Ratemaking Issues in Virginia: Suggestions for Legislative Clarification

Andrew P. Miller

Henry M. Massie
RATEMAKING ISSUES IN VIRGINIA:
SUGGESTIONS FOR LEGISLATIVE CLARIFICATION

ANDREW P. MILLER* AND HENRY M. MASSIE, JR.**

As one of the most powerful regulatory bodies in the United States, the State Corporation Commission often has been referred to as the fourth branch of government in the Commonwealth.1 The Commission was created by section 155 of the Constitution of Virginia of 1902, which conferred jurisdiction on it to prescribe the rates and regulate the services of transportation and transmission companies, to create and supervise corporations, and to levy state taxes on railroads and assess their property subject to local taxation.2 Section 156(c) of the Constitution also provided that "the Commission may be vested with such additional powers, and charged with such other duties . . . as may be prescribed by law in connection with the visitation, regulation or control of corporations." 3 Additional duties were imposed by statute on the Commission in subsequent years.4 The Constitution of Virginia provides that appeal from any final finding, decision settling the substantive law, order, or judgment of the Commission is directly to the Supreme Court of Virginia as a matter of right.5

The authority of the Commission as to its constitutional grant of power was made paramount to that of the General Assembly but, as

---

* A.B., Princeton University; LL.B. University of Virginia. Attorney General of Virginia.

** B.A., LL.B., University of Virginia. Member of the Virginia Bar.


2. The Commission is composed of 12 administrative divisions: 1) Clerk's Office, 2) Enforcement Division, 3) Division of Aeronautics, 4) Motor Transportation Division, 5) Bureau of Insurance, 6) Public Service Taxation Division, 7) Division of Motor Carrier Taxation, 8) Bureau of Banking, 9) Division of Securities and Retail Franchising, 10) Accounting Division, 11) Division of Public Utilities, and 12) Fire Marshal's Office. This list represents the recent realignment of the Commission.

3. Judge Catterall has said that little attention was initially paid to the italicized words; for example, today an individual cannot engage in the sport of sky diving unless that individual, the parachute, the airplane, the pilot, and the drop zone are licensed by the Commission.

4. Some of these additional responsibilities now include the regulation of insurance, banking, public utilities, and the issuance of securities.

5. VA. CONST. art. IX, § 4 (1971). However, Rule 5:18(g) of the Supreme Court Rules provides that the action of the clerk in awarding the appeal is subject to court review.
to its legislative grant, the Constitution provided that the General Assembly was superior. Article IX, section 2, of the present Constitution of Virginia, which became effective July 1, 1971, provides that the Commission shall issue all charters of domestic corporations and all licenses of foreign corporations to do business in this Commonwealth, and charges the Commission with the duty of administering the laws for the regulation and control of corporations doing business in Virginia and regulating the rates, charges, and services of railroad, telephone, gas and electric companies. Thus the constitutional grant of power as to public utilities has been broadened to include gas and electric companies. The jurisdiction of the Commission over other public utilities and in all other areas continues to be statutory, thus being subject to the will of the General Assembly.

The Commissioners are elected by the members of the General Assembly and serve for staggered six year terms. The Constitution provides that at least one member of the Commission must have the qualifications of a judge of a court of record. Although only one need have the qualifications of a judge, the Commissioners themselves actually have judicial, in addition to executive and legislative authority. In adversary proceedings before the Commission, the Commissioners should be looked

7. Article IX, section 1, of the new Constitution provides that there shall be three Commissioners; which number may be increased to no more than five by a majority vote of the members elected to each House of the General Assembly. Bills introduced in the 1972 session of the General Assembly to increase the members of the Commission from three to five were defeated. H. 72, 97 & S. 113, 381, Reg. Sess. (1972). There are conflicting views on the wisdom of increasing the number of Commissioners. Some believe that it will improve the system by providing more and better representation for diverse interests. Others contend that it will become more difficult to get things done and increase the time required to reach agreement since at least three Commissioners will have to concur in every decision. Consequently, they argue, little will be achieved in reducing the workload; the regulatory machinery would simply be made more cumbersome. The advisability of increasing the membership could be resolved by a general management study of the Commission. However, a resolution authorizing such a study was defeated in the House Rules Committee in 1972. S.J. Res. 14, Reg. Sess. (1972).

In addition to the three member Commissioners, the General Assembly has provided for a Commissioner of Insurance and a Commissioner of Banking to be appointed by the member Commissioners. The powers and duties of these positions are delegated by the Commission, which always retains ultimate decision making authority. See Va. Code Ann. § 12.1-16 (1973).

8. See Winchester § S.R.R. v. Commonwealth, 106 Va. 264, 55 S.E. 692 (1906); Norfolk & P.R.R. v. Commonwealth, 103 Va. 289, 49 S.E. 39 (1904); Atlantic Coast Line Ry. v. Commonwealth, 102 Va. 599, 46 S.E. 911 (1904). Virginia Code section 12.1-8 provides that administrative decisions may be made by one Commissioner whereas judicial and legislative decisions require at least two Commissioners.
upon by the parties as if they were judges in the courts of the Commonwealth and the actions of the parties tailored accordingly.9

Certainly one of the most widely known and important responsibilities of the Commission is that of prescribing rates, primarily the rates for electric, gas, and telephone service and for automobile insurance. These are matters that directly affect the pocket-book of every citizen and therefore have been areas of great controversy in the Commonwealth. The rates for electric, gas, and telephone service (public utilities) are made according to an entirely different method of rate making from those for automobile insurance because the former are fixed for each company and the latter generally are fixed for a large group of companies.

The method of public utility rate making employed in Virginia is stated in *Norfolk v. C. & P. Tel. Co.*10:

> Upon undertaking to fix rates for a public utility company of this character, the Commission must necessarily first ascertain (a) the value of the Company's property used and useful in the rendition of its intrastate service, (b) its annual gross revenues, and (c) its annual operating expenses. Upon accomplishing these objectives, it must then determine upon and set the percentage rate of return at such a figure as will afford the utility reasonable opportunity to earn a fair and just return on its investment.11

Insurance rate-making, although less conducive to brief explanation, generally involves determining the percentage of the premium dollar devoted to expenses and profit, the balance of the dollar being the amount that must be devoted to paying losses. Premiums are then adjusted up or down depending on how much the actual percentage losses exceeded or were below what the percentage figure should have been. In other words, if the expenses including profit were set at 40 percent of every premium dollar, 60 percent should be available to pay losses. If losses, however, were 80 percent of every premium dollar, rates would have to be increased to make more dollars available for losses.12 As one can well imagine, the most troublesome and debated point in both public

---

9. Of course, in criminal and tax cases, the Commission, as a court, reviews its action as a prosecutor. In such cases before the full Commission, it is often reviewing the administrative action of a single Commissioner. One is cited by Judge Catterall to “The Mouse's Tale” in “Alice's Adventure In Wonderland.”


11. Id. at 301-02, 64 S.E.2d at 777-78.

utility and insurance rate making is the profit factor.18 This is a critical matter to the Commission, which is charged by the following sections with fixing reasonable rates: 38.1-252, 38.1-279.5,14 and 56-234.

**PUBLIC UTILITIES**

Rate increases by public utilities are initiated by filing an application with the Commission. The case is set for hearing by order of the Commission with requirements for notification to the public15 and dates for the filing of testimony by all parties. After the order has been issued, the case appears on the weekly docket of the Commission until it is heard. Any party desiring to intervene can do so until the hearing has commenced.16

**The Fairfax Decision**

It had always been thought that Virginia had only "Commission-made rates" for public utilities.17 This meant that rates had to be

---

14. This section is a portion of an Act ruled unconstitutional by the Commission on July 2, 1972. The decision is being appealed to the Virginia Supreme Court.
17. Commonwealth v. Old Dominion Power Co., 184 Va. 6, 34 S.E.2d 364, cert. denied, 326 U.S. 760 (1945); Alkali Works v. Northern & W.Ry., 147 Va. 426, 137 S.E. 608 (1927). Temporary emergency relief, however, can be obtained pursuant to section 56-245 until such time as final rates can be approved. The supreme court has requested briefs in a case involving VEPCO (Records Nos. 7904, 7905, 7906) presently before it as to whether or not an order granting a temporary increase under this statute is mature for decision by the court. This section amended by the 1973 General Assembly to allow temporary relief simply upon a finding of an "emergency" by the Commission.
approved by the Commission before they could be used by a utility, regardless of whether the rates became effective pursuant to section 56-238 or section 56-240 (utility applications go into effect as originally filed unless suspended by the Commission). Thus, it was stated by Commissioner Ralph T. Catterall: "[O]ur uniform practice of suspending telephone rates that we disapprove means that failure to suspend means approval of the rates." 18

However, in Board of Supervisors of Fairfax County v. C & P Tel. Co.,19 Justice Thomas C. Gordon, Jr., stated: "We agree with the Company's contention that Section 56-240 sanctions company-made rates because it provides that rate schedules filed by a public utility become effective unless the Commission acts to suspend them." 20 It therefore appeared that all public-service companies, except telephone companies, could use "company-made rates" which had not been approved, if the Commission elected not to suspend the filed rates before the effective date requested in the application.21

It is interesting to note, however, that section 56-35, as amended by the 1971 session of the General Assembly, substituted the phrase "public service companies" for the phrase "transportation and transmission companies" so that the statute now reads in pertinent part: "[T]he Commission shall, from time to time, prescribe and enforce against [public service companies] such rates, charges. . . ." 22 This language raises a question as to whether section 56-240 sanctioning "company-made rates" conflicts with section 56-3523 and, if so, whether the Commission can sanction "company-made rates" for any public service company at this time.


20. Id. at 61, 182 S.E.2d at 32.

21. The Court stated that telephone companies, however, had to proceed under section 56-478, which "sanctions only 'commission-made rates' because it provides that only those rates prescribed by the Commission become effective." Id.

22. It should not be argued that the words "from time to time" mean that the statute contemplates methods of setting rates other than Commission prescription. These same words appeared in article XII, section 156(b) of the 1902 Constitution, which was interpreted in the Fairfax case.

23. That the General Assembly thought there was no conflict is apparent from the fact that both sections were reenacted simultaneously. This was before the Fairfax decision came down in June of 1971, however.
Since the Fairfax decision, rendered pursuant to section 156(b) of the 1902 Constitution which directed Commission prescription of rates for "transportation and transmission" companies, Virginia has adopted a new Constitution. Article IX, section 2 contains no requirement for Commission prescription of rates. In Fairfax, the court had explained that, in order to avoid holding section 56-241 unconstitutional, "we ... interpret that section as prescribing that the Commission's power over telephone company rates shall be as provided in Chapter 10 and 15 of Title 56 only insofar as those chapters do not conflict. And, insofar as those chapters do conflict, Chapter 15 dealing specifically with telephone companies, prevails." 24 As a result, it is debatable whether section 56-240 now applies to telephone companies, since no conflict exists with the 1971 Constitution, irrespective of the possible conflict presented by section 56-35.

A strong argument can be made that, in the absence of any conflict between the Constitution and the statute, there is no compelling reason to interpret section 56-241 so as to avoid the construction which sanctions "company-made rates" for telephone companies. The Commission has not yet employed the now constitutionally permissible procedure of allowing "company-made rates" for all privately owned utilities. There does not appear to be any rational basis for denying this option to telephone companies, and the new Constitution permits such a practice.

The exact "nature of the beast" known as the "company-made rate" is not defined. For example, must a customer who feels he is charged unfairly demand a hearing before the Commission, or can he appeal immediately to the Supreme Court of Virginia? The court expressly did not consider this question in Fairfax: "We leave open the question raised by the Company whether an appeal lies to this Court from a decision of the Commission pursuant to section 56-240 to permit proposed rates to go into effect automatically as a result of the Commission's failure to suspend them." 25 Since the language of section 56-240 speaks of appeal from action of the Commission "prescribing" rates, it is apparent that "company-made rates" are not mature for appeal. If, upon complaint concerning a "company-made rate," a full investigation cannot be completed for many months, can the persons paying the "company-made rate" obtain reparation, and what test period must the Commission

24. 212 Va. at 62, 182 S.E.2d at 33.
25. Id. at 63 n.4, 182 S.E.2d at 34 n.4.
employ to determine whether the rate is "just and reasonable?" These are but two issues that will confront the State Corporation Commission and the Virginia courts in the future.

Rate Prescription—The Portsmouth Gas Case

The supreme court has adopted the following definition of "prescribe" in Commonwealth v. Old Dominion Power Co.26 "According to Webster's International Dictionary, 2d Ed., 'prescribe' means: 'To lay down authoritatively as a guide, direction, or rule of action.'" 27 The Virginia statutes contain no requirement for a public hearing as a prerequisite to the prescription of rates for public utilities, although some court statements imply as much.28 Section 56-245 assumes a hearing on "the final determination of rates" before temporary emergency relief can be granted. Justice Gordon appeared to state a firm position on this point in the all-important Fairfax decision: "The proceeding . . . did not satisfy the procedural due-process requirement of a full hearing on the question of the approval or prescription of rates by the Commission." 29 Furthermore, the United States Supreme Court stated in Railroad Commission v. Pacific Gas & Electric Co.30 that: "The right to a fair and open hearing is one of the rudiments of fair play assured to every litigant by the Federal Constitution as a minimum requirement . . . There must be due notice and an opportunity to be heard, the procedure must be consistent with the essentials of a fair trial, and the Commission must act upon evidence and not arbitrarily . . ." 31 In addition to a full hearing and complete record containing the necessary relevant information, there should be a complete statement of the reasons upon which the action

26. 184 Va. 6 (1945).
27. Id. at .
29. 212 Va. at 62, 182 S.E.2d at 33 (emphasis supplied). Judge Catterall's opinion, however, is that the due process clause can be invoked only by companies that are the only parties from which property may be confiscated. Customers of the companies, he argues, are protected by the "just and reasonable" clauses in the law. One authority cited by him is Norfolk v. C & P Tel. Co., 192 Va. 292, 301, 64 S.E.2d 772, 777 (1951).
31. Id. at 393.
of the Commission was based,\textsuperscript{32} which, under Virginia law, unfortunately need not be written until an appeal is taken.\textsuperscript{33}

In all cases in which application for an increase in rates is made by a privately owned public utility, a hearing is held before a rate increase is granted. During these hearings, the Commission is performing in its legislative-capacity.\textsuperscript{34} Nevertheless, the decision of the Commission must be supported by the evidence of record.\textsuperscript{35} The extent of this legislative capacity is not defined. Basically, such hearings are characterized as legislative because they are concerned with prescribing rates for the future rather than being concerned with matters that have occurred in the past.\textsuperscript{36} The Supreme Court of Virginia has stated that a legislative body is acting in a legislative capacity when it "prescribes a course of conduct."\textsuperscript{37} The legislative nature of the hearing relieves the Commission of the strict rules of evidence that govern a judicial proceeding.\textsuperscript{38} The Commission has further interpreted it, and the Supreme Court has quoted this interpretation, to "permit the record to contain all material

\begin{itemize}
\item \textsuperscript{33} VA. CODE ANN. § 12.1-39 (Cum. Supp. 1971). The Commission, however, appears to be writing opinions voluntarily in support of its more important decisions. This practice is desirable, as parties often cannot determine whether to appeal until given an opportunity to study the reasons for the Commission's action. Otherwise, notice of appeal would have to be filed merely to get an opinion from the Commission upon which the decision to appeal could be based.
\item \textsuperscript{36} Hope Natural Gas Co. v. Federal Power Comm'n, 134 F.2d 287, 309-10 (4th Cir. 1943); \textit{rev'd on other grounds}, 320 U.S. 591, (1944); Baer Bros. v. Denver & R.G.R.R., 233 U.S. 479, 486 (1914).
\item \textsuperscript{37} Blankenship v. Richmond, 188 Va. 97, 103, 49 S.E.2d 321, 323 (1948).
\item \textsuperscript{38} Norfolk & W.R.R. v. Commonwealth, 162 Va. 314, 174 S.E.85 (1934) See note \textsuperscript{35} supra.
\end{itemize}
offered." 39 The legislative nature of the hearing also provides the Commission with a broad area of discretion in which it can exercise its judgment. 40 However, this legislative capacity is apparently not as broad as that exercised by a legislative committee; the court previously has cautioned that there is evidence that should not influence the action of the Commission, but "the order of the Commission will not be reversed because it admitted, or admitted and took into consideration, evidence which it should not have considered, unless it be plain that it permitted its conclusions to be determined by the improper evidence." 41 The simple fundamental that must be emphasized is that basic fairness dictates that all evidence received into the record by the Commission or relied upon by the Commission in making its decision must be disclosed to all parties for examination and comment. 42 Furthermore, the applicant must carry its burden of proof 43 and in presenting its case there are certain basic elements that must be proved.

In an attempt to provide some definition in the foregoing area, the Attorney General's Office appealed a rate increase granted to the Portsmouth Gas Company, questioning whether expert testimony was necessary to support the requested rate of return. Commonwealth v. Portsmouth Gas Company, 44 decided September 1, 1972, held that expert testimony on the rate of return is not such a fact as must support the Commission's decision in determining a rate. 45 By presenting non-expert testimony, the utility merely risks non-persuasion. 46 The court apparently allows "the Commission [to] apply its knowledge of cost of

41. 162 Va. at 323.
42. Judge Catterall notes that section 156(f) of the old Constitution expressly stated that the Commission could rely on matters of common knowledge where it required the record on appeal to contain the evidence "introduced or considered." Certainly, the Commission can take notice that interest rates are high. Evidence should be taken, though, as to low high.
44. 213 Va. 239 (1972).
46. There is still little indication as to where the line may be drawn regarding the amount of evidence required to carry the burden of proof. The Fairfax case makes it clear that the Commission cannot simply apply its expertise to facts not in the record and prescribe a lawful rate.
capital and fair rate of return on equity, obtained from other sources, to the facts." 47

The Portsmouth case is difficult to reconcile with the language in Fairfax. Moreover, the case is troublesome in that no opportunity exists for the parties to examine and cross-examine these "other sources." Cross-examination of a witness who does not possess the necessary expertise is useless. All that can be established is that he is unable to make the judgments necessary to establish a rate of return. However, the court did appear to distinguish cases in which the jurisdictional rate base and net annual earnings are contested.48 The basis for this distinction is unclear, and no readily ascertainable reason for it is apparent; nevertheless, the court stated: "Usually the jurisdictional rate base and the net annual earnings during the prescribed test period are contested, as well as the ultimate question of fair return on rate base which, of course, requires a consideration of cost of debt and cost of equity capital. Under such circumstances, expert testimony is a practical necessity. But where, as here, the basic facts are not controverted, expert testimony, while desirable, is not mandatory." 49 The obvious implication is that expert testimony is mandatory in cases where basic facts are controverted.

Consumer Representation

Article IX, section 2, of the Constitution of Virginia (1971), provides that the Commission must insure that the interests of consumers are represented in proceedings before it, unless the General Assembly otherwise provides for such representation. Pursuant to Code section 2.1-133.1 the General Assembly created a Division of Consumer Counsel within the office of the Attorney General which, as one of its duties, appears before the Commission on behalf of consumers. The Division since its inception in June of 1970 has appeared in over 100 cases before the Commission involving such matters as rates, service investigations, and other matters affecting consumers. It works closely with the legal division and staff of the Commission to insure that any matters adversely affecting the interests of the consumer are controlled

47. 213 Va. at 242, 191 S.E.2d at 222 (emphasis supplied).
48. Ironically, the only reason these elements were not disputed in the Portsmouth case was because "at the outset of the hearing counsel for the Company accepted [the Commission's] adjustments...." Id. at 240, 191 S.E.2d at 221.
49. Id. at 242, 191 S.E.2d at 222-23. The word "mandatory" in this context seems to be synonymous with "required by law."
and regulated properly. This duty consists of appearing in cases and presenting evidence, cross-examining witnesses, preparing legal briefs and arguments, and appealing adverse decisions. It also consists of improving and defining the law and procedures in this area.  

The greatest dilemma in ratemaking that has been observed in the course of appearing in rate cases on a regular basis is the matter of excessive regulatory lag. Rates for public utilities in Virginia are set on the basis of the experience of a previous test year, and by the time the new rates finally become effective, they may be out of date in that the costs on which they are based have either increased or decreased. 

It is for this reason that the supreme court, in Commonwealth v. VEPCO, has pointed out that the proceedings are legislative and that rates are made for the future. The difficult problem then arises of determining how far into the future the Commission should go in setting rates. Moreover, it is not consistent to project the expenses and the capital structure of a company into the future without also projecting its revenues and rate base.

In an attempt to face these problems squarely, the office of the Attorney General sponsored a bill which was passed by the 1972 session of the General Assembly providing for annual review of the rates of public utilities "when, in the opinion of the Commission, such annual review

50. In appeals from the Commission an odd situation can arise pursuant to the Rules of Court. A rate case may have numerous intervenors with very different interests. Intervenors who have filed written pleadings in the case are designated as appellees when an appeal is taken. Rule 5:6 requiring filing of assignments of cross error does not apply to appeals from the Commission pursuant to Rule 5:18(a). The appellee, however, may assign cross-error in his brief pursuant to Rule 5:20. If no additional designation of the record is made by an appellee, the strange result is that no parties know which of such appellees are going to file briefs in the case or what, if any, cross-error any such appellee may assign and argue against any other appellee. Furthermore, once all the briefs of the appellees are filed, the only party with an absolute right to reply is the appellant, who may be very much in sympathy with many of the assignments of cross-error made by the appellees. As to intervenors who have not filed a written pleading in the case or requested in writing that they be joined as appellees, section 8-490.1 overrides Rule 5:18(h) in part, in that such intervenors must be sent a Notice of Appeal. Within 21 days thereafter, an intervenor in this class must inform the appellant of his intention to participate in the appeal. Effective April 16, 1973, the rules were modified to correct these deficiencies. 213 Va. 459 (1973).


52. In Howell v. Catterall, 212 Va. 525, 186 S.E.2d 28 (1972), the court pointed out that inordinate delay could jeopardize a utility's "continued ability to render effective public service to its customers." Id. at 527, 186 S.E.2d at 30.

53. 211 Va. 758, 180 S.E.2d 675 (1971).
Accordingly, in the critical 1972 VEPCO case, the Commission stated in its majority opinion that "no projections will be considered beyond December, 1972," one year after the end of the test period. This was an important decision providing necessary guidelines which can be relied upon in the future.

After determining the proper revenues and expenses for rate-making, the Commission must find a jurisdictional rate base. By employing an original cost rate base, the multitude of problems presented in constructing a reproduction cost rate base are avoided. Original cost is also "among the lowest, if not the lowest, element to be taken into consideration in determining the fair value or rate base." The Commission also employs an end-of-period rate base "to offset the lag in the return of earnings during the period between the time the money is invested and the earnings are received."

If the end-of-period rate base of an expanding utility had been in existence throughout the test period, it would have generated considerably more revenues and expenses than those reflected in the historical test period figures. The criticism of using this type of approach to offset regulatory lag is that there does not appear to be any direct correlation between the effect on the utility of regulatory lag and the increment gained by the use of the end-of-period rather than the average rate base. The average rate base is the plant that generated the test period revenues and expenses and, from an accounting point of view, provides a more logical matching of investment with the relevant revenues and expenses.

After deciding upon a jurisdictional rate base, the Commission applies a percentage rate of return figure to the rate base in order to determine the necessary net operating income that the company should earn from


56. See Smyth v. Ames, 169 U.S. 466 (1898); Roanoke Water Works Co. v. Commonwealth, 140 Va. 144, 171, 124 S.E. 652, 660 (1924) (The court became so frustrated with attempting to determine present value that it suggested "as a panacea for this grievous economic evil the application of the 'golden rule theory' upon the part of both the seller and the consumer."); Petersburg Gas Co. v. Petersburg, 132 Va. 82, 110 S.E. 533 (1922); In re C & P Tel. Co., 85 P.U.R.N.S. 435 (S.C.C. 1950), aff'd, 192 Va. 292, 64 S.E.2d 772 (1951).

57. Board of Supervisors v. VEPCO, 196 Va. 1102, 1111, 87 S.E.2d 139, 145 (1955); see also Board of Supervisors v. Commonwealth, 186 Va. 963, 975, 45 S.E.2d 145, 150 (1947).

this investment.\textsuperscript{59} Judicial guidelines have been provided for determining the proper percentage rate of return.\textsuperscript{60} Generally, the judicial guidelines can be broken down into a "capital attraction" approach which attempts to analyze investor expectations and motivations and a "comparable earnings" approach which analyzes what capital can earn in various alternatives with comparable risks. It has been suggested that the two approaches provide conflicting standards,\textsuperscript{61} regardless of the merits of such contentions, the rate of return is an area of wide discretion based on evidence of record, judgment, and experience.\textsuperscript{62}

The Commission computes the rate of return on the total capitalization of the company.\textsuperscript{63} Logically, the total capital upon which the rate of return is formulated should be computed as of the same date as that of the rate base to which it is applied. The relevant investment should be matched with the capital it seeks to protect.\textsuperscript{64} The primary reason for determining a jurisdictional rate base under present circumstances, in which the issuance of securities by the utility is regulated and the stock is not "watered," is to charge the customers of the utility under the jurisdiction of the Commission rates proportionate to the Company’s investment to serve them.\textsuperscript{65} The capital of many utilities may not

\textsuperscript{59} The net operating income is the income after all expenses including depreciation and taxes, but before the capital costs.


\textsuperscript{63} See Commonwealth v. VEPCO, 211 Va. 758, 180 S.E.2d 675 (1971). In some cases, however, it may be necessary to develop a hypothetical debt-equity ratio as Judge Catterall said should have been done in Lynchburg v. C & P Tel. Co., 200 Va. 706, 719, 107 S.E.2d 462, 471 (1959). Although the supreme court did not feel that the evidence in that case warranted overturning the decision of the majority of the Commission to follow Judge Catterall’s suggestion, it appears that almost 13 years later his view in that case has become the unanimous view of the Commission as indicated by a ruling from the bench in Record No. 19152 involving the same C & P Tel. Co.

\textsuperscript{64} In Commonwealth v. VEPCO, 211 Va. 758, 180 S.E.2d 675 (1971), witnesses speculated on the rate of return on the total capital of the company as far as three years after the end of the test period or the date of the rate base. This is different from the use of a hypothetical debt-equity ratio in that imbedded costs are also projected.

\textsuperscript{65} Id. at 766.
be devoted entirely to its utility business, or it may be devoted to serving other customers not under the Commission's jurisdiction. The close correlation between rate base and rate of return in such a circumstance must be recognized as the rate base is merely an assignment of a portion of the total capitalization of the company to a particular jurisdiction for the purpose of determining the dollars that jurisdiction should contribute to a fair return for the utility's capital.  

One way to decrease the lag would be to use a fully projected test period one year into the future. This approach would also work well with the annual review system. But since this procedure's objective would be to make rates more representative of costs being experienced during the period the rates are used, there would no longer be any basis for compensating by the use of an end-of-period rate base. An average rate base should be used projected six months into the future after the end of the most recent 12-month period for which the necessary basic information is available.

The rate of return also should be based on the capital outstanding at the time the rate base is determined. The relevant revenues and expenses would be those projected for the full 12 month period. Actually, the revenues and expenses would be those of the most recent 12 month period adjusted to show the experience that can be expected for the next 12 months under the existing rates. Any additional adjustments for factors affecting the rate of return that can be quantified specifically should be separately considered, given a percentage value, and added to or subtracted from the percentage rate of return on total capital when it is translated into a rate of return on rate base. Rate of return is the proper place to recognize such adjustments rather than in the rate base, revenues, or expenses. Such necessary adjustments, if any, to offset recurring discrepancies in the return allowed and the return experienced

66. This requirement illustrates the absurdity of not having a standard procedure for allocating rate base in all jurisdictions in which the utility operates. Otherwise, some portions of the capital may be compensated more than once or not at all. Telephone companies have a basic method of allocation which is used universally, but electric and gas companies must assume the risk of differing allocation procedures.

67. Objection might be raised on the basis that a portion of the projected rate base is not "used and useful" as required by Virginia law. But the response is that it is "used and useful" within the meaning of those words in relation to the revenues, expenses, and capital that are also projected.

68. The Commission presently requires companies to present 12-month projections with each rate application. Over a period of time, the reliability of such projections for the purpose of setting rates could be judged.
should become well known to the Commission since it will be dealing with the utility annually.

The determination of a proper rate of return is essentially a matter of judgment and experience. Parties choosing to appeal a rate decision are faced with a presumption of correctness in favor of the Commission. Reversal requires a clear showing of abuse of discretion rather than mere technical deficiency.

The Office of Attorney General also sponsored a resolution (S.J. Res. 37 failed to pass the 1972 General Assembly) urging the Commission to adopt more comprehensive rules and procedures. The purpose of the resolution was to provide guidelines in the areas of discovery procedures, introduction of evidence, cross-examination of witnesses, and the status of intervenors. The Commission staff presently is engaged in drafting revised rules and procedures consistent with the resolution’s thrust.

There are other areas where further legislation may prove helpful. Sections 56-8.2 and 56-239, as amended by the 1971 Session of the General Assembly, provide that in any appeal from the Commission’s action prescribing or affecting rates of a public utility, the final order of the supreme court shall provide for refund of the difference, if any, between the rates prescribed by the Commission and those finally fixed. If the “company-made rate” provision in section 56-240 is used, there should be no question of the Commission’s authority to refund the difference between the filed rate and the final rate fixed after investigation. A statute should be enacted giving the Commission such authority.

69. Although the 1971 Constitution of Virginia makes no reference to the presumption of correctness contained in section 156(f) of the Constitution of 1902, there can be little doubt that decisions of the Commission carry a judicially recognized presumption of correctness. 73 C.J.S. Public Administrative Bodies and Procedure § 205 at 556-57 (1951). See also Commonwealth v. Portsmouth Gas Co., 213 Va. 239, 191 S.E.2d 220 (1972); Norfolk & P.R.R. v. Commonwealth, 103 Va. 284, 297, 49 S.E. 39, 42 (1904) (commissioners presumed to be experts in the matter of rates and charges).


71. It is emphasized that the wording of these statutes in part is: “In any appeal . . .” (emphasis supplied). The statute appears to apply to appeals by the utility or any intervenor.

72. Such legislation would be similar to and perform the same function as 49 U.S.C. § 15(7) (1970), which gives the I.C.C. authority to grant refunds in the case of “company-made rates.”

73. On remand of Board of Supervisors v. C & P Tel. Co., 212 Va. 57, 182 S.E.2d 30 (1971), the Commission ordered the company to refund the excess rates. Much time
Legislation also should be adopted providing for a two-part hearing in a rate case. The first part of the hearing should concern the rate of return and the dollar increase to which the utility is entitled. The second part should assign the various categories of customers from whom these dollars are to be raised. This latter determination relates to fair and equitable rate schedules. A party should be able to intervene in either or both parts of the hearing.

The principal advantage of the suggested two-step proceeding is that it would enable the participants in phase two to know the precise amount of revenue the company must raise from its jurisdictional customers at the time of considering rate design. Thus, the interests of the parties could be represented more knowledgeably than is feasible in a unitary hearing. Furthermore, this procedure would correct the very troublesome situation that arises when a utility applies for a rate increase of $1,000,000 implemented by certain rate schedules which are examined at the hearing, but the utility is finally awarded an increase of only $500,000 which is implemented by different rate schedules which are never examined at the hearing and which may require a proportionately greater number of dollars to be paid by one customer, or class of customers, than did the original schedules.

The supreme court has said that failure to hold a second hearing is not a denial of due process, but it also has held that granting a "different kind of rate schedule" from that contemplated by the parties without further examination does amount to a due process deprivation. The most orderly procedure would be to delay any consideration of rate design until a decision on the total revenue needs of the utility has been made. If the projected test year concept were employed, the was spent in argument over whether the Commission had the authority to order refunds and, if so, how it was to be accomplished. On appeal to the Supreme Court of Virginia, the refund order was affirmed on the basis that "a failure to comply with the Constitution of Virginia and with the statute is [not] a mere procedural imperfection or oversight." C & P Tel. Co. v. Arlington County, 213 Va. 339, 341 (1972).

74. The Commission agreed to such a course of action on motion of the Attorney General in the recent C & P Tel. Co. application for an increase in rates. Record No. 19152 (1972).


76. Appalachian Power Co. v. Commonwealth, 132 Va. 1, 9, 110 S.E. 360, 363 (1922) (rate schedule contemplated at hearing fixed separate rates upon primary or secondary power whereas rate schedule finally granted fixed a uniform flat rate).
number of dollars generated by the proposed schedules should then be based on a billing analysis of the projected period.\textsuperscript{77}

The confusion surrounding sections 56-35 and 56-240 also should be settled by the legislature. The requirement of Commission prescription of rates ought to be removed from section 56-35. It would be advisable to frame such an amendment in language similar to article IX, section 2, of the Virginia Constitution. Section 56-240 also should be amended to apply expressly to telephone companies, since there is no rational basis for allowing the "company-made rate" provision to apply to other public utilities but not to telephone companies. Specific reference to telephone companies would involve a simple amendment and would eliminate the present ambiguity. Finally, repeal of sections 56-478 and amendment of 56-241 is appropriate since the rates of telephone companies, as well as those of other utilities, would be provided for in Chapter 10 of Title 56.\textsuperscript{78}

\section*{The Corporation Commission and the Virginia Insurance Industry}

The authority of the Commission to regulate insurance companies is provided in section 38.1-29 of the Code of Virginia. The kinds of insurance business which the companies may transact in Virginia are classified and defined in article 2 of title 38.1 of the Code.

In the area of automobile insurance, there are various kinds of insurance that may be involved in a rate hearing. Generally, they are either liability insurance, which is insurance against loss by another caused by fault of the insured, or first party coverage of the person and property of the insured in which claims are paid regardless of fault. Liability insurance involves personal injury liability and property damage liability. They are treated separately for rate making purposes. First party coverage involves damage to any property of the insured resulting from collision, comprehensive coverage involving damage to the automobile

\textsuperscript{77} Decisions would have to be made concerning anticipated weather conditions, rate of increase in customers, and other various factors.

\textsuperscript{78} After the original drafting of this Article, Delegate Phillip Morris at the request of the Attorney General's Office introduced House Bills 1504, 1505, 1506, and 1509 in the 1973 session of the General Assembly to make the needed improvements and corrections referred to above. The most notable improvement is the addition of a refund provision to Code section 56-240. The fact and amount of refund is made discretionary with the Commission as the purpose of this amendment was simply to establish the authority of the Commission to award refunds in the case of a legally established "company-made rate."
by other than collision, loss of personal possessions contained therein, and medical payments insurance for injury to the person of the insured and his passengers. There have been numerous reasons assigned for the present high cost of automobile insurance, i.e., congested highways, inflated labor costs, high hospital and other medical expenses, and paper thin motor vehicles, but the fact remains that automobile insurance is costly and is a matter of great concern to the motoring public.

The business of insurance in Virginia and elsewhere occupies an unusual and enviable position in the law. Although obviously a highly competitive industry, it is not subject to the federal anti-trust laws. The Supreme Court of the United States held many years ago that issuing a policy of insurance was not commerce and therefore was a proper subject of state regulation in *Paul v. Virginia.* 79 Thereafter, the case of *German Alliance Ins. Co. v. Kansas* 80 held that the business of insurance was "'clothed with a public interest' and therefore subject 'to be controlled by the public for the common good.'" 81 Subsequently, the Supreme Court, in *United States v. South-Eastern Underwriters Ass'n,* 82 overruled its holding in the *Paul* case when confronted with federal, rather than state law, deciding that the business of insurance was in fact commerce among the states and subject to the federal anti-trust laws.

As an immediate reaction to the *South-Eastern Underwriters Ass'n* case, Congress passed the McCarran-Ferguson Act 83 which provided that federal legislation would not be enacted to pre-empt state law in the area of insurance regulation, except that the business of insurance should be subject to the federal anti-trust laws "to the extent that such business is not regulated by State law." 84 This Act has been interpreted to support any state system generally regulating the business of insurance. 85 The case of *Ohio AFL-CIO v. Insurance Rating Board,* 86 goes even further in stating that "there is nothing in the language of

79. 75 U.S. (8 Wall.) 168 (1868).
80. 233 U.S. 389 (1914).
81. Id. at 415.
86. 451 F.2d 1178 (6th Cir. 1971).
the McCarran Act or in its legislative history to support the thesis that the Act does not apply when the state's scheme of regulation has not been effectively enforced." 87 Petition for certiorari was filed with the United States Supreme Court in this case on April 27, 1972, one of the questions being whether:

On motion to dismiss complaint alleging Sherman Act violations relating to automobile insurance price fixing, does McCarran Act grant immunity to defendants as matter of law in face of factual allegations, supported by affidavits, that state does not "effectively" regulate the industry and has, in fact, abdicated its function in favor of regulation by industry itself? 88

This issue is of extreme importance, since a reversal of the holding of the Sixth Circuit could well sound the death knell for the so-called "competitive pricing laws" in effect in many states.

The Virginia Prior Approval System

Rates for automobile insurance in Virginia are determined by a "prior approval" system 89—the Commission must approve rates before they can be used by the companies. 90 Different considerations are involved than those for public utilities because, unlike public utilities, insurance companies have no monopoly. In determining a fair rate for insurance companies, section 38.1-269 allows them to pool their experience. 91

This "experience" is accumulated and filed by a licensed rating organization, and the rates thereby established (manual rates) may be used by all member or subscriber companies. Such companies also may file and use a uniform deviation from these rates if sufficient supporting information is supplied to the Commission and approval is obtained. 92

87. Id. at 1184.
89. Public notice and a hearing on proposed rate increases generally are accorded prior to Commission approval, but neither is required. Section 38.1-254 makes the matter of publication and hearing discretionary with the Commission.
90. See Va. Code Ann. § 38.1-253 (1950). The 1972 session of the General Assembly passed a "competitive pricing" or "no prior approval" law which was signed by the Governor to become effective on July 1, 1972. The Commission held this statute unconstitutional by order of July 6, 1972. The matter is on appeal to the Supreme Court of Virginia.
91. The companies are exempted from the prohibition of the federal anti-trust laws against price fixing by the McCarran-Ferguson Act.
In order to stimulate competition, companies are allowed to file independently if they have enough credible experience to establish rates. Rates other than manual rates or those based on deviations or independent filings may be charged to insureds obtaining coverage through the Virginia Automobile Insurance Plan ("Assigned Risk"), and also to those purchasing the substandard market, or to insureds desiring an excess rate for a specific risk.

**Investment Income as a Factor in Automobile Insurance Rates**

Insurance companies receive income not only from the insurance portion of their business, but also from investing the policyholder's premium dollar. Income earned from investment of the policyholder's premium in bonds, debentures, preferred and common stock, mortgages, and other forms of real estate investments is referred to broadly as "investment income." For many years, insurance companies argued that they were not required to consider investment income in deriving the amount of profit built into the insurance rates. The investment portion was said to be completely separate from the underwriting portion which should stand on its own.

Before 1965, the Commission did not consider investment income in establishing automobile insurance rates. In 1965, the Commission

---

93. See id. § 38.1-218.
94. Id. § 38.1-264.
95. Id. § 38.1-262.1.
96. Id. § 38.1-262. In addition, individual companies may propose certain variations in plans. For example, the "Safe Driver Plan" offers approximately a five percent discount from the basic manual rate; in return, the company may charge a premium that is 300 percent of the basic manual rate if a certain number of points are obtained. Judge Catterall, who opposes this plan, has commented that:

> The odds that [the insured] will win this gamble are six to one in his favor, the same as the odds in the game of Russian roulette. . . . A man who is more interested in saving money than in gambling can buy a policy from several large companies whose rates are more than 5 percent below the manual rates and whose policies do not contain the safe-driver plan. 1969 S.C.C. ANN. REP. 151, 161-62.

97. This led to the now-famous "two-pocket" speech by the Chairman of the United States Senate Sub-Committee on Antitrust and Monopoly on October 15, 1968, to the National Association of Mutual Insurance Agents in which he stated: "When someone turns his pocket inside out to show you how empty it is, but has $7 billion in the other pocket, it is difficult to take their claim of poverty too seriously."

98. Income from the investment of the unearned premium reserve previously had been considered in fixing fire insurance rates. Aetna Ins. Co. v. Commonwealth, 160 Va. 698, 169 S.E. 859 (1933). In Aetna it was stated: "It would appear to be just as reasonable in computing profit made from the purchase and sale of a flock of sheep to omit
began to consider evidence of income earned from unearned premium reserves, and in 1969, the Virginia Supreme Court, in *Virginia AFL-CIO v. Commonwealth*, required the Commission to consider investment income from loss reserves as well. It should be noted, however, that in determining investment income, the Commission considers net realized capital gains but does not consider net unrealized capital gains.

Since insurance rates are based on profits the companies should be allowed for each dollar of insurance written, it would appear that if an adequate profit factor were built into the rate, increases in policy sales would produce an increased company return. On this theory, the Commission does not attempt to fix the overall return to the company based on either its total investment or its net worth. The policy of encouraging insurance companies to compete cannot be implemented effectively if the overall return to the company is set by a regulatory body.

### The Virginia Insurance Market

There has been an increasing restrictiveness and tightening of the insurance market in Virginia, even among the larger independent companies which often write at lower rates. In *Commonwealth ex rel. State Corporation Commission v. The Aetna Casualty and Surety Co.*, the Commission emphasized the dilemma confronting it: “It has been our experience that many of the large independent companies have lower expenses. Many of them are more selective in deciding which group of motorists is least likely to give rise to claims; and their experience from the computation the income received from the wool clip and the natural increase at the lambing season, as to discard in the computation of profits produced by rates the increase in income due to the investment of that portion of the premiums held in hand to meet existing but future payable liabilities.” *Id.* at 721, 169 S.E. at 867.


101. See 1969 SCC, ANN. REP. 151, 158.

102. This is similar to the “operating-ratio” theory of rate making and is unlike public utility rate making, in which the Commission sets a return on net worth.

103. It can be argued that the insurance market will tend to be more restrictive in periods of high inflation. As a result of recent evidence, however, the Bureau of Insurance now indicates that the tightening of the insurance market is no longer as critical as it was in the late 1960's and that the market is actually becoming less restrictive.

104. Record No. 17680 (Va., May 15, 1967).
penses, particularly their acquisition costs, are lower. They can afford to charge lower rates because they insure better risks at lower costs of doing business and they appeal to the better risks because they charge lower rates.’’

Given the restrictive market and the need to insure all motorists, a problem developed concerning the means by which all Virginians could be enabled to obtain insurance from the company of their choice at fair and reasonable rates. A recent Commission study has proposed five areas of improvement:

1. the annualization of the rate-making process in insurance,
2. the trending of losses in such a manner as to rectify the continual underprovision that examination of the historical evidence reveals,
3. the treatment of investment income from policyholder supplied funds counterpart to the loss and unearned premium reserves,
4. the setting of a factor in the rate-making formula for underwriting profit, and
5. improved use of a factor in the rate-making formula to account for risk differentials by line of insurance.

The matter is still pending with no positive results yet achieved.

**Competitive Pricing**

Because of complaints about the serious restrictions in the insurance market, the Governor in early 1971 requested that a committee of the Virginia Advisory Legislative Council study the matter. The insurance companies represented to the committee that the insurance market would loosen up if the General Assembly passed a “competitive pricing” law. Such a law would substantially eliminate the lag that now exists between the time revised rates are submitted by the companies and the time they can be used under the present “prior approval” system. The companies also would be provided with more flexibility in setting rates, and thus they would have little reason to reject prospective policy-

---

106. See Introductory letter to the S.C.C. Study Report of October 1, 1971. The Office of the Attorney General sponsored legislation providing for the annual review of insurance rates which was passed by the 1972 session of the General Assembly and appears as section 38.1-255.1 in the present code. This legislation is similar to that which applies to public utilities. VA. CODE ANN. 38.1-255.1 (Cum. Supp. 1972).
holders willing to pay the cost. Competition, the companies argued, would keep the rates reasonable.

The VALC Study Committee presented a “competitive pricing” bill to the 1972 session of the General Assembly. The bill was introduced in the House and although the Attorney General, the Corporation Commission, and much of the insurance industry voiced strong objections, it passed.\textsuperscript{107} The Governor signed the bill to become effective July 1, 1972, in spite of the Attorney General’s advice—given at the Governor’s request—that he veto it due to certain inherent defects. On July 6, 1972, the Commission found the law unconstitutional.\textsuperscript{108}

Broadly, this law is a “file and use” law by which the companies can file their rates along with “supplemental rate information.” Immediately after filing, the new rates may be used. Commission approval of the rates is not required. It is suggested, however, that either the state must be the regulator of insurance rates or competition must be the regulator. If the state is to be the regulator, then the only practical way this can be accomplished is by a method of “prior approval” similar to the one Virginia now has. The pending study by the Commission may provide some answers for improving the implementation of the system. On the other hand, if competition is to be the regulator, the companies must be allowed a realistic opportunity to compete.

Such an opportunity can only be afforded under a flexible “use and no file” plan such as has existed in California for many years.\textsuperscript{109} There is no middle ground. The success of any law appearing to offer such middle ground must depend on the cooperation of the regulatory body in reacting as if the law were in fact a California type of law. Such legislation creates expectations in the mind of the public of regulatory controls and rate making standards which are not in fact employed.\textsuperscript{110} Under a true “open competition” law, the Commission’s role is that of an anti-trust watchdog guarding against anti-competitive practices such as illegal price fixing and collusion.

\textsuperscript{107} The objections related primarily to the form of the bill and not to the theory of “competitive pricing.”

\textsuperscript{108} Record No. 19145 (Va., July 6, 1972). Further discussion of this particular law is not appropriate at this writing, since the Office of Attorney General is a party to the appeal presently before the Supreme Court of Virginia.


\textsuperscript{110} For instance, a “file and use” bill suggests that the Commission has examined the filed information, but experience shows that many commissions with “file and use” laws never look at the filed information and act as if the law were instead a “use and no file” law.
If "open competition" is adopted, the companies should not be restricted by specific prior-approval type standards for setting rates. The policies offered to the public, however, should be of a standard form, subject to Commission approval, in order to provide a basis for a company-by-company comparison of rates. If the rates of a particular company are too high, that company should lose business. On the other hand, the commission also should monitor rates closely to ensure that they are not so low that the company's solvency and ability to pay claims is jeopardized.

Obviously, the success of any "open competition" law depends on a vigorous "shopping around" by the consuming public. To encourage such "shopping," the public must be knowledgeable about the variations in rates. One way to accomplish this is for the Bureau of Insurance to publish periodically a list of the filed rates of the companies. A substantial obligation also should be placed upon insurance agents to inform their clients of the alternatives available to them.

Few consumers shop for insurance. Their buying habits must be changed, since the theory of open competition can be tested successfully only through the reactions of a fully informed public. Anything less than true competition is not "open competition" at all, but loose, and consequently ineffective, state regulation.

**Conclusion**

The placing of the responsibility for the fixing of railroad rates in the hands of the State Corporation Commission at the 1902 Virginia Convention was characterized as "populism run mad." Since that time it cannot be said that the use of strong epithets to characterize the Commission has diminished one iota. Ironically the Commission has evolved as an institution to the point where its policies frequently are regarded as suspect by those today identified with "populism run mad."

The rate making function of the Commission is certainly as much a factor in its high profile position in state government as any combination of other responsibilities it performs. Such a highly technical and

---

111. A bill to correct certain defects in Virginia's 1972 "Competitive Pricing" legislation contained in Chapter 6.1 of title 38.1 of the Code passed the 1973 session of the General Assembly repealing Chapter 6.1 and enacting a new chapter 6.2. The bill was amended in the Senate at the request of Senator Clive Duval to require the Commission to publish such a list of rates periodically as a matter of law.

broad area of discretion cannot be exercised effectively without substantial public confidence. No service is performed on behalf of the public when this confidence is undermined by baseless accusations.

Informed public examination and review should be had of all Commission decisions. On its part, the Commission must aggressively study and adopt improvements in its policies and procedures. In so doing, the Commission will react appropriately to legitimate public concern and merit the confidence of the citizens it serves.