extraneous factors against which regulation was not obliged to protect. Clearly, these temporary excursions do not establish confiscation *per se*, as noted in *Boston Edison Co. v. Department of Public Utilities*: 105

We cannot say as a matter of law that the Constitution requires ratepayers to sustain the price of Boston Edison's stock above book value except to the extent absolutely necessary to maintain sufficient investor confidence to allow the business to continue as usual. Ultimately, it is investor confidence, not dilution considered by itself, that is the constitutionally significant criterion. 106

Even brief excursions below book value might tend to indicate

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106. *Id.* at 17, 375 N.E.2d 305, 317 (1978).

We do not necessarily endorse the Massachusetts court's application of this approach to the facts that were before it, but accept the principle stated when applied to short term impacts on the market to book value ratio. Minnesota, it could be argued, has been more
confiscation, though requiring consideration of other relevant factors. Where, however, the negative market-to-book ratio persists over several accounting periods, and perhaps several rate applications, confiscation should be found. Financial integrity, as protected by *Bluefield* and *Hope*, must minimally require the maintenance of stock prices somewhat above book value over the long run.¹⁰⁷ Where market prices fall below book value for sustained periods of time and new common shares are issued, those shares produce dilution of the existing shareholders' interest and are not competitive with market values of shares of unregulated companies.

Interestingly enough, the Minnesota commission has, indirectly, reinforced the existence of market prices below book value for many of the utilities it regulates. Since its 1977 decision in *Interstate Power Company*,¹⁰⁸ the commission has virtually adopted the discounted cash flow theory as its exclusive method. As stated by then-Commissioner Sasseville, dissenting in *Ottertail Power Company*:*¹⁰⁹

The Minnesota Public Service Commission has come to rely almost exclusively on the discounted cash flow method to determine the cost of equity capital. It is an important and valuable tool in ratemaking, but it is not a formula of objective and scientific certitude. It is not the pythagorean theorem. Rather, as all witnesses have stated, it is greatly reliant on the subjective judgments of the analyst who selects its component parts.¹¹⁰

The DCF theory, of course, had earlier been criticized by the commission and the Minnesota Supreme Court for the very reason that its application would tend to force the market price to book value. In *Northwestern Bell Telephone Co. v. State*,¹¹¹ the commission

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¹⁰⁷ Many commentators would argue that a market-to-book-value ratio at or slightly above one is not an adequate goal, since, to "merely . . . be able to issue new shares without dilution of per-share book equity ignores the competitive cost standard and has no valid rationale." Foster, *Fair Return Criteria and Estimation*, 28 BAYLOR L. REV. 883, 919 (1976). We need not address the argument from some increment of market price above book value currently since utilities under Minnesota jurisdiction have been below book value for several years running.


¹¹⁰ *Id.* at 34 (Sasseville, C., dissenting).

¹¹¹ 299 Minn. 1, 216 N.W.2d 841 (1974).

was quoted with approval by the court for these observations:

If this Commission undertook to drive the market price of the stock of a regulated company to book value and it became necessary to issue additional stock at a price below book in order to market such stock it would have the effect of confiscating a part of the value of the property of existing stockholders.\textsuperscript{112}

Barely three years after the court’s blessing of the commission’s refusal to directly adopt DCF results, the commission commenced a pattern which adopted DCF as the exclusive test. Simultaneously, it consistently reduced, to virtual elimination, the usual adjustments for market pressure and cost of issuance, which attempt to produce a market price sufficiently above book value to enable the sale of new common shares at net proceeds equal to book.\textsuperscript{113}

In addition, the commission’s use of North Central to adopt the lowest DCF study produced returns that were not credibly based.\textsuperscript{114}

\textsuperscript{112.} Id at 27, 216 N.W.2d at 857.

\textsuperscript{113.} The commission’s reduction was based upon two rationales: (1) even where a company was issuing new shares, the adjustment need not be applied to the growth portion of the DCF formula and (2) where a company did not intend to issue significant numbers of shares in the test year, no adjustment at all was appropriate. \textit{See} Minnesota Power & Light Co., Docket No. E-015/GR-77-360 (Minn. P.S.C. Feb. 3, 1978) (item (1)); Minnesota Power & Light Co., Docket No. E-015/GR-80-76 (Minn. P.U.C. Jan. 30, 1981) (item (2)). A cogent argument against both rationales is made by Foster:

Another question, assuming application of the DCF formula, is whether the adjustment should be applied only to the dividend yield portion or to the total return requirement, including the growth component. Some have contended that there is no market pressure or financing cost applicable to the growth component, and would adjust only the dividend yield.

That procedure looks to form instead of substantive content in an application of the discounted cash flow formula. Market pressure concerns the relationship between price paid for new capital and expected future earnings, not merely the relationship between the price and current dividends. The price of common stock is the present worth of all anticipated monetary benefits, not merely current dividends or future dividends at the current rate. Therefore, market pressure is an adjustment of the investor’s capitalization rate, not of the current dividend yield independent of the expected growth rate.

The error of the contention that market pressure, the discount from the current price required to attract new capital, relates only to dividends may be more obvious in the not uncommon situation where investors expect no growth of per-share earnings. If the price of a stock is one-hundred five dollars in day-to-day trading and investors pay one-hundred dollars to realize a future return of fourteen dollars, the adjusted capitalization rate is obviously 14 percent. I do not understand how the cost of capital can be any different if investor expectations take the form of a current dividend yield plus a dividend growth rate of 7 percent instead of the otherwise anticipated 14 percent return.

Costs of financing include underwriting commissions and expenditures incurred directly by the issuing company in order to give access to new capital. Like market pressure, costs of financing represent a reduction of the whole, not some fraction of what otherwise would be the net proceeds from a stock offering.

\textsuperscript{114.} This is evidenced by Hibbing Taconite Co. v. State, 302 N.W.2d 5 (Minn. 1980),
and were not, in fact, sufficient to enable significant improvement in the market-to-book ratio. While DCF contemplates that earned returns at the level indicated will move the market price to at least book value, utilities that were able to earn at or near the allowed rate continued to experience negative market-to-book ratios.

2. Equity Risk Premium

Historically, debt costs have been well below equity and were the least expensive external capital for construction purposes. Since, however, a utility with an inadequate rate of return on equity was in danger of poor financial ratings for its debt, there was ample incentive for adequate equity returns, even with the highly leveraged debt ratios typically carried by utilities. In today's economy, rising debt costs have actually outrun equity allowances, placing utilities in the anomalous position of providing a lesser return for its junior risk securities.

Rates of return on equity below interest rates on newly issued debt are confiscatory; they clearly do not meet the constitutional test of providing a return sufficient to enable the attraction of investors to equity as against debt. Equity and debt obligations are obviously alternative investment opportunities.

Some financial experts argue that, in periods of high inflation, the equity-to-debt premium could actually turn negative, justifying lower equity returns. No empirical proof of this has ever been provided to the Minnesota commission and, to the authors' knowledge, no witness has actually testified that the crossover into a negative equity risk premium has occurred in recent periods of unprecedented inflation. Yet, commission return allowances have been consistently below debt costs.

Without engaging in the more sophisticated debate as to the level of equity premium required, courts should at least determine that equity returns below debt costs are legally inadequate.

3. Bondrating Criteria Not Met

This factor may not be important in all cases because bondrating criteria are often difficult to obtain because of confidentiality asserted by rating agencies and the range of criteria for a given rating may be very broad and not meaningful for a utility situated

the only Minnesota Supreme Court decision to review a commission rate of return finding under North Central.
in the middle. There are those cases, however, where a utility is at
the low edge of a rating category and is able to produce evidence
of an imminent derating. A subfactor here would be rapid de-
clines or sustained substandard levels of interest coverage. 115

4. History of Inability to Earn at or Near the Rate Allowed

Over an extended period of time a commission is able to gauge
the realism of its orders—does the utility come close to actually
earning at the level authorized by the rate order? Factors prevent-
ing such earnings are generally associated with regulatory lag or
unpredicted levels of inflation. While not meaningful in terms of
one order, a consistent pattern of deficient earnings, in relation to
regular rate cases, would suggest that the regulatory practices are
producing confiscation.

5. Major Shifts in Investor Attitudes

At a recent rate case, one of the witnesses was the representative
of an institutional investor. He testified that his institution’s anal-
ysis required a return on investment in the range of nineteen to
twenty percent to interest it in an electric utility stock—a range
that was beyond that even requested in the case. The message
clearly given is that institutional investors currently have no at-
traction to electric utility stocks.

This was not always so. In fact, the same witness recounted how
in the 1960’s many electrical utilities had institutional investors as
the majority of their shareholders. A mass exodus of institutional
investors from utility stocks occurred in the 1970’s, to the point
where less than five percent of the subject company’s shares were
held by institutions. A change of this magnitude, coupled with
other indicia of declining investor preference for utility stocks,
should be regarded as strong evidence that historic returns are con-
stitutionally inadequate for the future.

D. Conclusion: Constitutional Standards

Justice Frankfurter, dissenting in Hope, was amazingly prophetic
of the dilemma facing judicial review in attempting to apply the
broad Bluefield-Hope criteria to the complex and radically altered
economy of the 1970’s and 1980’s. He said:

115. Coverage ratios represent the number of times that the utility’s net income ex-
ceeds its fixed costs of capital, thus indicating the relative safety of debt holders.
The requirement that rates must be "just and reasonable" means just and reasonable in relation to appropriate standards. Otherwise Congress would have directed the Commission to fix such rates as in the judgment of the Commission are just and reasonable; it would not have also provided that such determinations by the Commission are subject to court review.\textsuperscript{116}

Identifying marks do exist, which can relieve the court from total dependence upon the "expertise" of either the commission or any single witness the commission chooses to endorse. Particularly now, when utilities have fallen out of investor favor and yet bias in favor of the ratepayers is constantly urged, and even legislated, the court must be looked to for necessary constitutional protection. This it can provide by putting more flesh on the confiscation doctrine.

\textsuperscript{116} 320 U.S. 591, 626 (Frankfurter, J., dissenting).