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CONSTITUTIONAL PROTECTION FOR THE UTILITY INVESTOR: THE CONFISCATION DOCTRINE AFTER CLEVELAND ELECTRIC ILLUMINATING CO. v. PUBLIC UTILITIES COMMISSION OF OHIO

Robert E. Cleaves, IV*

I. INTRODUCTION

Nuclear power generation in the United States has experienced a short and troubled history.1 In 1953, utility companies began a major commitment to nuclear power.2 Twenty years later, nuclear power reached a highwater mark, as state and federal agencies authorized a record number of mega-watts to be drawn from nuclear facilities.3 In a short period of time, the energy industry witnessed a drastic change in the market. From 1972 to 1982, over 100 plants were cancelled.4 Economic losses were profound. The

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1 Though nuclear power was first developed in the 1940s, it was not until 1953 that Congress authorized the use of nuclear fission for non-military, commercial distribution. ENERGY INFORMATION ADMINISTRATION, OFFICE OF COAL, NUCLEAR, ELECTRIC AND ALTERNATIVE FUELS, UNITED STATES DEPARTMENT OF ENERGY, NUCLEAR PLANT CANCELLATIONS: CAUSES, COSTS AND CONSEQUENCES 4 (1983) [hereinafter cited as PLANT CANCELLATIONS]. This report provides a helpful sketch of the history of cancellations, the regulatory treatment in various states, and the reasons for termination.


3 PLANT CANCELLATIONS, supra note 1, at 4.

4 Id. Between 1972 and 1983, the industry cancelled plants at a progressive rate: seven in 1972; zero in 1973; seven in 1974; 13 in 1975; one in 1976; 10 in 1977; 14 in 1978; eight in 1979; 16 in 1980; six in 1981; and 18 in 1982. Id. at 5. The 100 cancelled units had the potential capacity of 110,000 MWe of electricity. Many of the plants cancelled were well beyond the planning stage. For example, of the 40 units cancelled between 1980 and 1982, 18 were already under construction. Id. at 6.

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Public Service Company of Indiana, for example, had invested nearly $2.5 billion in its Marble Hill nuclear project before deciding to abandon the plant.\(^5\) In Massachusetts, Boston Edison Company decided to cancel Pilgrim II's construction after making an investment of $278 million.\(^6\) In Washington, the problem was particularly severe. In the largest municipal bond failure in American history, the Washington Public Power Supply System (WPPSS) cancelled its two largest facilities and defaulted on $2.25 billion in bonds.\(^7\) Facilities surviving this cancellation trend face considerable pressure from both ratepayers and investors to reconsider continued construction.\(^8\)

The reasons for this abrupt change in the feasibility of nuclear power are varied and complex. According to a study of cancellations conducted by the United States Department of Energy, lower forecasted growth in the public's use of electricity contributed to the demise of nuclear power.\(^9\) Prior to the Arab Oil Embargo of 1973, the industry embarked on a vigorous effort to construct nuclear facilities. After 1973, fuel costs increased, and consumers were forced to conserve energy.\(^10\) As a result of this conservation effort, many power companies had excess capacity and little need for expanded facilities.

\(^9\) PLANT CANCELLATIONS, supra note 1, at 7.
\(^10\) Id. at 7. The study notes that between 1966 and 1972, energy forecasters predicted a seven percent annual growth rate in electricity usage. These reports prompted the energy industry to revise its schedule of the construction of nuclear plants to meet the increased demand. With the Arab Oil Embargo of 1973, the predictions of the past six years were radically revised. The Embargo caused a sharp increase in prices, which in turn resulted in impressive conservation efforts. From 1973 to 1982, the study documents a continued downward trend in long term energy use. Id. at 7. See also Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Cancelled Plants and Excess Capacity,* 132 U. PA. L. REV. 497 (1984).
In addition to excess capacity, the industry was plagued by an ever-changing regulatory maze. In 1971, for example, the U.S. Court of Appeals for the District of Columbia Circuit\(^\text{11}\) ruled that prior to the granting of a construction permit, the Atomic Energy Commission must prepare an environmental impact statement pursuant to the National Environmental Policy Act of 1969.\(^\text{12}\) The industry was also hampered by administrative obstacles stemming from the Three Mile Island accident.\(^\text{13}\) Following the event, the Nuclear Energy Regulatory Commission (NRC) adopted a number of measures which caused delays in construction. For example, the NRC imposed a ten month moratorium on the issuance of operating licenses, and subjected state and local evacuation plans to federal scrutiny.\(^\text{14}\) The regulatory requirements contributed to cancellations by imposing additional construction costs, particularly in the area of plant designs.\(^\text{15}\)

A highly inflationary economy also contributed to cancellations. The construction of Indiana’s Marble Hill facility was estimated at $1.4 billion in 1975;\(^\text{16}\) prior to its cancellation in 1984, the completion estimate was $7 billion.\(^\text{17}\) The Michigan Consumers Power Company’s Midland plant, though still under construction in 1984, increased in price from $267 million in 1965 to an estimated $3.4 billion upon completion.\(^\text{18}\) And in New York, Long Island Lighting Company’s Shoreham nuclear facility, whose future remains un-


\(^{12}\) The National Environmental Policy Act of 1969, 42 U.S.C. § 4332 (1976 & Supp. V 1981), provides that “every recommendation or report or proposal for legislation and other major Federal actions significantly affecting the quality of the ‘human environment’ must include a detailed statement discussing the environmental impact of the proposed action.”

\(^{13}\) On March 28, 1979, water pumps malfunctioned at Metropolitan Edison’s Unit 2 at Three Mile Island, Harrisburg, Pennsylvania. As a result of the malfunction, the nuclear reactor’s radioactive core was temporarily exposed.

\(^{14}\) PLANT CANCELLATIONS, supra note 1, at 26.

\(^{15}\) The Department of Energy study notes the quantitative impact of regulatory changes on the high incidence of plant cancellations. Of the companies with cancelled plants between 1973 and 1982, no firm relied on regulatory changes as the primary justification for termination. Despite this finding, the study reports that regulatory changes are the third most commonly cited reason for cancellation; the industry claims that these changes influenced the cancellation of 38 facilities. PLANT CANCELLATIONS, supra note 1, at 26.

\(^{16}\) Supra note 5, at col. 4.

\(^{17}\) Id.

\(^{18}\) Id. See also Stoler, supra note 7, at 39.
certain, has a completion price of $4 billion—a drastic increase from its $241 million estimate in 1965.

Rising costs only increased the need for borrowing. Contrary to the period of 1960 to 1965, when over half the capital required for construction came from the utility’s internal sources, by 1980, external borrowing contributed to fifty-three percent of the needed capital. Industry dependence on external borrowing was further exacerbated by the inability to raise capital in the securities market. The original premise that nuclear generation was the most profitable and efficient method of generating electricity was no longer unassailable. In fact, by 1982, the U.S. Department of Energy found that new nuclear facilities would offer economic advantages over coal fired facilities only in the New England and South Atlantic regions.

This analysis had unavoidable consequences for the private investor. Between 1965 and 1980, the average rate of return on a stockholder’s investment declined. Market prices became depressed and investors were steered away from utility stocks. The down turn was so dramatic that by early 1984, some utility stock prices were down as much as 50% from their 1983 value. A direct consequence of this decline was the reduction of the company’s earnings per share. To reverse this devaluation, utilities embarked on a “capital minimization” strategy. Rather than issue

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19 Id.
20 Id.
21 PLANT CANCELLATIONS, supra note 1, at 19. According to the study, among the internal sources relied on for construction include retained earnings, depreciation, and deferred taxes.
22 Id. at 26.
23 Id.
24 The study also found that in the southwest and north central regions of the United States, coal-fired plants had a clear economic advantage.
25 PLANT CANCELLATIONS, supra note 1, at 4-32. See also ENERGY INFORMATION ADMINISTRATION, UNITED STATES DEPARTMENT OF ENERGY, STATISTICS OF PRIVATELY OWNED ELECTRIC UTILITIES IN THE UNITED STATES, 1980 ANNUAL CLASSES A AND B COMPANIES (1981); FEDERAL POWER COMMISSION, STATISTICS OF PRIVATELY OWNED ELECTRIC UTILITIES IN THE UNITED STATES, 1974 (1975); MOODY’S PUBLIC UTILITY MANUAL, VOL. 1 (1981); SALOMON BROTHERS, MARKET RESEARCH GROUP (1982).
26 PLANT CANCELLATIONS, supra note 1, at 25. For example, the Public Service Company of New Hampshire’s stock dropped from $20 a share to $8 in six months. This decline coincided with the decline in confidence over the unfinished Seabrook II facility and statements by company auditors that bankruptcy was a possible consequence. Stein, Public Service Stock Hits a Low, Boston Globe, April 4, 1984, at 37.
27 N.Y. Times, Feb. 10, 1984, at D1, cols. 1, 2.
28 PLANT CANCELLATIONS, supra note 1, at 25.
29 Id.
new stock, companies reduced investments in anticipation of slowing the downward slide in stock prices. In the effort to restore the financial health of the utility, such capital intensive projects as nuclear facilities were often the first to be dropped.\textsuperscript{30}

The dramatic losses created by cancellation have prompted investors and the consuming public to question who should bear the costs. To the privately owned power industry, the answer is simple. Since a public utility is a joint enterprise involving private capital and public regulation, the risks associated with the investment must be shared.\textsuperscript{31} A majority of state jurisdictions,\textsuperscript{32} and the Federal Energy Regulatory Commission,\textsuperscript{33} agree with this position, and apportion the costs of cancelled facilities among both consumers and investors. An alternative approach to this sharing of costs emphasizes the lack of any tangible benefits to consumers.\textsuperscript{34} Finding that cancelled projects are of no use to the consumer,\textsuperscript{35} a growing number of state regulatory commissions have denied any recovery of the investment in the rate structure.\textsuperscript{36}

Utility companies have responded to this denial by challenging the legal authority of a state to deny any recovery through rates. It is asserted that state regulatory agencies are engaged in unconstitutional rate-making.\textsuperscript{37} According to the utilities, the state has confiscated their property in violation of the fifth and fourteenth amendments to the United States Constitution.\textsuperscript{38} It is argued that by requiring the utility to provide efficient and adequate electrical service, the state has encouraged the development of nuclear power.\textsuperscript{39} When the facility is cancelled, the state, through its rate-making power, prevents the industry from receiving an adequate return on its investment.\textsuperscript{40} According to the

\textsuperscript{30} Id. The study notes that nuclear plants have 30 to 100 percent higher capital costs than coal fired facilities.
\textsuperscript{31} See infra at note 111.
\textsuperscript{32} See infra text and notes at notes 112-14.
\textsuperscript{34} This is the used and useful approach to cancellation costs. See infra text and notes at notes 144-52.
\textsuperscript{35} Stoler, supra note 7, at 34.
\textsuperscript{36} Infra at note 114.
\textsuperscript{37} Id.
\textsuperscript{38} Id.
\textsuperscript{39} Id.
\textsuperscript{40} Id.
utility industry, this return falls below the constitutional minimum as recognized by the United States Supreme Court.\textsuperscript{41}

This article will focus on the constitutional parameters of utility rate-making, with particular emphasis on the issue of cancellation costs of privately owned utilities.\textsuperscript{42} Section II examines the rate-making process and provides an overview of how state and federal agencies adjust utility rates. The three components of a rate-making scheme—operating expenses, the ratebase, and the rate of return—will be discussed. Section III explores how cancellation costs are accommodated within this process. A survey of the various methods of treating cancellation costs illustrates that while a minority of states either grant or deny the utility the entire amount, a majority of jurisdictions apportion losses among both investors and consumers.

Finally, Section IV reviews the constitutional challenge to complete denial in \textit{Cleveland Electric Illuminating Co. v. Public Utilities Commission of Ohio}. Beginning with a general discussion of takings in the context of public utilities, the analysis turns to Ohio's regulatory scheme and alleged constitutional infirmities. The significance of rulings by the Ohio courts and United States Supreme Court will then be discussed. The article concludes by suggesting that while constitutional limitations on state rate-making do exist, legislatures can adopt laws which deny any recovery of expenses incurred in the construction of cancelled plants.

\section{II. THE RATE-MAKING PROCESS}

An analysis of how cancellation costs are apportioned by state and federal regulatory agencies necessitates a general description of the rate-making process. The role which government plays in the field of public utilities can be traced to the 19th century, when a combination of market forces and public demand resulted in regulation over certain industries in the private sector.\textsuperscript{43} By the

\textsuperscript{41} \textit{Id.}

\textsuperscript{42} The utility industry consists of both public and private companies; only the latter is discussed in this article. Such public facilities as the Tennessee Valley Authority and the Washington Public Power Supply Company have unique regulatory problems upon cancellation of a plant. In contrast to privately owned facilities, where both investors and ratepayers divide the costs of cancellation, public facilities can only resort to ratepayers for recovery. \textit{See generally PLANT CANCELLATIONS, supra} note 1, at 38.

\textsuperscript{43} For a general history of government regulation of the private sector, \textit{see generally FAINSOD, GORDON \\& PALAMOUNTAIN, GOVERNMENT AND THE AMERICAN ECONOMY} (3d ed. 1959).
20th century, this regulation had great impact on public utilities. Both state and federal agencies created utility commissions, which are responsible for overseeing the public utility enterprise.\textsuperscript{44} A primary responsibility of these commissions is the setting of utility rates. This is achieved by adopting a rate-making "formula," which is calculated by considering the various expenses incurred by the utility, and determining what expenses are to be passed on, through rates, to the consumers.

A. The History of Public Utility Regulation

The origins of public utility regulation can be understood with reference to market forces. Under a perfect market system, competition among enterprises fosters the lowest possible prices for the consumer and the most efficient distribution of scarce resources. However, when the marketplace is dominated by only a single or by few enterprises, efficiency and economy are no longer promoted; instead, output is reduced and prices increase. To combat these adverse effects, the government restricts market dominance.\textsuperscript{45}

For industries "clothed with a public interest,"\textsuperscript{46} regulation took a different form. Government recognized that some enterprises continued to function efficiently and in the public interest by dominating the market.\textsuperscript{47} Therefore, instead of attacking their market power, both state and federal governments imposed continuous supervision. In the early 19th century, state governments assumed this supervisory role by regulating innkeepers, carriers, and ferrymen.\textsuperscript{48} By the 1870's, states imposed restrictions on grain warehouse rates; and by the 1880's, railroads were subject to regulation in 30 states and territories.\textsuperscript{49} At the federal level, Con-

\textsuperscript{44} Id.


\textsuperscript{46} See infra text at note 169.

\textsuperscript{47} E. NICHOLS, RULING PRINCIPLES OF UTILITY REGULATION, RATE OF RETURN 70 (1955).

\textsuperscript{48} For example, in 1820, Congress permitted the District of Columbia the power of supervising private wharves and chimney sweeping. Act of May 15, 1820, Ch. 104, § 7, 3 Stat. 587. See also SCHWARTZ, supra note 45, at 31.

\textsuperscript{49} SCHWARTZ, supra note 45, at 31.
gressive responded with the creation of the Interstate Commerce Commission.\(^{50}\) This combination of state and federal regulation has, throughout the 20th century, resulted in supervision over a wide range of industries, including transportation, communications and energy.\(^{51}\)

Government regulation over private industry takes many forms.\(^{52}\) Antitrust laws, for example, have an indirect effect on industry by proscribing certain behavior in the marketplace.\(^{53}\) Economic regulation, on the other hand, has a direct impact on the industry, as the regulator—often granted the authority of setting rates—substitutes the forces of the marketplace with prescribed revenue requirements and maximum rates of return.\(^{54}\) The regulation of nuclear power is primarily economic. Commissions are authorized to assure fair prices, adequate service, and a reasonable rate of return for the utility investor.\(^{55}\)

**B. The Elements of the Rate-making/Rate of Return Approach**

The primary concern of a public utility regulator is the fixing of rates.\(^{56}\) Often acting under a broad statutory mandate to set rates that are “just and reasonable,”\(^{57}\) state and federal regulatory commissions determine a rate structure that defines which costs are to be passed along to the consumer, and dictates the proper rate of return to the utility investor. The traditional formula in setting rates is the Ratebase/Rate of Return approach: operating expenses (“O”) plus the ratebase (RB) multiplied by the rate of return (RR)(O + RB x RR).\(^{58}\)

Operating expenses, the first component in the formula, are simply those reasonable costs incurred by the utility in providing

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\(^{50}\) The commission was created through the Interstate Commerce Act, 49 U.S.C. § 11 (1976).

\(^{51}\) SCHWARTZ, supra note 45, at 31.

\(^{52}\) E. GELLHORN & R. PIERCE, REGULATED INDUSTRIES 7 (1982).

\(^{53}\) Id.

\(^{54}\) Id. at 7-8.

\(^{55}\) Id. at 8.

\(^{56}\) J. BAUER, UPDATING PUBLIC UTILITY REGULATION 1 (1966).

\(^{57}\) In New York, for example, the Public Service Commission enforces PUB. SERV. LAW § 65(1)(McKinney 1984), which states in pertinent part: “All charges made or demanded by any such gas corporation, electric corporation or municipality for gas, electricity or any service rendered or to be rendered, shall be just and reasonable and not more than allowed by law or order by the commission.”
the public adequate service. Some of the more common expense items include maintenance, depreciation and all taxes. More controversial are advertising outlays, which have been included as a cost of rendering service, and losses incurred in the unprofitable pursuit of business, which are often not categorized as an operating expense. One commentator notes that "reasonableness" is the guiding principle when categorizing operating expenses. According to this assertion, if the utility incurs the expenses, it is prima facie reasonable and the burden rests on the party challenging the expense to prove otherwise. Another commentator's interpretation of what constitutes operating expenses is based on the "good faith" standard. It is argued that absent management's bad faith, a regulatory commission cannot "ignore the necessary, fair and reasonable expense of operation incurred in the rendition of service" and must "allow such expenses constituting charges upon income..." 

Once a regulatory commission determines that an item is an operating expense, the utility does not receive the entire amount in one rate determination. Rather, the cost is amortized over a fixed period of time. By spreading the cost over several years, consumers do not make a single payment for property that produces only incremental benefits. To the investor, amortization

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58 A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 45 (1969). The formula has been stated a number of ways. See GELLOHORN & PIERCE, supra note 52, at 97 n.1.
59 PRIEST, supra note 58, at 45. See also BAUER, supra note 56, at 2-4.
60 The classification of all taxes as operating expenses is well established law. PRIEST, supra note 59, at 51. As Justice Brandeis stated in Galveston Elec. Co. v. City of Galveston, 258 U.S. 388, 399 (1922), "[i]t is necessary to deduct from gross revenues the expense and charges, including all taxes."
62 BAUER, supra note 56, at 3.
63 Id.
64 PRIEST, supra note 58, at 50.
65 Id. at 50.
66 Id. at 67. For an illustration of how the Federal Energy Regulatory Commission defines amortization, see 18 C.F.R. 101 (1984), which describes the accounting principle in the following manner: "[T]he gradual extinguishment of an amount in an account by distributing such amount over a fixed period, over the life of the asset or liability to which it applies, or over the period during which it is anticipated the benefit will be realized."
prevents the immediate advantage of an expense whose useful life is longer than the rate period.

Added to operating expenses is the second component of the formula, the ratebase. This component is “the total investment in, or fair value of, the facilities of a utility employed in providing its service.” While jurisdictions disagree over the appropriate method to use in measuring the value of the base, a completed project will often be included in the rate structure if it is determined that construction was “prudent” or “used and useful” to the consumer. As stated by Justice Brandeis in Missouri ex rel. Southwestern Bell Tele. v. Missouri Pub. Serv. Comm’n, prudence involves “investments which, under ordinary circumstances, would be declared reasonable.” Similar to operating expenses, there is a presumption that reasonable judgement is exercised. The burden, however, rests on the party challenging the investment.

The “used and useful” concept is controversial. The principle is based on the belief that consumers should only be burdened with a utilities’ expenses if there is some immediate benefit to the public. Absent a statutory mandate to exclude all property not providing current service to the consumer, some regulatory commissions, through their discretionary authority, have expanded the concept to include cancelled facilities that were prudently constructed but which provided no direct benefit to the consumer.

When costs involve the construction of facilities, a commission must consider whether the cost of “construction work in progress” (CWIP) and “allowance for funds used during construction” (AFUDC) are to be included. CWIP costs, which include labor,

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67 PRIEST, supra note 58, at 139.
68 Id.
69 Id. See also NEPCO Mun. Rate Comm’n v. F.E.R.C., 668 F.2d 1327, 1333 (D.C. Cir. 1981).
70 262 U.S. 276, 289 n.1.
71 Id.
73 See infra text and notes at notes 144-52.
74 See infra text and notes at notes 115-42.
76 PLANT CANCELLATIONS, supra note 1, at 37. See also EDISON ELECTRIC INSTITUTE, SURVEY ON CONSTRUCTION WORK IN PROGRESS IN RATE BASE (1976).
77 Id.
materials, and property, are frequently denied rate-base treatment by the discretion of the regulatory commission because they are not "used and useful" to the public.\(^78\) When CWIP costs are denied, utilities are often permitted to recover the expense through AFUDC by accumulating the cost of capital in CWIP.\(^79\) AFUDC costs are essentially the accumulated costs of capital in constructing the plant. They can be incurred through interest payments in debt financing, or dividend payments to both preferred and common shareholders. Upon completion of the facility, both CWIP costs and accumulated AFUDC costs become incorporated in the ratebase. Through this method, utilities earn a deferred return on CWIP expenses.\(^80\)

Once the ratebase has been determined, the final task is to select a percentage figure rate of return. This rate is multiplied by the base to establish a fair return for the utility investor.\(^81\) The rate of return involves the cost of capital incurred in the financing of a project. A substantial amount of capital is borrowed through debt financing and preferred stock, both requiring annual interest and dividend payments. Additional capital is raised through common equity shareholders who demand a return on their investment.\(^82\)

There is no precise formula for calculating a fair rate of return.\(^83\) Unlike the ratebase, which is determined largely by the discretion of the regulatory commission, the fair rate of return is subject to substantive judicial review to insure that the return granted does not amount to an unconstitutional taking.\(^84\)

As a primary function of regulatory commissions, the setting of rates involves the classification of costs into the various components of the rate-making formula. Regulators are granted broad

\(^78\) As clarified by the Massachusetts Department of Public Utilities, excluding CWIP costs is not a determination that the utility does not deserve a return on invested capital; rather, "it simply is a policy choice to defer recovery of those legitimate earnings until the project is completed." See infra note 115, at 456.

\(^79\) E. GELLHORN, REGULATED INDUSTRIES 122 (1982).

\(^80\) Id.

\(^81\) PRIEST, supra note 58, at 191.

\(^82\) One commentator likens the rate of return to no more than a fishing license: "The utility's return allowance might be compared to a hunting or fishing license with a limit on the catch. Such a license does not guarantee that the holder will catch anything at all; it simply makes the catch legal (up to a specified limit) provided the holder is successful in his efforts." F. WELCH, CASES AND TEXT ON PUBLIC UTILITY REGULATION 478 (1968).

\(^83\) See generally BAUER, supra note 57, at 14-73.

\(^84\) See infra text and notes at notes 153-205.
authority in the rate-making process, and exercise wide discretion in determining what costs incurred by the utility will be passed along to the consumer. In recent years, the costs of cancelled nuclear facilities have been the center of controversy in rate-making proceedings.

III. INCLUSION OF CANCELLATION COSTS

The costs associated with cancelled nuclear facilities can represent a high percentage of a utility's capital expenditures. In the rate-making process, utilities request the recovery of these costs through higher rates. It is the responsibility of the regulatory commission to determine the revenue requirements of the utility and insure the utility a fair rate of return on its investment. This section reviews the expenses incurred by a utility in the cancellation of a nuclear facility. Following this discussion is a survey of the methods employed by various jurisdictions in apportioning the expenses between the rate-payer and the investor.

The termination of a plant is a costly matter. Cancellation costs include a large outlay of cash expenditures devoted to the purchase of land, labor, materials, equipment, studies, and permits and licenses. Additionally, the utility incurs AFUDC, contract cancellation penalties, salvage value, and site shutdown expenses. To recoup these losses, the utility appeals to the proper regulatory commission, requesting a rate increase that reflects the increased revenue requirements to cover the expense. The agency then faces the difficult and controversial task of properly characterizing the losses.

As previously discussed, cancellation costs can be considered either as operating expenses or as a portion of the ratebase. When a commission excludes recovery, the investor assumes the entire loss. If, however, the commission places the costs under either category of the rate-making formula, the issue becomes whether the full amount is to be recouped. If the utility is granted

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85 According to the Department of Energy Study, these cash expenditures are often the largest portion of the cancellation expense and, at the time of cancellation, the expense most accurately known. PLANT CANCELLATIONS, supra note 1, at 37.

86 These penalties occur when the plant is cancelled prior to the completion of contract work with vendors. While settlements are often negotiated, this abandonment cost is significant. Id.

87 The salvage value, while not a direct cost, is considered a "negative" cost. It is the amount gained from the resale of the abandoned facility.

88 PLANT CANCELLATIONS, supra note 1, at 33-38.

89 See supra text and notes at notes 59-82.
recovery, an additional consideration is whether the costs will be recouped in one rate adjustment, or amortized over a number of years. Unique statutory schemes and varying regulatory practices defy broad generalizations about cancellation cost treatment. Despite different approaches, apportionment falls into three broad categories: complete recovery of the investment; partial recovery with varying time periods of amortization and, in some cases, disallowance of the cost of capital; or complete denial of costs associated with a plant not currently used and useful.

A. Full Recovery of Costs

New York is the only jurisdiction to grant utilities full recovery of cancellation costs on a regular basis. Given the authority to set rates that are "just and reasonable," the New York Public Service Commission (NYPSC) permits recovery despite the general principle in the regulatory field to deny a portion of the investment. The loss is categorized as an operating expense, amortized over a period of time. The unamortizable component of the rate-making formula, the ratebase, assumes the cost of capital.

The decision of the NYPSC in *Re Rochester Gas & E. Corp.* illustrates this treatment of cancellation costs. In 1980, Rochester Gas & Electric Corporation joined three other area utilities in requesting the permission to recover their investment in the cancelled Sterling power project. The utilities argued that costs for the construction of the physical plant were "operating expenses" that should be amortized. The balance of the loss, the cost of capital and AFUDC, should receive ratebase treatment. In opposing this comprehensive recovery, consumer groups argued that because public utilities are joint economic ventures between consumers and investors, there should be an equitable

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90 *PLANT CANCELLATIONS, supra* note 1, at 49.
91 N.Y. PUB. SERV. LAW, § 65, subd. 1; § 66, subd. 12; § 72 (McKinney 1984).
92 See infra text and notes at notes 111-52.
93 *PLANT CANCELLATIONS, supra* note 1, at 49.
94 45 PUB. UTIL. REP. 4th (PUR) 386 (1982), Opinion No. 82-1.
95 These included Orange and Rockland Utilities, Inc., Central Hudson Gas and Electric Corporation, and Niagra Mohawk Power Corporation. *Id.* at 387.
96 *Id.* at 387.
97 *Id.*
98 *Id.*
99 *Id.* at 391.
sharing of costs. The NYPSC disagreed, and adopted the approach of the utility.

Beginning with the premise that the investment in the project is an amortizable operating expense, the NYPSC refused to depart from the common practice of including capital cost in the ratebase, "irrespective of the relative benefits that may have flowed from the abandoned or incomplete project." The commission refused to accept the economic argument, asserted by Commissioner Mead in a vigorous dissent, that public utilities are a "sharing of responsibility between the ratepayers and the shareholders." The commission placed heavy emphasis on the utilities' "service obligation," a legal requirement in New York that utilities must provide efficient and adequate electrical service.

New York is not alone in granting full recovery of cancellation costs. For example, North Carolina's Public Service Commission (NCPSC), acting within its discretionary authority, permitted Virginia Electric and Power Company (VEPCO) to recover losses of its North Anna 4 facility through an operating expense amortization, and in the ratebase as a component of working capital. While following New York by categorizing the loss as a cost of service, the NCPSC granted only partial rate base treatment of the unamortized portion by making a distinction between the senior capital shareholder and the investor of common equity. The commission ruled that because senior capital shareholders were only associated with the cancelled facility through their original investment, the utility should recover all capital costs in the rate base. As to the common equity shareholder, who could actually influence the entities' day to day policies, the commission was less sympathetic and denied certain components of the ratebase.

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100 Id.
101 Id.
102 Id. at 412.
103 Id. at 391.
104 PLANT CANCELLATIONS, supra note 1, at 49; PIERCE, supra note 10, at 518 n.119; A Survey of Regulatory Treatment of Plant Cancellation Cost, 111 PUB. UTIL. FORT. (Mar. 31, 1983) 52.
106 Id. at 346.
107 Id. at 347.
108 Id.
109 Id.
While reaching a similar result, New York and North Carolina have different regulatory philosophies. New York embraces the argument that utilities should be granted full recovery because state law requires them to meet their service obligation efficiently and adequately, and nuclear power is a response to that requirement. The North Carolina Commission has rejected this approach, and instead treats recovery as an equitable issue, with emphasis on the degree to which each investing party participates in the flawed investment.\footnote{Full recovery of cancellation costs, as demonstrated in Re Rochester Gas & E. Corp., is not without controversy. At least one commentator attacks the approach as an incentive to the utility to behave contrary to the public interest. It is argued that full recovery allows the utility to earn a favorable rate of return irrespective of the wisdom of the investment. Moreover, in many cases, an incentive is created to cancel plants that would otherwise benefit the consumer, since commissions often impose penalties for excess capacity; in this circumstance, economic benefits are greater than completion costs. Pierce, supra note 10, at 542. An alternative view applauds New York's full recovery approach on the basis that in some circumstances, cost apportionment preserves a favorable market for utility stock and prevents the cost of capital from rising. Robinson, Utility Fiascoes—Who Should Pay?, 108 Pub. Util. Fort. (Dec. 17, 1983) 17, 19-20.}

**B. Partial Recovery**

A majority of state jurisdictions,\footnote{For a list of state jurisdictions which have granted partial recovery, see Plant Cancellations, supra note 1, at 44-45.} along with the Federal Energy Regulatory Commission,\footnote{For an illustration of apportionment under the Federal Energy Regulatory Commission, see Northern States Power Co., [1979-1982 Transfer Binder] Util. L. Rep. (CCH) ¶ 12,516, at 15,987 (F.E.R.C. 1981).} grant partial recovery. While apportionment schemes vary considerably,\footnote{Plant Cancellations, supra note 1, at 43-48.} the distribution of losses is based on the widely recognized regulatory concept that the operation of a public utility involves risks and controls that must be shared equally by investors and consumers.\footnote{Pierce argues that apportioning the loss between the consumer and the investor by, for example, allowing the utility to recover out of pocket expenses but denying a portion of the cost of capital, "creates[s] the proper incentive for plant investment." Pierce, supra note 10, at 543. Pierce provides a thorough analysis of both legal and economic issues confronting regulators of the nuclear industry.}

This "joint venture" approach to apportioning losses can be found in Re Boston Edison Company,\footnote{Re Boston Edison Co., 46 Pub. Util. Rep. 4th (PUR) 431, appeal aff'd, Attorney} Boston Edison Company's 1981 rate case before the Massachusetts Department of Public Utilities (DPU). In 1971, Boston Edison Company (BECO) made
the decision to construct a second nuclear facility, Pilgrim II, in Plymouth, Massachusetts.\textsuperscript{116} While Pilgrim II had a number of investors,\textsuperscript{117} BECO owned approximately 59\% of its stock.\textsuperscript{118} Throughout the 1970’s, BECO’s construction was plagued by financial uncertainty,\textsuperscript{119} regulatory lag,\textsuperscript{120} and decreased use of energy.\textsuperscript{121} Financial analysts lowered the company’s bond ratings,\textsuperscript{122} sending BECO’s financial stability into question.\textsuperscript{123} In 1977, the construction was further hampered by regulatory delays from the Atomic Safety and Licensing Board;\textsuperscript{124} it was not until the beginning of 1980 that the Nuclear Regulatory Commission granted BECO a construction permit.\textsuperscript{125} By that time, the projected completion cost of Pilgrim II grew to $3.22 billion.\textsuperscript{126} Despite the company’s commitment to build Pilgrim II in the midst of regulatory delays and inflated costs, the project was cancelled on September 23, 1981.\textsuperscript{127} The utility immediately appealed to the DPU for full recovery of its $278 million loss.\textsuperscript{128}

Acting under its broad discretionary authority,\textsuperscript{129} the DPU found that cancellation losses required “separate, independent and unique rules that properly reflect the just balance of the affected interests.”\textsuperscript{130} The commission divided the costs between the utility investor and the consuming public by permitting recovery of all costs prudently incurred. All expenditures occurring after June, 1980 were disallowed on the basis that it was then that “project uncertainty had become intolerably high” and cancella-

\begin{itemize}
\item Re Boston Edison Co., 46 PUR 4th at 433.
\item Id.
\item Id. at 462-70.
\item Id.
\item This factor was emphasized in the Supreme Judicial Court’s opinion in Attorney General v. Department of Public Utilities, 390 Mass. Adv. Sheets 208, 229, 455 N.E.2d 414, 426 (1983).
\item Id.
\item Id. at 463.
\item Id. at 469.
\item Id.
\item 390 Mass. Adv. Sheets at 210, 455 N.E.2d at 415.
\item Re Boston Edison, 46 PUR 4th at 434.
\item The Massachusetts Department of Public Utilities acts under the authority of MASS. GEN. LAWS ANN. ch. 164, § 94 (West 1976).
\item Re Boston Edison Co., 46 PUR 4th at 435.
\end{itemize}
tion would have been prudent. Those costs made before June of 1980 were recovered through the rate structure over a 13 year amortization period.

Several considerations contributed to DPU’s decision to reject the exclusion of all investments not “used and useful.” First, DPU’s apportionment scheme was widely shared by other state regulatory agencies facing the issue of extraordinary utility losses. Second, the DPU found compelling the magnitude of BECO’s investment and the potentially harmful effects of complete denial of recovery on the company’s ability to provide adequate service. The agency noted that the loss represented 25% of the company’s permanently invested capital. DPU regulations prevented the recovery of CWIP or AFUDC costs until the completion of the project. Thus, BECO was faced with the prospect of writing off the entire $278 million as a loss. The consequences of such a loss would be, according to the DPU, quite dramatic. With such a result, an investment in BECO would be viewed as too high a risk, and the company would be threatened by insufficient capital. In short, the financial consequences were considered “inevitable and devastating.” The agency accepted BECO’s gloomy scenario of loss of earnings, lower bond ratings, and the increased cost of capital. The financial instability described by BECO was, in the opinion of DPU, “acute enough to give us great pause.”

131 Id. at 470.
132 Id. at 473. While allowing certain prudent costs to be recovered through the rate base, the DPU did not allow recovery of the equity rate of return portion of AFUDC, which was denied on the basis of regulatory precedent.
133 46 PUR 4th at 435.
134 The Department emphasized that “the ability of the company to meet its service obligation in an adequate fashion must be, we submit, the prior and controlling consideration here.” Re Boston Edison Co., 46 PUR 4th at 460.
135 Id. at 456.
136 Id. at 471. The reasons for excluding the equity portion of the AFUDC were put forth by the Department: “We are convinced by the company’s argument that the shareholder will never realize a return on his investment as found appropriate by the department, if the scales are ‘perpetually tipped’ toward the ratepayers. A ‘good faith’ decision to invest funds in construction projects is not a sufficient ground to guarantee a return on an ultimately failed investment.”
137 Id. at 459.
138 Id. The DPU was unwilling to accept the opinion of Commissioner Sprague, whose lone dissent emphasized the application of the used and useful approach to ratemaking. Sprague, in asserting the used and useful argument, was unconvinced that the consumer should share in the financial risks of the investor: “In our free enterprise system, it is a fundamental business principle that the owners of a corporation benefit when a corporate strategy creates profits, but bear the burden when funds are expended on ventures that fail.” Id. at 479.
On appeal in Attorney General v. Department of Public Utilities, the Massachusetts Supreme Judicial Court found that the DPU was within its statutory authority to reject the used and useful approach. The court found no compelling reason to alter its practice of showing judicial deference to utility rate-making. Judicial deference, however, did not prevent the court from commenting on the agency’s decision. In upholding the order, the court noted with approval DPU’s concern for preserving investor confidence in the utility industry. In fact, the court agreed that disallowing recovery might pose a “serious threat to the company’s integrity.”

Massachusetts illustrates how one jurisdiction grants ratebase treatment of cancelled nuclear project losses. In Re Boston Edison Co., the commission applied a prudence standard in dividing costs between the consumer and the investor. The Commission refused to saddle the consumer with imprudent business decisions; however, a concern for financial stability and the continued service obligation made apportionment of prudent investment losses inevitable.

C. Complete Denial of Cancellation Costs

In Ohio, Oregon, Wyoming, and Washington, utilities are often denied any recovery of cancellation costs. In Office of Consumers’ Counsel v. Public Utilities Commission, for example, the Ohio Supreme Court reversed a commission order granting rate recovery of the cancellation costs associated with four nuclear facilities. The court construed Ohio law as prohibiting recovery

140 Id.
142 As the court stressed, “investor confidence is not an insignificant element in utility regulation. A judgement that the adverse consequence of disallowing of recovery would be a serious threat to the company’s integrity, and indirectly to its customers, was warranted.” Id.
143 See PIERCE, supra note 10, at 518-19. Pierce notes that other commissions apply the “used and useful” approach when dividing costs. Unlike Massachusetts, other jurisdictions assume the decision to invest is prudent, but deny investors a return on the cost of capital. Therefore, the utility recovers all operating expenses. Id. at 518-19.
144 See PIERCE, supra note 10, at 519 n.128-129.
146 See infra text and notes at notes 217-22.
of investments that fail to provide service, since the cost failed to meet the definition of operating expenses.\textsuperscript{147}

In other jurisdictions, legislative denials of recovery are more explicit. In \textit{Pacific Power & Light Company},\textsuperscript{148} Oregon law prevented the utility from recovering costs in the cancelled Pebble Springs and WPPSS No. 5 nuclear facilities.\textsuperscript{149} In Wyoming, a similar statutory provision prevented the commission from allowing recovery of the failed WPPSS 4 & 5 and Pebble Springs facilities.\textsuperscript{150}

Administrative discretion can also result in complete denial. In Washington, for example, the Pacific Power & Light Company's request for recovery of their losses in Pebble Springs and WPPSS was rejected.\textsuperscript{151} The commission reasoned that other regulatory bodies with jurisdiction over the cancelled facilities had already granted favorable treatment. Allowing further rate relief would result in double recovery.\textsuperscript{152}

A survey of state and federal treatment of cancellation costs associated with nuclear projects indicates that complete denial or complete recovery is rare. More common is the division of costs between utility investors and consumers. When state law prevents any recovery associated with a cancelled facility, a utility can assert that exclusion of such costs prevents the utility investor from earning a reasonable rate of return. It is argued that the

\textsuperscript{147} Id.
\textsuperscript{148} 49 PUB. UTIL. REP. 4th (PUR) 82 (Or. Puc. 1982); see also American Bar Association, 1983 Annual Report, Section of Public Utilities Law 83.
\textsuperscript{149} OR. REV. STAT. § 5 Ch. 757, 355 (1979) provides: "[N]o public utility shall, directly or indirectly, by any device, charge, demand, collect or receive from a ratebase which includes within it any construction, building, installation, or real or personal property not presently used for providing utility service to the customer."
\textsuperscript{150} Lower Valley & Light Inc., No. 9617-sub 11, at 9 (Pub. Serv. Comm'n of Wyo., Dec. 2, 1982). Wyoming law instructs the regulatory commission to include only "the property and business of any public utility used and useful."
\textsuperscript{151} Washington Utils. & Transp. Comm'n v. Pacific Power & Light Co., 51 PUB. UTIL. REP. 4th (PUR) 158 (Wash. Utils. and Transp. Comm'n, 1983). See also People's Orgn. For Wash. v. State of Washington Util., 101 Wash. 2d 425, 679 P.2d 922 (1984). There, the Washington Supreme Court held that a statute empowering the commission to determine fair value for rate-making purposes for property used and useful to consumers did not allow inclusion in the ratebase for cancellation of two nuclear facilities. The court held that the uncompleted facilities were not used and useful to the public and, therefore, the commission could not grant ratebase treatment for CWIP costs.
state has confiscated property in violation of the fifth and fourteenth amendments to the United States Constitution.

IV. RATE-MAKING AND THE CONFISCATION DOCTRINE

While state and federal regulatory agencies are not uniform in their apportionment of losses, each rate-setting order must conform to constitutional standards. The Takings Clause of the fifth amendment, and by incorporation the fourteenth amendment, provides that no private property shall be taken by government without just compensation. Within the context of the government’s regulation of utility rates, this clause is referred to as the confiscation doctrine. This section first traces the development of the Takings Clause in the general area of government regulation. Judicial review of public utility regulation is then analyzed.

Government’s regulation of private property does not immediately rise to the level of a taking in which just compensation is due. As stated in Pennsylvania Coal Co. v. Mahon, it is only when regulators have gone “too far [that] it will be recognized as a taking.” While state and federal courts have disagreed on what constitutes “too far,” the prevailing model in takings law is the “diminution in value” theory. Under this approach, the Court focuses on the extent of economic harm. The Court examines the impairment of the owner’s right to profit from her property. If the value is “severely reduced,” a taking has occurred and compensation must follow. The exercise of judicial review of rate-setting orders roughly follows this economic diminution model. However, before discussing the Supreme Court’s con-

153 Specifically, the relevant language of the fifth amendment provides that “property [shall not] be taken for public use without just compensation.” U.S. CONST. amend V.
154 See infra text and notes at notes 172-75.
156 260 U.S. 412 (1922).
157 Id. at 415.
158 Compare State of Maine v. Johnson, 265 A.2d 711 (Me. 1970) (private property subject to state wetlands control board is a taking without just compensation) with Just v. Marinette County, 56 Wis.2d 7, 201 N.W.2d 761 (1972) (not an unconstitutional taking when owner is prevented from filling in marshland). The United States Supreme Court has not been entirely consistent or clear on the subject. See Plater, The Takings Issue in a National Setting: Floodlines and the Police Power, 52 TEX. L. REV. 201, 252 (1974).
160 Id.
161 See infra text and notes at notes 202-05.
temporary treatment of constitutional law and public utilities, a brief legal history will reveal that the Court has not always exercised substantive judicial review in the area of government regulation.

The scope of the fifth and fourteenth amendments became controversial in the 1800's, when federal and state governments recognized the need to regulate certain businesses affecting the public interest. One common form of regulation was the setting of rates which, as the United States Supreme Court ruled in *Munn v. Illinois*,\(^{162}\) was not a taking. The issue before the Court in *Munn* was the constitutionality of an Illinois statute requiring grain elevator operators to obtain licenses and abide by certain rate limitations.\(^{163}\) The owners of one grain elevator asserted that the statute was invalidated by the fourteenth amendment's proscription against government deprivation of property without compensation.\(^{164}\) In rejecting the argument, the Court explained why property "affected with a public interest"\(^{165}\) could be regulated. The Court described the power to regulate certain commerce as a power "inherent in every sovereignty."\(^{166}\) Following the tradition of English common law, the Court ruled that when "private property is affected with a public interest," it can no longer be considered entirely "private."\(^{167}\) Property becomes imbued with this public interest when, according to the Court, "[it is] used in a manner to make it of public consequence, and affect the community at large."\(^{168}\) Without deciding which property fell within the definition of public interest, the Court found that because the grain warehouses were a "gateway of commerce" under which all grain shippers passed, the plaintiff's business was "clothed with a public interest."\(^{169}\)

The Court in *Munn* went beyond affirming the power of a state to regulate certain property by rate-making. It also ruled that the legislature was to be given substantial deference in setting those

\(^{162}\) 94 U.S. 113 (1876).

\(^{163}\) Id. at 115. "An act to regulate public warehouses and the warehousing and inspection of grain, and to give effect to art. 13 of the Constitution of this State," approved April 25, 1871.

\(^{164}\) Id. at 119-22.

\(^{165}\) Id. at 130.

\(^{166}\) Id. at 125.

\(^{167}\) Id. at 126.

\(^{168}\) Id.

\(^{169}\) Id. at 132.
rates. Because the function of determining rates was legislative in nature, it was not the Court's role to "fix a maximum beyond which any charge made would be unreasonable."170 Acknowledging that this rate-making power could be abused, the Court believed that the legislature was the only proper forum for the setting of rates. The Court advised private property owners seeking protection against unreasonable rates "to resort to the polls, not to the courts."171

In the years following Munn, the Court took a closer look at the constitutional parameters of rate-making. While continuing to acknowledge that rate-making was within the proper exercise of the police power, the Court developed a judicial role in the rate-making process. Presented with a state regulation of railroad rates, the Court, in Stone v. Farmer's Loan & Trust Co.,172 declared that rate-making must be reasonable: "[The] power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation. Under pretense of regulatory fares and freights, the state cannot require a railroad corporation to carry persons or property without reward; neither can it do that which in law amounts to a taking of private property without just compensation, or without due process of law."173 The Court in Stone suggested that the issue of reasonableness could only be answered conclusively by the judiciary, with reference to the fifth and fourteenth amendments.174 This standard of reasonableness, developed in later decisions, became recognized as an element of the confiscation doctrine.175

By the end of the 19th century, the Court had several opportunities to emphasize and articulate its substantive role in the regulatory process. In Chicago M & St. P Ry. Co. v. Minnesota,176 for example, the Court struck down as unconstitutional a Minnesota statute delegating to a railroad and warehouse commis-

170 Id. at 133-34.
171 Id. at 134.
172 116 U.S. 307 (1886).
173 Id. at 331.
174 Id. See Justice Frankfurter's concurring opinion in Federal Power Commission v. Natural Gas Pipeline, Inc., 315 U.S. 575, 609 (1942): "[W]hile the doctrine of 'confiscation,' as a limitation to be enforced by the judiciary upon the legislative power to fix utility rates, was first applied in Chicago M & St. P. Ry Co. v. Minnesota, 134 U.S. 418, that decision followed principles, expounded in Stone v. Farmers Loan & Trust Co., 116 U.S. 307. Mr. Justice Waite, who decided the opinion in the Stone case as well as the earlier decision in Munn v. Illinois, 94 U.S.113, was therefore the author of the doctrine of confiscation, and its corolary, judicial review."
175 Id.
sion the final, unreviewable authority in setting rates. Relying on Stone, the Court emphasized that the power to regulate is not without limit, and any statute which prevents the judiciary from considering reasonableness must fall.177

In Covington & Lexington Turnpike Co. v. Sandford, the Court held unconstitutional a Kentucky statute reducing the level of tolls collected by a turnpike owner.178 Accepting the state’s assertion that “it is not the province of the courts to enter upon the merely administrative duty of framing a tariff of rates for carriage,”179 the Court emphasized its responsibility to determine when such rates deprived individuals of their property rights. In Covington, the tolls were so great a financial imposition on the company that roads could not be maintained and dividends could not be distributed to shareholders.180 What began as a valid exercise of the police power became an invalid taking of private property.

Finally, in Smyth v. Ames, the Court held that a Nebraska statute regulating the rate of rail freight deprived companies of just compensation.181 The Court found that the basis for all rate calculations was the fair value of property used by the public.182 The costs of construction, improvements, stocks and bonds, probable earning capacity, and operating expenses were considered important components of the calculation.183 The Court in Smyth v. Ames emphasized a balanced relationship between the regulated investor and the consumer: “What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience,” while the public cannot demand more than the regulated enterprise is worth.184

Between Munn and its decision in Smyth v. Ames, the Court developed constitutional standards for reviewing the regulation of public utilities. While the state could set rates for businesses imbued with the public interest, the reasonableness of these rates was not, as the dissenting justice in Munn v. Illinois feared, “at

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176 134 U.S. 418 (1890).
177 Id. at 455-56.
178 164 U.S. 578 (1896).
179 Id. at 593.
180 Id. at 595.
181 169 U.S. 468 (1898).
182 Id. at 546.
183 Id. at 547.
184 Id.
the mercy of a majority of [the] legislature.”185 Exactly when the imposition of regulation became unreasonable was, of course, a difficult legal issue. While Covington and Smyth v. Ames suggested that reasonableness was linked to the continued success of the company to maintain services and attract investors, it was not until the 20th century that the Court fully developed the concept of confiscation.

In Federal Power Commission v. Hope Natural Gas Co.,186 the Court addressed whether the federal government’s rate-setting of a natural gas utility company was unreasonable and thus a confiscation of property in violation of the fifth amendment. Justice Douglas, writing for the majority, emphasized the concept of judicial deference found in earlier opinions.187 The Court recognized that “under the statutory standard of just and reasonable it is the result reached not the method employed which is controlling.”188 Justice Douglas then proceeded to the constitutional question of “reasonableness.” The adjusting of rates, wrote Justice Douglas, “involve[d] a balancing of the investor and consumer interests.”189 Financial integrity of the company was viewed as a “legitimate concern,”190 since “it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business.”191 The Court then expanded on the concept of revenue requirements: “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.”192 This “financial integrity” test provides a standard for assessing whether a rate-making scheme has deprived public utilities of their constitutional protections against confiscation.193

185 94 U.S. 140 (1876).
186 320 U.S. 591 (1944).
187 Justice Douglas noted with approval the FPC v. Natural Gas concept of judicial deference, stating “under the statutory standard of just and reasonable it is the result reached not the method employed which is controlling.” Hope further recognized that the Commission’s determination has a “presumption of validity,” and that a challenger to a ratemaking order has to overcome a “heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.” Id. at 602.
188 Id. at 602.
189 Id. at 603.
190 Id.
191 Id.
192 Id.
193 See infra text and notes at notes 202-05.
Since the *Hope* opinion in 1944, the Court has had few occasions to comment extensively on the confiscation doctrine and public utilities. In *Permian Basin Area Rate Cases*, the Federal Power Commission prescribed rates for natural gas production. The commission's rate scheme was attacked as confiscatory. On the basis of *Hope*, the Court was unwilling to strike down the rate-making as unconstitutional. The Court concluded that the Commission followed the lessons gained from *Hope* by properly balancing investor and consumer interests. The Court in *Permian*, however, did not emphasize the "financial integrity" test; rather, it declared that the rates fell within a "broad zone of reasonableness."

The significance of the Court's "broad zone of reasonableness" approach in *Permian* is not widely agreed upon. According to one commentator, the decision marks the Court's retreat to *Munn*, when the judiciary exercised no substantial review over rate-making. It is argued that with *Permian*, the Court implicitly conceded that "the Constitution no longer provides any special protection for the utility investor." As a result, it is asserted that the Court has "abandoned even the limited scope of substantive review of rates that it retained in *Hope*." An alternative analysis rejects this reading of *Permian* as a substantive change in the Court's level of judicial review. According to this view, *Permian* merely repeats the *Hope* requirement of insuring financial integrity through a fair rate of return of capital.

An historical analysis of confiscation and public utilities suggests a progression from legislative hegemony to substantive judicial review. Beginning with almost complete deference to the legislature in *Munn*, the Court recognized the judiciary's proper role in rate-making with *Stone, Covington*, and *Smyth v. Ames*. The standard of judicial review, and the articulation of the confiscation doctrine, were further advanced with *Hope* and *Per-
Absent an abrupt change in the Court’s analysis, the confiscation doctrine as applied to public utilities involves four fundamental principles. A challenger to a rate order carries the heavy burden of demonstrating that the order is invalid because it is unjust and unreasonable in its consequences.202 Secondly, the commission’s action will be safe from constitutional attack provided the order falls within a “broad zone of reasonableness.”203 As a third principle, the constitution does not bind regulators to any one single formula or combination of formulas.204 Finally, confiscation will not occur if rates are high enough to “assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.”205

In recent years, these principles have been used by utilities and consumer groups in arguing the proper apportionment of losses associated with cancelled nuclear facilities.206 While the United States Supreme Court has not taken the opportunity to comment extensively on confiscation in the context of cancelled nuclear facilities, the confiscation doctrine has been frequently discussed at the state level.

V. THE CONFISCATION DOCTRINE AND THE OHIO SUPREME COURT

With the increasing cancellation of nuclear projects, state courts have settled the issue of apportionment by reference to the confiscation doctrine. In Ohio, where the construction of two nuclear facilities was terminated prior to completion, the state supreme court applied state law to prevent any recovery. This proscription prompted a constitutional challenge by utilities, and the request was a dramatic and arguably flawed application of the Hope “financial integrity” test. After a brief history of the termination of Ohio’s nuclear facilities, the article analyzes the Ohio Supreme Court’s interpretation of state law and constitutional doctrine in Cleveland Electric Illuminating v. Public Utilities Commission of Ohio.207 An analysis of the appeal to the United States Supreme Court will follow, along with a critique of the

202 Hope, 320 U.S. at 602.
203 Permian, 390 U.S. at 770.
204 Hope, 320 U.S. at 602.
205 Id. at 603.
206 See infra text and notes at notes 223-25.
decision and a discussion of the constitutional parameters of apportionment through legislative reform.

In 1973, the Cleveland Electric Illuminating Company (CEI), in conjunction with other utilities commonly referred to as the Central Area Power Coordination Group (CAPCO), began the construction of four nuclear generating facilities—Davis Besse Units 2 and 3 and Erie Units 1 and 2.\footnote{\textit{Id.}}

Like nuclear development nationwide, lower consumer demand and increased regulatory control throughout the 1970's dampened CAPCO's optimism for the project.\footnote{\textit{Id.}} The Arab Oil Embargo of 1973 forced CAPCO consumers to conserve electricity, thus decreasing the demand for additional sources of energy.\footnote{\textit{Id.}} Moreover, the 1979 accident at Three Mile Island had a disastrous effect on the company.\footnote{\textit{Id.}} The Nuclear Regulatory Commission issued new design requirements for plants of the design used by CAPCO, causing additional delays and cost overruns.\footnote{\textit{Id.}} By January of 1980, CAPCO made the decision to terminate the entire project.\footnote{\textit{Id.}}

Prior to cancellation, CAPCO had spent $246 million on the planning and construction of the facilities. CEI had lost $56.4 million in the project, and in February of 1980 the utility appealed to the Public Utility Commission of Ohio (PUCO) for a rate increase to recover the investment. In \textit{Re Cleveland Electric Illuminating Co.}, the commission granted recovery by categorizing the losses as current operating expenses, with amortization over a 10 year period.\footnote{\textit{Id.}}

Accepting CEI's request, PUCO relied on Ohio law, which empowers PUCO to determine "the cost of the utility in rendering the public utility service for the test period."\footnote{\textit{Id.}} The commission refused to construe the statute in a manner that would limit recovery of operating expenses to property "used and useful" to the public. Instead, PUCO declared that Ohio law gave the agency authority to allow the utility to recoup the losses through a rate increase. In its order, PUCO applied the standard that "if the expenditures are prudent, amortization should be permitted."\footnote{\textit{Id.}}

\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{PUB. UTIL. REP. 4th (PUR) 494} (Ohio Pub. Util. Comm'n, July 10, 1980).}
\footnote{\textit{Id.}}
\footnote{\textit{OHIO REV. CODE § 4909.15 (A)(4) (Baldwin 1983).}}
\footnote{\textit{Re Cleveland Electric Illuminating Company, 38 PUB. UTIL. REP. 4th (PUR) at 526.}}
On appeal to the Ohio Supreme Court in *Consumers Counsel v. Public Utilities Commission* ("Cleveland"), a number of citizens groups and the City of Cleveland challenged the administrative order. Specifically, the plaintiffs focused on whether PUCO could lawfully permit the utility to treat its investment in the four cancelled plants as amortizable costs. It was argued that Ohio law mandates recovery of current operating expenses, and that while a majority of jurisdictions permit recovery, PUCO is not permitted to look beyond state law. In short, the Ohio General Assembly intended that no recovery should be permitted. The court analyzed the statutory language and agreed with appellants that the prudence standard should not be applied. Noting that Ohio law allows the normal, recurring expenses of the utility, the court refused to permit CEI's "extraordinary loss" to "be transformed into an ordinary operating expense pursuant to section 4909.15 (A)(4) by Commission fiat." Denying cost recovery and reversing PUCO's order, the court recognized that the loss could cause financial uncertainty. However, this threat, however, did not "imbue the commission with the authority to rewrite the statutes."

The utility sought rehearing of *Cleveland I* on the basis that the prohibition against the recoupment of cancellation costs under section 4909.15(A)(4) constituted a confiscation of private property in violation of the fifth and fourteenth amendments to the United States Constitution. Because Ohio law requires every public utility to meet a service obligation, the utility argued that the construction of the plants was in response to this obligation. Thus, when the facilities failed, the utilities were entitled to recoup their losses either as a component of the ratebase or as operating expenses. The failure of the Ohio General Assembly to accommodate CEI's losses meant that the state was requiring the construction of the facility, and then preventing a reasonable return on the investment.

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217 67 O.O.3d 96, 97, 423 N.E.2d 820, 821.
218 67 O.O.3d at 102, 423 N.E.2d at 826.
219 67 O.O.3d at 103, 423 N.E.2d at 827.
220 Id.
221 67 O.O.3d at 105, 423 N.E.2d at 828-29.
222 Id.
223 Reh'g denied, No. 80-1528, September 1, 1981.
224 See OHIO REV. CODE ANN. § 4905.22 (Baldwin 1983).
225 See infra text at note 242.
The Ohio Supreme Court refused to address the constitutional issue and denied the rehearing.\textsuperscript{226} CEI's subsequent appeal of \textit{Cleveland I} to the United States Supreme Court was dismissed on the procedural basis of a want of a properly presented federal question.\textsuperscript{227} Because subsequent rate adjustments continued to involve the losses associated with the cancellation of the plants, CEI was able to assert its constitutional claim before both PUCO and the Ohio Supreme Court.\textsuperscript{228} In October of 1981, PUCO considered the same expenditures at issue in \textit{Cleveland I}. Mandated by that decision, the commission denied recovery.\textsuperscript{229}

In a second rate proceeding which also involved cancellation costs, the utility again failed to recover losses in the cancelled plants. PUCO, though sympathetic to the utility, was constrained by \textit{Cleveland I}'s ruling that such losses could not be categorized as operating expenses.\textsuperscript{230}

In \textit{Cleveland Electric Illuminating Company v. Public Utilities Commission of Ohio} ("\textit{Cleveland II}"), CEI once more appealed the order to the Ohio Supreme Court, which finally examined the merits of the constitutional argument.\textsuperscript{231} After dismissing the utility's request for a reconsideration of the court's statutory interpretation of section 4909.15(A)(4) in \textit{Cleveland I}, the court addressed the issue of whether the proscription against recovery of cancellation costs was an unconstitutional confiscation of property without just compensation.\textsuperscript{232} The court found controlling its earlier pronouncement in \textit{Dayton Power & Light Co. v. Public Utilities Commission of Ohio}, where a utility unsuccessfully sought the recovery of costs associated with its coal fired generating unit.\textsuperscript{233} In reviewing the history of the confiscation doctrine

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\item \textsuperscript{226} See Ohio Supreme Court, \textit{rehearing denied}, Case nos. 80-1347, 80-1528, 80-1480 (Sept. 1, 1981).
\item \textsuperscript{227} Cleveland Electric Illuminating Co. v. Office of Consumers Counsel, 455 U.S. 914 (1982).
\item \textsuperscript{229} Opinion and Order of the Ohio Public Utilities Commission, Case No. 81-1096-EL-COI. CEI appealed the order to the Ohio Supreme Court, which was dismissed without opinion in Cleve. Elec. Illum. Co. v. Pub. Util. Comm., Case No. 82-165. On appeal, the United States Supreme Court dismissed the case for want of a properly presented federal question. 459 U.S. 1094 (1983).
\item \textsuperscript{230} Opinion and Order of the Ohio Public Utilities Commission, Case No. 81-146-EL-AIR.
\item \textsuperscript{231} 4 Ohio St. 3d 107, 447 N.E.2d 746 (1983).
\item \textsuperscript{232} 4 Ohio St. 3d at 109, 447 N.E.2d at 748.
\item \textsuperscript{233} 4 Ohio St. 3d 91, 447 N.E.2d 733 (1983).
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and public utilities, Dayton was particularly influenced by one commentator's reading of Permian. According to this view, a "broad zone of reasonableness" was an implicit suggestion by the Court that "the Constitution no longer provides any special protection for the utility investor.\(^\text{234}\) Dayton embraced this analysis, noting that since Permian, the United States Supreme Court has continually rejected constitutional claims of confiscatory rate orders.\(^\text{235}\) These rejections stemmed from procedural infirmities,\(^\text{236}\) or for want of a substantial federal question.\(^\text{237}\) As to the latter, the Court has determined that no constitutional claim exists without issuing a full opinion.\(^\text{238}\)

Thus, the court in Cleveland II found Dayton's rejection of the constitutional argument controlling. It was concluded that section 4909.15(A)(4), by disallowing the loss of cancellation, does not violate the fifth and fourteenth amendments to the United States Constitution. For a third and final time, CEI appealed the Ohio decision to the United States Supreme Court.

On appeal, CEI argued that the Ohio Supreme Court misunderstood the meaning of Hope and Permian.\(^\text{239}\) Appellants contended that although Hope rejected the idea that the constitution imposed methodological strictures on the state, the decision did not indicate a return to the Munn v. Illinois standard of legislative hegemony and complete lack of judicial review. The Supreme
Court rejected the appeal for want of a substantial federal question.240

There is considerable doubt whether Ohio's interpretation of the constitution gains support in the case law. While Permian stresses the highly deferential nature of judicial review of rate-making appeals, the Court is careful to remind regulatory commissions that "pertinent constitutional limitations" do exist.241 Among these limitations is the confiscation doctrine. As articulated through Hope, the doctrine involves the assurance that rates are high enough to insure successful operation, maintain financial integrity, attract capital, and compensate investors for their risks.242 Rather than adopt Hope as the proper standard, the court in Dayton and Cleveland II reduced the concept of judicial deference to judicial abdication.

The Ohio Supreme Court took the unnecessary step of engaging in a historic debate over the effect of Permian's "zone of reasonableness" test on the Hope "financial integrity" test. Leaving aside this ambiguity in constitutional law, the Ohio rate-making scheme could have been saved from a takings challenge without the court's speculation on the lasting validity of Hope. In the circumstances of Cleveland I, the issue of confiscation could have been addressed by reference to the financial impact of denying recovery. There was every indication, from both company and investor analysts, that a denial of recovery would not have seriously jeopardized the future obligations of the utility to its customers or the future investments of shareholders.243 The court could have simply concluded that the stability of the company was not in serious jeopardy. The rate-order, therefore, was well within either Permian's "broad zone of reasonableness" or Hope's "financial integrity."

When Cleveland II was appealed to the United States Supreme Court, the dismissal for want of a substantial federal question only contributed to the confusion over the confiscation doctrine.

240 104 S. Ct. 47, 78 L.Ed. 68 (1983).
241 Permian, 390 U.S. 769.
242 See supra text and note at note 192.
243 Justice Lochner, in his concurring opinion in Cleveland I, was impressed by the utility's Annual Report of 1979, where shareholders were told that a denial of recovery "should not have a material adverse impact on the financial position of the Company." 67 O.O.3d at 107, 423 N.E.2d at 831. As one company official pointed out, "despite the downturn [in stock prices], CEI is a strong, well-run company; we're not in financial trouble." ENERGY USERS NEWS, Feb. 1, 1982.
If, as both courts and commentators maintain, the dismissal is a ruling on the merits,\textsuperscript{244} it might also indicate the Court's willingness to accept Dayton's pronouncements that "the Constitution no longer provides any protection for the utility investor."\textsuperscript{245} Because a summary disposition can occur only after a cursory review of the case, it would seem that the significance of the Court's dismissal of Cleveland II cannot indicate more than its willingness to accept the outcome that Ohio law does not violate the fifth and fourteenth amendments to the United States Constitution.

**VI. CONCLUSION**

Dayton's sweeping assertion about the confiscation doctrine and public utilities presented a compelling reason for the United States Supreme Court to accept the appeal and issue a full opinion. The summary dismissal leaves unresolved the future of the Hope "financial integrity" test during a time of increased cancellations and a growing desire by courts and commissions to receive guidance on the issue. If the Ohio Supreme Court's analysis is followed, the task of judicial review will be highly deferential and quite possibly an inaccurate reading of constitutional law. On the other hand, an application of the Hope standard requires the Court's attention to economic factors which indicate the degree of operational success and financial integrity.

While the application of Ohio law to CEI would seem to pass the more stringent test of Hope, other cancellations require more difficult judicial decisions. For example, the Public Service Company of Indiana has claimed that without relief connected with the cancellation of the half-built, $2.5 billion Marble Hill nuclear project, bankruptcy will result.\textsuperscript{246} If Indiana's regulatory agency denied all recovery through the ratebase, a court would have to apply the Hope test by assessing financial stability and determining whether a confiscation had occurred. This determination involves economic conjecture, and is arguably beyond the competency of the judiciary. The alternative, however, is a sweeping denial of any constitutional protection. As this article suggests, this approach is not well grounded in legal precedent.

\textsuperscript{244} See supra note 238.
\textsuperscript{245} See supra text at note 234.
\textsuperscript{246} N.Y. Times, at D1, cols. 5-7. The history of Marble Hill is a familiar one. Construction began in 1975, when the Public Service Company of Indiana was experiencing steady growth. The plant's future was jeopardized by conservation efforts and regulatory lag. The cost increased from the original projection of $1.4 billion to over $7 billion.