strate that Sammons of Illinois struck an unreasonable balance, or one that increased overall costs.

45. Colquitt's and Turley's testimony support the efficiency and reasonableness of administering service in the municipalities on a complex-wide basis. (Tr. at 196, 174–75, 250–51).

46. Colquitt is Sammons of Illinois's Controller. Colquitt testified that Smith's calculations distorted the financial data by ignoring earlier years in which Sammons of Illinois's return on its investment was minimal or even negative. (Tr. at 167–235).

47. Turley, Sammons of Illinois's Vice-President of Operations, testified that the rate increases at issue were justified by higher expenses in the municipalities and by improvements made to equipment and cable used to provide service in the municipalities. (Tr. at 239–56).

48. Burnham, a consultant in the cable industry, testified that the rates charged by Sammons of Illinois in 1987, 1988, 1989, 1990, and 1991 were lower than the national average of basic rates during those years. (Tr. at 256–94).

49. The court agrees with Sammons of Illinois's Controller, Colquitt, that, to measure Sammons of Illinois's return on investment, it is proper to use the accounting unit through which Sammons of Illinois tracks its own revenue and investment, the Ottawa Complex. Using this accounting unit eliminates the artificial distortions created by the allocation method of accounting. (Tr. at 133–34, 155–56, 173–74, 196–97).

50. Colquitt is a Certified Public Accountant and is qualified to testify on such matters. Smith is neither a Certified Public Accountant nor a Certified Financial Advisor. Smith does not possess an accounting degree. Smith's only formal accounting training was twelve hours of college classes attended some twenty-seven years ago. Smith also acknowledged at trial that he is not an auditor and that he does not perform financial auditing according to standards governed by the American Institute of Certified Public Accountants. Smith admitted he was not qualified to testify whether the allocations were consistent with generally accepted accounting principles. (Tr. at 155–56, 168–72, 181, 196–97, 398).

51. Once Smith obtained the allocated information, however, he introduced additional allocations based upon his own assumptions. He developed formulae and ratios to allocate revenues and expenses between basic service, the service at issue here, and premium service like HBO and Cinemax. (Tr. at 81–82; PXs 35, 38).

52. One of Smith's formulae understated the program expenses attributable to basic service. In rebuttal, Smith admitted that his allocation of these expenses understated those expenses for basic service, resulting in an overstatement of Sammons of Illinois's rate of return. Smith explained that he did not possess the actual data concerning expenses prior to his original calculations. Smith ultimately conceded, however that he did possess the actual data prior to his testimony and prior to the municipalities' offer of his original calculations into evidence. On May 29, 1993, before trial, Smith had prepared an alternative calculation using the data. When he testified on June 10, 1993, he presented an incomplete analysis. (Tr. at 82, 176–77, 305–06, 371–74; *compare* PX 38 *with* DX 9).

53. After allocating revenues and expenses to basic service, Smith estimated the rate of return earned by Sammons of Illinois for each year between 1987 and 1991. He estimated the rate of return on a static or stand-alone basis. In other words, he took each year separately and calculated the rate of return in that year. He then compared the allocated net income earned by Sammons of Illinois to the net income it would have earned had it earned what Smith considered to be a reasonable rate of return. (Tr. at 57–58; PXs 38, 40).

54. Smith used his static method even though he had used different methods in other cases to analyze rates. In particular, he had used what he called a dynamic or cash-flow method that analyzes the rate of return for an investment over the entire life of the investment. Smith admitted that, using this method, a cable company's return on

its investment will appear to be low or even negative in the early years of the investment. In his static model, however, Smith assumed a flat rate of return. He made no effort before his direct examination to reconstruct the information that would be necessary to do a cash-flow analysis. (Tr. at 58–59, 64–65, 128–30).

55. Smith opined that a reasonable annual rate of return for Sammons of Illinois for each year from 1987 to and including 1991 would have been between 10% and 15%. He based this opinion on what he called the weighted cost of capital. He said that a reasonable rate of return must be based on the return that was necessary to attract capital. This in turn is based upon the market value of debt and equity during the relevant time period. An investor's return on debt and return on equity would be weighted according to Sammons of Illinois's actual debt to equity ratio to determine a rate of return. (Tr. at 28).

56. Smith, however, admitted that he did not rely on Sammons of Illinois's actual debt-to-equity ratio when he settled on his 10% to 15% range of reasonableness. He used industry averages. (Tr. at 339).

57. Colquitt established that Sammons of Illinois had no debt. Accordingly, under Smith's cost of capital method, the annual reasonable rate of return for Sammons of Illinois for the years in question should have been 18% to 20%, the rate of return on equity during the relevant time period that Smith used to determine what rate he considered reasonable. (Tr. at 198–200).

58. For each municipality, Smith performed two calculations. First, he subtracted the revenue that would have been earned using a 10% rate of return "test" from what Smith estimated Sammons of Illinois actually earned in each municipality. Second, he deemed the amounts earned in excess of 10% to be unreasonable. He then repeated the process using a 15% rate of return test. (Tr. at 36–39; PXs 38, 40).

59. Colquitt opined that Smith's method suffered from two additional shortcomings that render it invalid. First, Smith ignored the life-cycle of Sammons of Illinois's cable system in the municipalities. Smith focused only on the period after 1986, even though Sammons of Illinois had rebuilt the system in 1982–84. He did not factor this large capital investment into his analysis. By ignoring these earlier years, Smith inflated the apparent rate of return. (Tr. at 67–72, 175–76).

60. These earlier years will not be excluded when judging whether Sammons of Illinois's rate of return in 1987–91 was reasonable. A cable system is a long-lived asset. Cable companies and investors analyze rates of return on such assets over their life-cycle. To do otherwise would disregard the reality that the costs of building or rebuilding a cable system are concentrated in the early years. The rate of return during these early years is typically low or even negative. Years after the investment, however, returns increase. The proper way to evaluate the reasonableness of rates is to incorporate into the analysis what happens in the earlier years. (Tr. at 58–59, 67–70, 175–76, 180–82; PXs 38, 40; DX 6).

61. Second, Smith disregarded the overall rate of return and, in doing so, never accounted for the time value of money. Not only are rates of return low or negative in the early years, but money earned in those earlier years is worth more than money earned in the later years. This principle should be incorporated into the analysis. Smith treated a dollar earned or lost in 1987 as equivalent to a dollar earned or lost in 1991 even though a dollar earned in 1987 can be invested and in 1991 be worth more than $1. By separating each year and disregarding the time value of money, Smith again inflated the overall rate of return by overemphasizing the returns in later years at the end of the life-cycle. (Tr. at 77–78, 177–78, 232–33).

62. Accordingly, the court rejects Smith's opinion that Sammons of Illinois's rates were unreasonable.

63. The evidence defendants adduced demonstrates that the rates were reasonable.

64. First, Colquitt prepared an analysis using complex-wide data. Colquitt used actual data from Sammons of Illinois's general ledger. Sammons of Illinois could reason-

ably determine its rates and could evaluate the reasonableness of its rates using this data. (Tr. at 179–81; DX 6).

65. Second, Colquitt adjusted for the programming expense used in Smith's initial calculations by using the actual programming expenses of basic service. (Tr. at 183–84; DX 6 at 3).

66. Third, Colquitt chose 1983 as the point from which to begin his analysis as opposed to Smith, who started with 1987. Colquitt chose 1983 based upon discussions with engineering personnel at Sammons of Illinois and financial data that showed a large investment in the Ottawa complex between 1982 and 1984. Colquitt had a reasonable basis to conclude that Sammons of Illinois rebuilt the complex during this period prompting the beginning of a new life-cycle. (Tr. at 182–83; DX at 3).

67. Finally, Colquitt corrected Smith's disregard of the time value of money by rating the various returns earned in each year by a discount factor. (Tr. at 184–91; DX 6 at 3).

68. Colquitt determined what annual rate of return earned each year from 1983 to 1992 would have produced for Sammons of Illinois the same amount of total income that it actually received in varying amounts over the course of those years. In other words, between 1983 and 1991, Sammons of Illinois's rate of return varied dramatically. The rate of return was low in the early years and higher in the later years. Using his discount calculation, Colquitt was able to determine the annual rate of return that would have produced the same total discounted income that Sammons of Illinois in fact earned during those years if Sammons of Illinois had earned in each of the individual years on a static or stand-alone basis. That rate was 11.85%, well within the 10% to 15% range that Smith testified was reasonable. (Tr. at 184–85, 188–90; DX 6 at 3).

69. Colquitt graphed the results of his analysis. This graph reveals that Sammons of Illinois's cumulative rate of return between 1983 and 1992 always has been at or below a level that Smith considered reasonable. The rate began at about 4%, declined to 3.15% over the next three years, and then rose to 11.85% by 1992. Between 1983 and 1990, Sammons of Illinois's rate of return was below 10% per year. Only in 1991 did Sammons of Illinois realize an overall rate of return of more than 10%. (Tr. at 191–92; DX 6 at 1).

70. Based on Colquitt's analysis, and assuming that Smith's 10% to 15% range was correct, Sammons of Illinois's rates over the period were reasonable. (Tr. at 200–01).

71. The municipalities contended that the earlier years were immaterial because Sammons of Illinois never asked the municipalities for rate increases to compensate for the lower rates of return. In 1987 and 1988, however, when the actual rates of return were being earned, it would have made no sense for Sammons of Illinois to apply for a rate increase. More importantly, the issue before the court is whether Sammons of Illinois's rates were reasonable overall. It is relevant to consider whether Sammons of Illinois's rates in the earlier years resulted in a rate of return below that which is a reasonable rate of return. (Sch. (e) at 1, ¶ 2; *id.* at 8, ¶ 1; Tr. at 249).

72. Colquitt's analysis therefore supports the reasonableness of Sammons of Illinois's rates. (Tr. at 178–94).

73. The municipalities attempted to resurrect their case by offering the rebuttal testimony of Smith, who used a life-cycle or dynamic analysis. The court rejects this analysis because it contains numerous deficiencies. (Tr. at 340–57, 361–70; PX 46).

74. First, as with his initial analysis, Smith allocated revenues and expenses to the various municipalities. (PX 46).

75. Second, Smith distorted the valuation of the system at the end of the life-cycle. According to Smith, a life-cycle analysis requires that the system be valued at the beginning and at the end of the life-cycle. Smith, however, used two different valuation methods. At the beginning, Smith used the "book" value of the system, namely, the value reflected in the accounting records of Sammons of Illinois, but at the end, he used what he described as a rule-of-thumb value based upon the net cash flow of the system in the

previous year. Had he used the same valuation technique in both instances, the rate of return that he calculated would have been lower. (Tr. at 388–90, 418, 421–22).

76. Third, Smith failed to recognize Sammons of Illinois's investment in the cable service system. He admitted that, in some of his life-cycle calculations, he used net investment, which inflated the rate of return. He also failed to account for a large investment in addressable converters described by Turley. (Tr. at 419–20).

77. Fourth, as he ultimately conceded on cross-examination, Smith disregarded recognized cost accounting authority by failing to account for working capital in his return calculation, again underestimating expenses and overestimating the rate of return. Until he was confronted with an authoritative source, Smith persisted in arguing that working capital had no place in the calculation. (*Compare* Tr. at 378–80 *with* Tr. at 411–14 and DX 15).

78. Further, Smith admitted that some of the numbers on the first page of PX 46, an analysis of ten-year return on investment, were incorrect. Despite repeated attempts, the municipalities were unable to establish precisely what effects these mistakes had on Smith's calculations. Accordingly, even if the court accepted Smith's method, his analysis was inconclusive. (Tr. at 424–27).

79. The rates that Sammons of Illinois actually charged for Marseilles and Naplate throughout the period resulted in a reasonable rate of return. Sammons of Illinois earned no more than a reasonable rate of return and thus did not breach its franchise agreements. (PX 40; ¶¶ 10–30).

80. Colquitt also prepared an alternative analysis in which he allocated revenues and expenses to individual municipalities. Colquitt attempted to account for Sammons of Illinois's actual programming expense, the cable system life-cycle, and the time value of money. This analysis showed an overall shortfall of approximately $1.9 million between what Sammons of Illinois actually earned and what a reasonable rate of return, as defined by Smith, would have produced. Although Ottawa showed a slight surplus, this surplus was overwhelmed by shortfalls in the other three municipalities due to cross-subsidization. (Tr. at 192–93; DX 7).

81. In judging the reasonableness of Sammons of Illinois's rates, the court finds that this large shortfall further supports the reasonableness of Sammons of Illinois's rates. Given the accounting realities associated with providing cable service to small municipalities, it was reasonable for Sammons of Illinois to establish rates that on a complex-wide basis resulted in a reasonable rate of return. (DX 7).

82. A host of other facts support the finding that Sammons of Illinois's rates were reasonable and that it complied with its franchise agreements. Turley testified at length about the budgeting process that Sammons of Illinois used to control costs and set competitive rates in the Ottawa Complex. Sammons of Illinois formulated its rates based on what neighboring systems charge their subscribers. Sammons of Illinois even conducted surveys of neighboring systems to ensure that Sammons of Illinois's rates were lower than the rates in nearby communities. Such pricing strategy demonstrates the reasonableness of Sammons of Illinois's rates. (Tr. at 241–46).

83. Turley also testified that Sammons of Illinois's expenses in the Ottawa Complex are relatively higher than in the other systems she oversees across the country. Turley explained that the high expenses are due to a strong labor union and Sammons of Illinois's commitment to use modern equipment in the complex. These factors further support the reasonableness of Sammons of Illinois's rates. (Tr. at 242–45).

84. Sammons of Illinois's rates were also low compared to national averages. Burnham testified to this fact which is supported by data from Paul Kagan's reference guide, which Smith recognized as authoritative. Sammons of Illinois's rates compared as follows:

Year	Sammons Rate	National Average Rate
1987	$ 9.50	$12.18
1988	$11.00	$13.86
1989	$11.55	$15.21
1990	$12.10	$16.78
1991	$12.70	$17.95

This comparison is even more favorable because the rates in 1988–91 all became effective on dates after January 1. This comparison further exemplifies the reasonableness of Sammons of Illinois's rates. (Tr. at 90–93, 281–83).

85. In sum, the rates Sammons of Illinois charged for basic cable service since 1986 have been in compliance with the Cable Act and the franchise agreements with each of the municipalities at all times. (Sch. (1) at 19, ¶ 25).

CONCLUSIONS OF LAW

1. This court has original jurisdiction of this action pursuant to 28 U.S.C. §§ 1331 and 1337 in that the action arises under and is governed exclusively by the Cable Act, 47 U.S.C. § 521–59.

2. Venue in this district is proper under 28 U.S.C. § 1391(b). (Sch. (1) at ¶ 1).

3. The Cable Act prohibited municipalities from regulating cable television service rates after December 29, 1986. 47 U.S.C. §§ 521, 543(b), (c).

4. Under the Cable Act, the FCC was required to issue regulations "which authorize the franchising authority to regulate rates for the provision of basic cable service in circumstances in which a cable system is not subject to effective competition." 47 U.S.C. § 543(b)(1).

5. The Cable Act directed the FCC to review periodically its effective competition regulations to take into account developments in technology and to amend the regulations as necessary. 47 U.S.C. § 543(b)(3).

6. In its initial *Report and Order* announcing regulations to implement the Cable Act, the FCC determined that each of the municipalities was located within a market area with effective competition. *Report and Order*, FCC 85–179, adopted April 11, 1985, released April 19, 1985; *see* 50 Fed.Reg. 18637 (May 2, 1985); 47 C.F.R. §§ 76.33, 76.54 (1986).

7. In *ACLU v. FCC*, 823 F.2d 1554 (D.C.Cir.1987), *cert. denied*, 485 U.S. 959, 108 S.Ct. 1220, 99 L.Ed.2d 421 (1988), the Court of Appeals for the District of Columbia Circuit upheld most of the FCC implementing regulations, but found that the "signal availability standard" utilized by the FCC to define effective competition was "arbitrary and capricious." 823 F.2d at 1573. The Court remanded "that issue to the agency for a reasoned explanation of its chosen standard or the development of a new standard." *Id.*

8. Following the decision in *ACLU*, the FCC announced modification of the signal availability standard in its *Second Report and Order* released on April 29, 1988. *Second Report and Order*, 53 Fed.Reg. 17,049 (May 13, 1988). Under the modified FCC regulations, the municipalities were not considered areas with effective competition. The FCC delayed full implementation of the new rules for six months from the release date of the *Second Report and Order* to provide "a sufficient amount of time for a cable operator to adapt to the onset of regulation as a consequence of changes made herein." (Sch. (1) at ¶ 6).

[1] 9. Because the *ACLU* Court struck down the FCC regulations *ab initio*, cable rates in the municipalities were improperly deregulated. Also, the FCC regulations issued after the enactment of the Cable Act subjected Sammons of Illinois to rate regulation, effective October 29, 1988. *Sammons*, 795 F.Supp. at 265–66 (order denying summary judgment).

10. Even though Sammons of Illinois was subject to regulation, the municipalities' claims still fail as a matter of law.

11. In regulating Sammons of Illinois, the municipalities were obligated to comply with the following procedures, which they failed to do.

12. The FCC regulations implementing the Cable Act established administrative procedures by which a municipality could challenge an FCC determination that effective competition existed. 47 C.F.R. §§ 73.686, 76.7, 76.33 (1986). The municipalities never challenged the FCC's 1986 determination that Sammons of Illinois was subject to effective competition. (Sch. (1) at ¶ 14).

[2] 13. Under 47 C.F.R. § 76.33, franchising authorities that choose to regulate

the cable service industry must, among other things, allow an opportunity for interested parties to comment on the authority's decision to regulate or on the reasonableness of the cable rates. The municipalities failed to comply with 47 C.F.R. § 76.33: they never conducted public hearings and never solicited written comments. Therefore, the municipalities are barred from challenging the rates.

[3] 14. The municipalities failed to take final action within 180 days on any basic cable rate increase proposed by Sammons of Illinois since 1986; therefore, those increases are deemed granted as a matter of law under the Cable Act, 47 U.S.C. § 543(d).

15. Moreover, the court's finding that the cable systems in the municipalities were improperly deregulated allows inquiry into the reasonableness of Sammons of Illinois's rates during the period at issue. *See Ottawa v. Sammons*, 795 F.Supp. at 264.

[4] 16. The basic cable rates charged by Sammons of Illinois in the municipalities were reasonable and appropriate, thus no rebate or refund is necessary.

17. The franchise agreements for Ottawa and Streator explicitly provided that Sammons of Illinois was entitled to a 6% increase per year. PX 1 at 3, § 7; PX 3 at 4–5, § 7.

18. To the extent additional increases were subject to municipal approval, the court concludes that: (a) the municipalities failed to hold the necessary public hearings on Sammons of Illinois's rate increases, so they are deemed approved, and (b) the rate increases taken by Sammons of Illinois were reasonable, were consistent with the franchise agreements, and would have been approved. (47 U.S.C. §§ 541(c), 543(d); 47 C.F.R. §§ 76.33).

19. The rates were reasonable and no rebate to the municipalities is appropriate. The municipalities have failed to carry their burden to prove by the preponderance of the evidence that Sammons of Illinois breached its franchise agreements by charging excessive rates. To the contrary, the evidence at trial demonstrated that defendants complied with all applicable provisions of the franchise agreements or ordinances with the municipalities.

CONCLUSION

For the foregoing reasons, judgment is entered in favor of the defendants Sammons Communications, Inc. and Sammons Communications of Illinois, Inc. and against the plaintiffs Cities of Ottawa, Marseilles, and Streator and the Village of Naplate as to counts I, III, V, and VII of the complaint.

IT IS SO ORDERED.

Paul STANCZYK, Plaintiff,

v.

BLACK & DECKER, INC., a foreign corporation, and DeWalt, a division of Black & Decker, Inc., Defendants.

No. 91 C 4054.

United States District Court,
N.D.Illinois, E.D.

Nov. 10, 1993.

Injured user of miter saw brought products liability action against manufacturer to recover for design defect in guard. Manufacturer moved to exclude testimony of user's expert. The District Court, Zagel, J., held that expert's opinion about safer design for guard was inadmissible.

Motion granted.

Evidence ⚷555.7

Mechanical engineer's expert testimony that miter saw guard could be designed leaving only about one-eighth of an inch of blade exposed was inadmissible in products liability suit alleging defective design of guard that left as much as 2.5 inches exposed; engineer offered no testable design since user lacked the $20,000 to $40,000 allegedly necessary to

understanding" must be construed together to give effect to parties' intent). Read together these writings reveal an ambiguity regarding the capacity in which Griffin intended to exercise the options. The letters, insofar as they purport to exercise the option on behalf of Development, are inherently inconsistent with the assignment agreement's transfer of Development's option rights to the Trust, Naing and Griffin. The checks, on the other hand, suggest it was neither Development nor Trust but a third party, "Wynmark Properties," on whose behalf Griffin exercised the options "by paying the option price" as prescribed in the option agreements. To resolve this ambiguity, it is permissible, and necessary, to consider the extrinsic evidence which, as we have already held, raises a genuine issue of fact concerning Griffin's intent.

For the reasons set out above, the judgment of the district court is

Reversed and Remanded.

VIRGIN ISLANDS TELEPHONE CORPORATION, Petitioner,

v.

FEDERAL COMMUNICATIONS COMMISSION and United States of America, Respondents.

American Telephone & Telegraph Co. Ameritech Operations Companies, Intervenors.

VIRGIN ISLANDS TELEPHONE CORPORATION, Petitioner,

v.

FEDERAL COMMUNICATIONS COMMISSION, Respondent.

Nos. 92-1063, 92-1347.

United States Court of Appeals, District of Columbia Circuit.

Argued Feb. 25, 1993.

Decided April 16, 1993.

In consolidated petitions for review, telephone company challenged order of the Federal Communications Commission (FCC) requiring that company refund amounts earned during six-month interim rate period which exceeded its annual interstate access rates. The Court of Appeals, Harry T. Edwards, Circuit Judge, held that FCC acted arbitrarily and capriciously in using six-month evaluation period, rather than standard two-year period, to determine reasonableness of interim rates.

Petition No. 92-1374 denied; petition No. 92-1063 granted.

Randolph, Circuit Judge, filed dissenting opinion.

1. Telecommunications ⚷347

Mechanism by which the Federal Communications Commission (FCC) orders refunds where local telephone exchange carrier has violated an outstanding rate-of-return prescription must provide carrier with a fair opportunity to achieve its regulated rate of return over the long-term. Communications Act of 1934, § 4(i), as amended, 47 U.S.C.A. § 154(i).

2. Telecommunications ⚷12

Issues must be raised before the Federal Communications Commission (FCC) as a prerequisite to review by the Court of Appeals.

3. Telecommunications ⚷349

Refusal of Federal Communications Commission (FCC) to entertain petition for reconsideration was justified, where petition was filed one day late, and extenuating circumstances did not prohibit petitioner from filing within prescribed time limits; petitioner's counsel admitted that tardiness was caused by miscommunications within firm. Communications Act of 1934, § 405(a), as amended, 47 U.S.C.A. § 405(a).

4. Telecommunications ⚷332.1

Federal Communications Commission (FCC) acted arbitrarily and capriciously in using six-month evaluation period to determine reasonableness of telephone compa-

ny's interim rate increase, instead of employing usual two-year rate-monitoring period; throughout administrative process, FCC indicated that interim rate would be evaluated in light of impact on company's earnings over standard two-year rate-monitoring period, and record revealed no justification for deviating from standard practice. Communications Act of 1934, §§ 201–205, as amended, 47 U.S.C.A. §§ 201–205.

Petition for Review of an Order of the Federal Communications Commission.

Robert J. Aamoth, with whom Gertrude J. White was on the brief, for petitioners. Matthew J. Harthun also entered on appearance for petitioner.

James M. Carr, Counsel, Federal Communications Commission, (FCC), with whom Renee Licht, Acting Gen. Counsel, Daniel M. Armstrong, Associate Gen. Counsel, and John E. Ingle, Deputy Associate Gen. Counsel FCC, and Robert B. Nicholson and Robert J. Wiggers, Attys., U.S. Dept. of Justice, were on the brief, for respondents.

Oeter D. Keisler, Francine J. Berry, and David P. Condit entered appearances for intervenor American Tel. & Tel. Co.

Alfred W. Whittaker and Floyd S. Keene entered appearances for intervenor Ameritech Operating Companies.

Before: EDWARDS, D.H. GINSBURG, and RANDOLPH, Circuit Judges.

Opinion for the Court filed by Circuit Judge HARRY T. EDWARDS.

Dissenting opinion filed by Circuit Judge RANDOLPH.

HARRY T. EDWARDS, Circuit Judge:

In the wake of the devastation caused by Hurricane Hugo in September, 1989, the Virgin Islands Telephone Corporation ("Vitelco" or "the company") applied to the Federal Communications Commission ("FCC" or "the Commission") for a temporary rate increase to offset anticipated reductions in demand for interstate access services. The FCC initially found the rate revision justified and authorized Vitelco to raise its rates for the first six months of 1990. However, upon completion of an investigation into the reasonableness of the revised rates, the FCC found that Vitelco had earned in excess of its authorized rate of return during the period that the interim rates were in effect. Consequently, the Commission ordered Vitelco to refund all amounts charged from January to June, 1990, in excess of its annual access rates, plus interest.

Following several failed attempts to get administrative reconsideration of the refund order, Vitelco filed these consolidated petitions for review. Vitelco maintains that the Commission's reliance on a six-month evaluation period to determine the reasonableness of the interim rates was arbitrary and capricious in this case. We agree. Throughout the administrative process, the Commission indicated that Vitelco's interim rates would be evaluated in light of their impact on the company's earnings over the standard two-year rate-monitoring period. Such an approach would have been congruent with the FCC's standard theory of rate-of-return regulation and consistent with prior Commission practice. In its ultimate decision, however, the Commission arbitrarily deviated from standard practice and employed a six-month monitoring period. Because the record reveals no reasonable justification for the FCC's action in this case, we grant the petition for review.

I. BACKGROUND

A. *Rate of Return Prescription*

The Communications Act of 1934, ch. 652, 48 Stat. 1064 (codified as amended at 47 U.S.C. §§ 151–613 (1988)), authorizes the FCC to regulate interstate telecommunications services to ensure that tariffs are just, reasonable and nondiscriminatory. 47 U.S.C. §§ 201–205 (1988). One means the Commission may use to achieve this end is the imposition of a rate of return prescription on local exchange carriers like Vitelco. *AT & T v. FCC*, 836 F.2d 1386, 1388 (D.C.Cir.1988); *see also Nader v. FCC*, 520

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F.2d 182, 203–04 (D.C.Cir.1975) (the power to prescribe rates of return is "necessary for the Commission to carry out its [rate-making] functions in an expeditious manner"). The Commission's regulation of rates of return is premised on the notion that the FCC can set a target rate that balances investors' interests in competitive returns on capital against ratepayers' interests in fair pricing. *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S.Ct. 281, 288, 88 L.Ed. 333 (1944). Thus, the FCC attempts to set the target rate of return high enough to "assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital," while simultaneously limiting the ability of carriers to charge ratepayers exorbitant prices. *Id.; see also AT & T*, 86 FCC 2d 221, 223 (1981). Because of changing market forces and the amorphous nature of the interests being weighed, this balancing is an imprecise science. *See United States v. FCC*, 707 F.2d 610, 618 (D.C.Cir.1983). So when the Commission exercises discretion in selecting a target rate, it is understood that the choice represents merely one point within a broad "zone of reasonableness." *AT & T*, 836 F.2d at 1390 (quoting *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C.Cir.1987) (en banc)).

The means by which the regulated rate of return drives actual carrier pricing is straightforward. Carriers subject to rate of return prescriptions set their service charges so that projected revenues exceed projected operating expenses by an amount that will yield the authorized rate of return. *AT & T*, 836 F.2d at 1388. If the carrier's projections prove correct, net return on capital will match the authorized return. However, because of the indeterminacy of the figures used in the calculations, carriers "will virtually never" earn precisely their authorized rate of return. *Id.; see also Communications Satellite Corp.*, 3 FCC Rcd 2643, 2647 (1988) (FCC has "long recognized the imprecision inherent in requiring carriers to set tariff rates that will produce the exact level of revenues necessary to produce the anticipated return"). For this reason, the Commission allows for a "spread" or "buffer" range above the authorized return within which the Commission will not take remedial action. *Authorized Rates of Return for the Interstate Service of AT & T Communications and Exchange Telephone Carriers*, 58 RR 2d 1647, 1648–49 (1985) ("*Authorized Rates*"); *Communications Satellite Corp.*, 3 FCC Rcd at 2647.

To alleviate some of the imprecision inherent in the prescribed rate of return methodology, the FCC has devised several safeguards, one of which is particularly relevant to this appeal. To provide carriers with a fair opportunity to achieve their authorized rates of return, the Commission employs what it deems a "long evaluation period" allowing short-term earnings "peaks" and "valleys" to offset each other. *MCI Telecommunications Corp. v. Pacific Northwest Bell Tel. Co.*, 5 FCC Rcd 216, 217 (1990). In selecting this approach, the FCC weighed the ratepayers' interests in more frequent rate reviews (to limit the possibilities for overcharges) against the carriers' desire for longer review periods (to dampen the impact of short-term oscillations). *Authorized Rates*, 58 RR 2d at 1652. The Commission ultimately concluded that these competing interests intersect at a two-year rate-monitoring period. 47 C.F.R. § 65.701(a) (1992); *Authorized Rates*, 58 RR 2d at 1651–52. The two-year monitoring period minimizes the impact of seasonal "peak" and "valley" earnings periods. Moreover, since local exchange carriers must revise their access charges on an annual basis, *see* 47 C.F.R. § 69.3(a), they may correct for erroneous projections in the first year through rate adjustments in the second year. *See Authorized Rates*, 58 RR 2d at 1652.[1]

As originally crafted, the Commission's rate of return regulations required an automatic refund of any amount collected in excess of a carrier's authorized rate of

1. There appears to be no barrier to more frequent mid-course corrections. *See AT & T*, 836 F.2d at 1389 n. 1. However, this does not diminish the benefits of longer review periods since carriers may make concomitantly more corrections within the given evaluation period.

return plus the specified buffer. *See Authorized Rates*, 58 RR 2d at 1653–57. However, we rejected the *mandatory* refund rule as arbitrary and capricious, holding it inconsistent with the Commission's regulatory theory of rate-of-return prescription. *See AT & T v. FCC*, 836 F.2d at 1389. The fundamental flaw in the Commission's mandatory refund scheme was that it created a one-way ratcheting effect, forcing carriers to refund earnings accumulated in excess of their authorized return, but prohibiting carriers from recouping earnings shortfalls. *Id.* at 1390. Thus, when measured beyond the short term, carriers subject to the Commission's mandatory rate-of-return and refund regulations were virtually sure to suffer an economic loss. *Id.* at 1391.

[1] Our decision in *AT & T* did not question the Commission's authority under the Communications Act to order refunds of amounts collected in violation of a rate-of-return prescription. *Id.* at 1392. That issue had been addressed in *New England Tel. & Tel. Co. v. FCC*, 826 F.2d 1101, 1107–08 (D.C.Cir.1987), *cert. denied*, 490 U.S. 1039, 109 S.Ct. 1942, 104 L.Ed.2d 413 (1989), where we specifically held that the Commission has authority under section 4(i) of the Communications Act, 47 U.S.C. § 154(i), to order refunds in conjunction with rate-of-return prescriptions. The decision in *AT & T*, however, emphasized that the Commission's authority to order refunds where a carrier has violated an outstanding rate-of-return prescription

> must ... be exercised in a way that does not contradict the Commission's own theory of rate of return regulation. An obvious example of a scheme that would be consistent with the Commission's view of the rate of return prescription as a minimum, is one in which the carrier, in addition to being required to return amounts that exceeded the target return, would be permitted to recover amounts by which it fell short of the target. We are confident that the Commission can imagine other schemes that would not tend to prevent carriers from earning the return needed to enable them to attract necessary capital. It is of course the Commission, not this court, that is empowered to exercise its judgment in choosing a course of action. We do not mean to suggest that any one valid course of action is preferable to any other. If the Commission's choice is to survive judicial scrutiny, however, it must conform to the Commission's understanding of its task.

AT & T, 836 F.2d at 1392 (citations omitted). In short, the Commission's refund mechanism must provide carriers with a fair opportunity to achieve their regulated rates of return over the long-term.

B. *Vitelco's Interim Rates*

On September 17–18, 1989, the U.S. Virgin Islands were devastated by Hurricane Hugo. *See generally* Michael York, *Deadly Hugo Slams Puerto Rico, Virgin Islands; Storm Leaves Thousands Homeless*, WASH.POST, Sept. 19, 1989, at A1. Hugo cut a swath of damage across the archipelago, destroying, among other things, approximately 90% of the telephone lines on St. Croix and 60% of the lines on St. Thomas. *See* Direct Case of Vitelco, Docket No. 90–124 (Apr. 6, 1990) at 2 ("*Direct Case*"), *reprinted in* Joint Appendix ("J.A.") at 56. Because of reductions in hardware capacity, Vitelco anticipated a dramatic decrease in demand for interstate access services. *See id.* at 1–2. Thus, Vitelco sought special permission from the FCC to increase its access service charges for the first six months of 1990. *See* Letter from Gertrude J. White, Counsel for Vitelco, to Judith A. Nitsche, Chief, FCC Tariff Review Branch (Nov. 16, 1989) ("*Application No. 1*"), *reprinted in* J.A. at 1.

In its request, Vitelco explained that the rule against retroactive ratemaking prevented Vitelco from waiting until the actual extent of the decrease became known before recouping its losses through higher rates. *See* Letter from Gertrude White to John Cimko, Chief, FCC Tariff Division (Dec. 1, 1989), *reprinted in* J.A. at 4. Instead, the company asked for permission to increase its switched and special access rates for the first half of 1990 while telephone systems on the islands were re-

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stored. *See* Letter from Gertrude White to Donna R. Searcy, Secretary, FCC (Dec. 8, 1989) at 1 and Appendix A ("*Application No. 2*"), *reprinted in* J.A. at 8. The requested increase was designed not to compensate Vitelco for costs directly attributable to the hurricane (*e.g.*, hardware damage not covered by insurance), but to protect the company's income stream. *See id.* at 3–4; *Application No. 1* at 2–3.

In order to estimate the hurricane's effect on demand for access services, Vitelco analyzed demand data for August, the month immediately preceding Hugo, and October, the month immediately following Hugo. *See Application No. 2* at Appendix C. In addition, the company adjusted its projected minutes-in-use data to reflect a decrease in the number of access lines expected to be in service for the first six months of 1990. *See id.* Based on these and other adjustments detailed in the attachments to *Application No. 2*, Vitelco requested special permission to increase its interstate access rates for the first six months of 1990. At the end of that time, Vitelco's annual access tariff revisions, which were to be filed by the company on April 2, 1990, were to take effect as scheduled. To expedite matters, Vitelco also requested that the FCC waive its 45-day notice and supporting data requirements for standard rate revisions. *See id.* at 4.

On December 12, 1989, the FCC's Common Carrier Bureau ("the Bureau") notified Vitelco that it would grant the company's request for an interim rate increase. *See* Letter from John Cimko to Gertrude White (Dec. 12, 1989), *reprinted in* J.A. at 41. In addition, the Bureau agreed to waive the two procedural rules identified in Vitelco's application. *See id.* However, the Bureau emphasized that the Commission had not approved the interim rates and that the Bureau's letter allowing the rates to go into effect did not "prejudice any subsequent action which the Commission or Bureau may take." *Id.* Shortly thereafter, the Bureau issued an order in which it explained that it had granted Vitelco's request in order to preserve the company's pre-hurricane income stream and protect Vitelco's financial integrity. *See Virgin Islands Tel. Corp.*, 5 FCC Rcd 112 (1989). Nonetheless, "because the possibility exist[ed] for Vitelco to accumulate earnings above its authorized rate of return," the Bureau suspended the interim rates for one day, issued an accounting order, and initiated an investigation into the reasonableness of the rates pursuant to section 204(a) of the Communications Act, 47 U.S.C. § 204(a). *Id.* In its order designating issues for investigation, the Bureau explained that "the purpose of [the] investigation [was] to determine whether the [interim] rates may be excessive, *i.e.*, whether the rates ... produce revenues that exceed a revenue requirement that is computed in accordance with ... the Commission's Rules." *Virgin Islands Tel. Corp.*, 5 FCC Rcd 1622 (1990). In furtherance of the investigation, Vitelco was ordered to submit a "direct case" demonstrating that the interim rates were not excessive, including cost and demand data beginning September 1, 1989 and "ending with the most recent data available." *Id.*

As the company accumulated actual data from the first three months of 1990, it became apparent that the expected decline in demand had not materialized. *See Direct Case* at 10 ("demand for January and February of 1990 is higher than originally anticipated"). Indeed, demand over the first three months of 1990 was higher than Vitelco would have projected even in the absence of Hugo. *See* Supplement to Direct Case of Vitelco, Docket No. 90–124 (May 15, 1990) at 3 ("*Supplemental Direct Case*"), *reprinted in* J.A. at 73. Vitelco attributed the unusually heavy volume to the use of "coin telephones, customers sharing telephones with other residents and pent-up tourist demand." *Direct Case* at 11. In addition, because only about half of Vitelco's equipment was in service during the first quarter of 1990, Vitelco enjoyed a corresponding decrease in operating expenses. *See Supplemental Direct Case* at 3. As a result of the coincidence of heavy volume and diminished operating expenses, Vitelco's annualized earnings for interstate access services over the first three months of 1990 were in excess of

thirty-six percent; roughly three times the company's twelve percent authorized rate of return. *See Supplemental Direct Case* at Exhibit I.

This data became available to Vitelco as the company prepared to file its annual access rate revisions on April 2, 1990, in which the company would propose tariffs for the service year beginning July 1, 1990 (at the termination of the interim period). In response to its surprisingly strong earnings through the first quarter of the year, Vitelco "vastly" reduced its standard access rates. AT & T Response and Opposition to Direct Case, Docket No. 90–124 (June 14, 1990) at 3 ("*AT & T Response*"), *reprinted in* J.A. at 81. However, because the standard access rates did not take effect until July of that year, and "[b]ecause demand remained above forecast levels, the rate of return for the remainder of the period during which the [interim] rates were in effect continued to be above authorized levels." Further Direct Case of Vitelco, Docket No. 90–124 (Dec. 21, 1990) at 2 ("*Further Direct Case*"), *reprinted in* J.A. at 102.

In light of Vitelco's performance during the first half of 1990, the FCC concluded that Vitelco had "overearned" *during that time* and that the interim rates were therefore unjust and unreasonable. *Virgin Islands Tel. Corp.*, 6 FCC Rcd 7350, 7351 (1991) ("*Refund Order*"). In reaching its conclusion, the FCC did not find that Vitelco's demand projections in December of 1989 were based upon incorrect data, or that the company made erroneous calculations using that data. Nor did the FCC find that Vitelco's earnings from January 1, 1989 through December 31, 1990, had exceeded the authorized 12% rate of return for that period. Instead, the FCC simply "annualized" the return Vitelco had earned *during the six-month interim rate period* and found it to be above "authorized levels." *Id.* Consequently, the FCC ordered Vitelco to refund, with interest, any amounts earned during the six-month interim period in excess of the then applicable 12% rate. *See id.* at 7352.

On January 3, 1992, Vitelco filed a motion to stay the refund order so that it might seek agency reconsideration or judicial review. *See* Motion for Stay of Vitelco, Docket No. 90–124 (Jan. 3, 1992), *reprinted in* J.A. at 117. However, the company did not actually file its motion for reconsideration with the FCC until January 16, 1992, one day beyond the filing deadline established by section 405 of the Communications Act, 47 U.S.C. § 405(a). *See* Vitelco Petition for Reconsideration, Docket No. 90–124 (Jan. 16, 1992), *reprinted in* J.A. at 157. In an accompanying motion for leave to file a late petition for reconsideration, Vitelco explained that the untimeliness of the petition resulted from "miscommunications within the undersigned counsel's law firm, which was wholly the result of error on the part of undersigned counsel." Vitelco Motion to File Petition for Reconsideration One Day Late, Docket No. 90–124 (Jan. 16, 1992), *reprinted in* J.A. at 149. In a separate filing, Vitelco argued that the Commission should treat its motion for stay as a timely filed petition for reconsideration. *See* Vitelco Reply to Opposition, Docket No. 90–124 (Jan. 31, 1992) at 6–9, *reprinted in* J.A. at 193. While these motions were pending, Vitelco filed a petition for review of the refund order, No. 90–1063, with this court.

The FCC eventually granted Vitelco's motion to stay the refund order, *see Virgin Islands Tel. Corp.*, 7 FCC Rcd 4235, 4237 (1992), declined to consider the stay motion as a timely filed petition for reconsideration, denied Vitelco's motion to file one day late, and dismissed Vitelco's petition for reconsideration as untimely. *See Virgin Islands Tel. Corp.*, 7 FCC Rcd 4238 (1992). On August 10, 1992, Vitelco filed another petition for review with this court, No. 92–1347, this time challenging the FCC's dismissal of its motion for reconsideration. We have consolidated the two petitions and herein resolve both.

II. Discussion

A. *The Dismissal of Vitelco's Petition for Reconsideration*

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tion, a number of the arguments briefed before this court were not presented to the FCC. Yet, it is fundamental that issues must be raised before the Commission as a prerequisite to our review. *See* 47 U.S.C. § 405; *Action for Children's Television v. FCC*, 906 F.2d 752, 755 (D.C.Cir.1990). Thus, unless the Commission unlawfully dismissed Vitelco's petition for reconsideration, the arguments that Vitelco failed to raise below are procedurally barred.

[3] Section 405 of the Communications Act provides that petitions for reconsideration must be filed within thirty days of the date on which the FCC action complained of takes place. 47 U.S.C. § 405(a). Here, Vitelco indisputably missed its filing deadline. The refund order was issued on December 16, 1991, and Vitelco's petition for reconsideration was not filed until January 16, 1992—31 days later. Although section 405 does not absolutely prohibit FCC consideration of untimely petitions for reconsideration, we have discouraged the Commission from accepting such petitions in the absence of extremely unusual circumstances. *See Reuters, Ltd. v. FCC*, 781 F.2d 946, 951–52 (D.C.Cir.1986). In this case, extenuating circumstances did not prohibit Vitelco from filing within the prescribed time limits. Vitelco's counsel freely admits that its tardiness was caused by miscommunications within the firm. Therefore, the Commission's refusal to entertain Vitelco's petition for reconsideration was justified.

Nonetheless, the foreclosed issues are not those that are central to the disposition of this case. Vitelco's fundamental complaint on appeal is that the FCC's decision to evaluate the reasonableness of the company's interim rates over a six-month period was arbitrary and capricious. This issue *was* raised repeatedly before the Commission throughout the administrative proceedings. *See, e.g., Further Direct Case* at 2–3 (use of six-month monitoring period inconsistent with Commission precedent); Rebuttal of Vitelco, Docket No. 90–124 (June 28, 1990) at 5 (Commission should not use an abbreviated review period for interim rates), *reprinted in* J.A. at 90; *Direct Case* at 11–12 (monitoring period for the interim rates should be April 1, 1989 to July 1, 1990); *Supplemental Direct Case* at 3 (conclusions concerning the interim rates cannot be reached "until the appropriate monitoring period is determined"). Thus, when the Commission finally disposed of the case, it *did* pass on the issues that are the focus of this dispute. *See Refund Order*, 6 FCC Rcd at 7351 (holding six-month review period appropriate and rejecting Vitelco's "good faith" forecasting argument). We have no difficulty in concluding, therefore, that the matters upon which our decision hinges were adequately raised before the Commission and are properly cognizable by this court.

B. *The Merits of the Commission's Decision*

[4] Under the Commission's rate-of-return prescription rules, the earnings of local access carriers are evaluated over consecutive two-year periods that begin on January 1 of odd-numbered years and end on December 31 of even-numbered years. 47 C.F.R. § 65.701(a); *see also Ohio Bell Tel. Co. v. FCC*, 949 F.2d 864, 870 (6th Cir.1991) ("Commission's practice is to review earnings over a two-year period"); *MCI Telecommunications Corp. v. Southern Bell Tel. & Tel. Co.*, 5 FCC Rcd 1954 (1990) (two-year monitoring period is "existing Commission policy"). The two-year review period allows the Commission to monitor interstate access rates while still providing carriers an opportunity to respond to changing market conditions with mid-course rate revisions. For instance, Vitelco's annual access rates were revised in July of each year. Thus, within each two-year monitoring period, the company would normally have two scheduled rate revisions to correct for excessive or inadequate earnings.

In this case, Vitelco attempted to use its rate revision opportunities to keep its earnings within the permissible range. In its annual access rate filing in April, 1990, Vitelco significantly reduced the rates that

were to take effect in July, 1990.[2] Since Vitelco only had data for the first three months of the year, and since a full one-fourth of the standard monitoring period remained after the interim period (July to December, 1990), it was not unreasonable for Vitelco to believe that it could reduce its earnings over the two-year review period to an acceptable level. Indeed, this case is a prototypical example of the kind of situation in which the two-year monitoring period should protect carriers from having their rates adjudged based on unforeseen and unforeseeable earnings variations over short intervals.

Thus, it was unremarkable when, throughout the administrative process, the Commission appeared to embrace its standard practice of evaluating carrier earnings over a two-year period. For instance, in the order suspending the interim rate, the Bureau explained that the purpose of the ensuing investigation was to determine whether the interim rates would allow "Vitelco to accumulate earnings above its *authorized rate of return.*" *Virgin Islands Tel. Corp.*, 5 FCC Rcd at 112 (emphasis added). Similarly, in its order designating issues for investigation, the Bureau explained that "the purpose of [the] investigation [was] to determine whether the [interim rates] may be excessive, *i.e.*, whether the rates ... produce revenues that exceed a revenue requirement that is computed in accordance with ... the Commission's Rules." *Virgin Islands Tel. Corp.*, 5 FCC Rcd at 1622. Thus, throughout the investigation, it appeared that Vitelco's earnings over the first six months of 1990 would be factored into the FCC's standard bi-annual evaluation, covering January 1, 1989 to December 31, 1990.

The surprise came when the Commission rendered its ultimate decision in the case. In that decision, the Commission concluded that Vitelco had earned in excess of "its authorized return during the January–June 1990 period." *Refund Order*, 6 FCC Rcd at 7351. Given the structure of rate-of-return prescriptions, the Commission's conclusion is a nonsequitur. Under the present system, the target "authorized return" is a number that has meaning only in relation to the full two-year monitoring period. Thus, it makes no sense to speak of the "authorized return" for the January–June, 1990 period. The Commission's reasoning is analogous to that of a parent who admonishes his child not to eat more than one candy bar per day, and then concludes that the prescription has been violated when he observes the child eat the first half of a candy bar in less than one minute. The "one-candy-bar-per-day" rule, like the "authorized return" rule, only has meaning with respect to the predetermined period of time. As the "authorized return" rule is presently formulated, that period of time is two years. If the Commission is allowed to uncouple the rate-of-return percentage from its temporal mooring without warning or explanation, the meaningful constraints that rate-of-return prescriptions provide turn into *ad hoc* limitations governed only by the preferences of the decisionmaker.

This case exemplifies the evil of ignoring the temporal dimension of rate-of-return regulation. Here, the Commission's narrow focus on Vitelco's earnings during the first six months of 1990 led it to exclude from consideration alleged underearnings during 1989. *See Direct Case* at 12. Similarly, the imposition of an arbitrarily short monitoring period precluded consideration of Vitelco's annual access rate revisions and their effect on earnings over the remainder of 1990. Thus, although Vitelco's projections were apparently made in good faith and were based on the best available information, the Commission ordered a refund of "excessive" earnings over a limited period of time simply because those projections turned out to be wrong. The Commission attempts to defend the abbreviated monitoring period used in this case by linking it directly to the period of time that Vitelco's interim rates were in effect. *Refund Order*, 6 FCC Rcd at 7351. However, this conflates two independent time frames—the period during which a rate is in effect and the period over which a carri-

2. The record indicates that Vitelco reduced its switched access rates by 43%, its switched transportation rates by 25%, and its special access rates by 27%. *AT & T Response* at 4.

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er's earnings are measured—without reason or explanation. In order to assess the reasonableness of Vitelco's earnings as against the authorized rate of return, the Commission was required to consider earnings for the entire period during which the authorized rate was in effect.

The arbitrariness of the Commission's refund order is highlighted by the FCC's apparent disregard for past practice. Prior to the conclusion of the Vitelco investigation, the Commission had an opportunity to pass on another set of interim rates. *See Investigation of Special Access Tariffs of Local Exchange Carriers*, 5 FCC Rcd 1717 (1990) ("*US West*"). In *US West*, the Commission declined to evaluate the carrier's special access rates, which had been in effect from April to October, 1985, in terms of a six-month monitoring period. *See* 5 FCC Rcd at 1718–19. The similarities between *US West* and this case are striking. Just as in *US West*, the rate schedule at issue in this case was designed to respond to a unique set of circumstances—here, the destruction of a majority of Vitelco's lines by a natural disaster. Vitelco's rates were expressly interim and were, like the rates in *US West*, the first of their kind to be filed by the company. Finally, just as in *US West*, the company filed for a downward rate revision barely three months into the interim rate period. Indeed, the Commission itself explicitly recognized the similarities between the two cases. *See Refund Order*, 6 FCC Rcd at 7351 (interim rates in *US West* were first of their kind, were revised three months into access period, and were based on unique circumstances). Nonetheless, the Commission concluded that *US West* was not controlling because, "Vitelco increased rates during the access year for the sole purpose of avoiding underearnings that did not occur." *Id.* at 7351.

We are unpersuaded by the Commission's attempt to distinguish *US West*. The Commission's reasoning may be reduced to a single proposition: Vitelco is liable for "excessive" earnings because, with the benefit of hindsight, the Commission has found that the company was wrong when it projected a decrease in demand. This proposition, though, contravenes the fundamental principles underlying rate-of-return regulation. Naturally, any time a carrier's interim rates, set to offset anticipated shortfalls, generate greater than expected returns, it will follow that the interim rates were not necessary to protect the carrier's income stream; that is, the carrier miscalculated. Under the Commission's construction, a refund in such a situation would always be warranted—*i.e.*, interim rates that generate earnings in excess of the standard rate of return are *per se* unreasonable. Yet, this leads to the same systematic bias against carriers—forcing carriers to disgorge excess profits, but absorb shortfalls—that we held unlawful in *AT & T*. Thus, the fact that the projections upon which Vitelco's interim rates were based turned out to be wrong is not sufficient to distinguish the present case from *US West*.

Not only has the FCC failed to take into account the temporal dimension of rate-of-return regulation, but it has also ignored the factors that should be considered in determining whether remedial action is necessary. As we explained above, the Commission's prescribed rate of return is not Mosaic law, but a single point within a broad range of reasonable rates. Furthermore, the prescribed rate of return is but "one component" of a carrier's tariff schedules. *Nader*, 520 F.2d at 201. Projected operating expenses, market forecasts and competitive conditions must also be considered by carriers when they settle on a final access rate. Given this multitude of inputs, the prospective selection of a tariff that will generate the prescribed rate of return is necessarily an imprecise endeavor. Thus, once the Commission finds that a carrier has exceeded (as a pure mathematical matter) its prescribed rate of return, it should then consider other relevant factors in determining whether a rate is unreasonable and a refund warranted. *See Las Cruces TV Cable v. FCC*, 645 F.2d 1041, 1047 (D.C.Cir.1981) (Commission must consider all relevant factors in ordering refunds under section 204).

Naturally, the specific factors to be considered in any given case will vary with the circumstances. However, a few general categories of concerns will nearly always be relevant. For example, in the past, the Commission has considered whether the carrier's projections were reasonable at the time they were made. *See Public Serv. Comm'n v. The Chesapeake and Potomac Tel. Co.*, 5 FCC Rcd 5518, 5519 (1990) ("unique forecasting difficulties justified "dichotomy" between projected and actual earnings). Likewise, the actual harm suffered by ratepayers should be weighed in any refund decision. *Las Cruces TV Cable*, 645 F.2d at 1047; *see also Communications Satellite Corp.*, 3 FCC Rcd at 2646 ("customers' failure to file petitions or complaints . . . is also a relevant factor"). Furthermore, prior to ordering a refund, the Commission will likely want to take into account changes in the market environment. *See Communications Satellite Corp.*, 3 FCC Rcd at 2646; *see also Nader*, 520 F.2d at 205 (prescribed rates cannot remain binding "during periods of rapidly changing economic conditions"); *cf. Western Union Tel. Co.*, 95 FCC 2d 881, 910–11 (1983) (competitive forces substantially justified excessive earnings). Finally, the Commission must factor overriding equitable considerations into any refund decision. *Las Cruces TV Cable*, 645 F.2d at 1047; *see also Communications Satellite Corp.*, 3 FCC Rcd at 2646 (Commission's inaction could have misled carrier). Although the ultimate decision to order a refund lies within the discretion of the FCC, courts are duty bound to look "closely to see if the agency [has] considered relevant factors and if it [has] struck a reasonable accommodation among them." *Las Cruces TV Cable*, 645 F.2d at 1047. Though we do not intend to describe an exhaustive or mandatory list of considerations, we can find no indication that the Commission weighed any of these factors when it issued its refund order to Vitelco.

In short, Vitelco was justified in assuming that the Commission would evaluate earnings over the relevant "authorized return" monitoring period; the earnings over the interim rate period being but one factor in the calculation. Although we decline to say that the Commission may never adopt a monitoring period that mirrors an interim rate period, its decision to deviate from the standard two-year monitoring period in this case was unforeshadowed and unjustified. Therefore, the Commission was bound to evaluate Vitelco's earnings in light of the company's two-year earnings performance.

III. Conclusion

Although the Commission was well within its discretion in deciding to dismiss Vitelco's petition for reconsideration, the central questions upon which our opinion turns were adequately raised below. Based on our review of the administrative record and the rate-of-return prescription system, we hold the Commission's unjustified departure from its prior rate-monitoring practice to be arbitrary and capricious. Therefore, petition number 92–1374 is denied, petition number 92–1063 is granted, and we remand this case to the Commission so that it may reevaluate Vitelco's earnings over the correct measuring period, January 1, 1989 to December 31, 1990.

RANDOLPH, Circuit Judge, dissenting:

Anticipating a decline in demand for its services in the wake of Hurricane Hugo, Vitelco sought interim six-month rate increases to make up the difference. Vitelco described its request as a short-term emergency measure, necessary "to ensure the financial integrity of the Company." Letter from Gertrude J. White to John Cimko, Chief, FCC Tariff Division 1 (Dec. 1, 1989) ("Cimko Letter"). Despite Vitelco's failure to present adequate data to support its assertions, the Commission allowed the increases, subject to a refund if investigation showed the interim rates not to be reasonable. The Commission's investigation, conducted a few months later, conclusively showed just that. Rather than a decline in revenues, Vitelco enjoyed a large increase. My colleagues nevertheless set aside the Commission's order requiring Vitelco to refund the overcharges. I therefore dissent.

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The Commission's mistake, as the majority sees it, was in evaluating Vitelco's earnings during the time the increased rates were in effect rather than over the conventional two-year monitoring period. The idea is that the Commission's departure from its normal course caught Vitelco by "surprise." Maj. op. at 1238. One is reminded of General DeGaulle's quip: since politicians do not believe what they say, they are quite surprised to be taken at their word. Vitelco's complaint is a horse of the same color.

At Vitelco's urging, the Commission waived 47 C.F.R. § 61.38's demand for extensive supporting data to justify rate increases. The Commission did so in light of Vitelco's representation that the company "will be able to furnish to the FCC a complete update of revenues, expenses and rate base as part of the tariff filing due on April 1, 1990. At that time, sufficient information concerning the recovery effort from Hurricane Hugo will be available to respond to FCC requirements." Letter from Gertrude J. White, Vitelco counsel, to Judith A. Nitsche, Chief, FCC Tariff Review Branch 2 (Nov. 16, 1989); *see also* Letter from Gertrude J. White to Donna R. Searcy, Secretary, FCC 4 (Dec. 18, 1989). Rather than passing upon Vitelco's request beforehand, the Commission deferred final judgment until Vitelco furnished the data. And the Commission did so in the face of Vitelco's recognition that, in the company's words, "in the unlikely event that usage returns to pre-hurricane levels in the very near future," the Commission can take action "to guard against potential overearnings." Cimko Letter at 1-2. These statements make sense only if Vitelco expected the Commission to evaluate its earnings, not over a two-year period, but during the time the interim rates were in effect. Vitelco indeed invited such an evaluation as the *quid pro quo* for the Commission's waiving its rules. The Commission's final decision therefore came as no surprise to the company. Having allowed the interim rate increases to go into effect "subject to an investigation and an accounting order put in place specifically to protect ratepayers should the decline in demand predicted by Vitelco not materialize," the Commission simply ordered refunds when Vitelco's prophesy did not come true. *Virgin Islands Tel. Corp.*, 6 F.C.C.R. 7350, 7351-52 (1991).

Unlike the situation contemplated in *American Telephone & Telegraph Co. v. FCC*, 836 F.2d 1386, 1391 n. 5 (D.C.Cir. 1988), Vitelco was not seeking increased rates as an adjustment to its authorized rate of return after experiencing shortfalls over, say, the first twelve months of the two-year monitoring period. Instead, "Vitelco increased rates during the access year for the sole purpose of avoiding underearnings that did not occur." 6 F.C.C.R. at 7351. In further contrast to *AT & T*, the refund order here does not condemn Vitelco to suffer underearnings in the long run, the medium run, or even the short run. On this point, the Commission's answer to Vitelco—and now to the majority opinion—strikes me as conclusive: "The *Refund Order* requires only a one-time refund of charges assessed during an extraordinary six-month period chosen by Vitelco itself for special treatment. Even after Vitelco implements that refund, the company will still have earned at *or above* its rate of return for that period." Brief for Respondents at 32.

As to *US West*, my colleagues find the similarities between it and this case "striking." Maj. op. at 1239. I find them nonexistent. The rates in *US West* "were part of a partially new regime.... [They] were allowed to take effect at the conclusion of a comprehensive investigation of US West's and other local exchange carriers' initial attempts to tariff interstate access services in accordance with the Part 69 access charge system." *Investigation of Special Access Tariffs of Local Exchange Carriers*, 5 F.C.C.R. 1717, 1718 (1990). Vitelco's interim rate increases were nothing of the sort. The Commission properly analyzed Vitelco's interim rates in terms of the limited objective Vitelco defined for them. The interim rates rested not on any "comprehensive investigation," but on Vitelco's predictions, predictions the company admitted lacked adequate supporting data. And in

US West, the Commission explicitly cautioned against taking its decision to mean "a six month period could [n]ever establish an adequate basis to measure compliance with a rate of return prescription." *Id.*

This should have been a simple case. No great policy issues were at stake, no fundamental principles hung in the balance. Vitelco thought a hurricane's destruction threatened its financial integrity. The Commission allowed a temporary rate increase on condition that the telephone company back up its forecast of dire need with facts, as it said it would. When Vitelco could not do this, the Commission—taking Vitelco at its word—properly ordered the company to refund the increased charges. I would deny the petition for review.

James Walter BONHAM, Appellant,

v.

DISTRICT OF COLUMBIA LIBRARY ADMINISTRATION, Appellee.

No. 91-7017.

United States Court of Appeals, District of Columbia Circuit.

Argued Oct. 15, 1992.

Decided April 16, 1993.

Library patron filed pro se complaint against government concerning closing of public library on Easter. The United States District Court for the District of Columbia, Stanley Sporkin, J., dismissed action for failure to state a claim. Appeal was taken. The Court of Appeals, Mikva, Chief Judge, held that patron's allegation that closing of public library on Easter Sunday violated establishment clause was sufficient to overcome dismissal for failure to state a claim.

Reversed and remanded.

1. Constitutional Law ⚷84(1)

In order to pass constitutional muster, laws and government practices involving religion must have secular legislative purpose, have principal or primary effect that neither advances nor inhibits religion, and not result in excessive entanglement with religion or religious institutions. U.S.C.A. Const.Amend. 1.

2. Constitutional Law ⚷84.5(11)

Library patron's allegation that closing of public library on Easter Sunday violated establishment clause was sufficient to overcome dismissal for failure to state a claim; library was only branch which was generally open on Sundays. U.S.C.A. Const. Amend. 1; Fed.Rules Civ.Proc.Rule 12(b)(6), 28 U.S.C.A.

3. Statutes ⚷184, 215, 216, 217.4, 219(1)

In determining legislative purpose of law or government practice, reviewing courts generally look to text of statute or rule, legislative history, administrative interpretations, testimony of parties who participated in enactment or implementation of challenged law or practice, historical context, and sequence of events leading to passage of law or initiation of practice.

4. Constitutional Law ⚷84(1)

No de minimis exception to traditional establishment clause analysis exits on issue of whether government practice may be deemed endorsement of religion. U.S.C.A. Const.Amend. 1.

Appeal from the United States District Court for the District of Columbia (D.C.Civ. No. 90-0992).

Michael Vatis, amicus curiae appointed by the Court, with whom Kenneth S. Geller, Washington, DC, was on the brief, supporting appellant.

Lutz Alexander Prager, Asst. Deputy Corp. Counsel, with whom John Payton, Corp. Counsel, and Charles L. Reischel, Deputy Corp. Counsel, Washington, DC, were on the brief, for appellee.

DISTRIGAS OF MASSACHUSETTS CORPORATION and Distrigas Corporation, Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION, Respondent.

Boston Gas Company, et al., Intervenors.

DISTRIGAS OF MASSACHUSETTS CORPORATION and Distrigas Corporation, Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION, Respondent.

Boston Gas Company, Intervenor.

BOSTON GAS COMPANY, Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION, Respondent.

Bay State Gas Company, et al., Intervenors.

Nos. 83-1633, 83-1728 and 83-1777.

United States Court of Appeals, First Circuit.

Argued March 6, 1984.

Decided June 14, 1984.

Seller of imported liquefied natural gas applied for rate increase under Natural Gas Act, but the Federal Energy Regulatory Commission denied rate applied for. On petition for review, the Court of Appeals, Breyer, Circuit Judge, held that: (1) while Commission properly required seller, rather than ratepayers, to pay certain future tax liability, Commission acted arbitrarily in deducting such sum from seller's rate base; (2) Commission properly deducted from seller's balance sheet sum which it had loaned to its parent company in return for demand notes; (3) Commission did not act arbitrarily in allowing seller working capital allowance based on only five days' worth of adjusted annual expenses; (4) in calculating need for working capital, Commission properly excluded sum representing prepaid insurance premium; (5) Commission properly departed from lower sales estimate on basis of later actual sales figure; (6) Commission erred in ordering "refund" to gas customers for past excessive charges; and (7) refunds were calculated on proper basis.

Affirmed in part, vacated in part, and remanded.

1. Gas ⟹14.5(6)

As long as argument of Federal Energy Regulatory Commission on natural gas rate issue is logical, consistent with traditional rate-making principles, supported by substantial evidence in record, and not otherwise arbitrary, Court of Appeals must uphold result reached by Commission. Natural Gas Act, § 19(b), 15 U.S.C.A. § 717r(b); 5 U.S.C.A. § 706(2)(A, E).

2. Gas ⟹14.4(3)

On application for rate increase brought by seller of imported liquefied natural gas, while Federal Energy Regulatory Commission properly required seller, rather than ratepayers, to pay $4.6 million future tax liability incurred before seller became regulated, Commission acted arbitrarily in deducting such sum from seller's rate base until the deferred taxes became due. Natural Gas Act, §§ 1 et seq., 4, 15 U.S.C.A. §§ 717 et seq., 717c.

3. Gas ⟹14.4(3)

On application for rate increase brought by seller of imported liquefied natural gas, Federal Energy Regulatory Commission did not err in deducting from seller's balance sheet $6.5 million which it had loaned to its parent corporation in return for set of demand notes, upon determination that funds were not readily enough available to seller to count as regulated utility balance sheet capital. Natural Gas Act, §§ 1 et seq., 4, 15 U.S.C.A. §§ 717 et seq., 717c.

4. Administrative Law and Procedure ⇐502

Agency is free to interpret, supplement, revise, and even depart from previously existing rule, provided that it offers adequate, and adequately supported, explanation.

5. Gas ⇐14.4(7)

On application for rate increase brought by seller of imported liquefied natural gas, Federal Energy Regulatory Commission did not act arbitrarily in departing from its general 45-day formula in deciding to allow seller working capital allowance based on only five days' worth of adjusted annual expenses. Natural Gas Act, §§ 1 et seq., 4, 15 U.S.C.A. §§ 717 et seq., 717c.

6. Gas ⇐14.4(7)

On application for rate increase brought by seller of imported liquefied natural gas, Federal Energy Regulatory Commission, in calculating seller's need for working capital, did not err in excluding amount of insurance premium that seller had prepaid one day after relevant 13-month period, thereby effectively lowering determination of seller's monthly working capital needs. Natural Gas Act, §§ 1 et seq., 4, 15 U.S.C.A. §§ 717 et seq., 717c.

7. Gas ⇐14.4(5)

On application for rate increase brought by seller of imported liquefied natural gas, Federal Energy Regulatory Commission, in setting price, properly departed from its lower sales estimate based upon test year sales, inasmuch as later actual sales figures, arising after test year, provided adequate basis for Commission to conclude that seller's estimate was not reasonably accurate indicator of likely actual sales during period. Natural Gas Act, §§ 1 et seq., 4, 15 U.S.C.A. §§ 717 et seq., 717c.

8. Gas ⇐14.4(5)

On application for rate increase brought by seller of imported liquefied natural gas, it was reasonable for Federal Energy Regulatory Commission to deduct from gas rates amount that reflected revenues that seller obtained from selling "cool-down" services to liquefied natural gas tankers, although Commission abused its discretion in ordering "refund" to gas customers of half of revenues obtained from such sales prior to rate increase, as it had no authority to order refunds to compensate customers for past excessive charges. Natural Gas Act, §§ 4, 5, 15 U.S.C.A. §§ 717c, 717d.

9. Gas ⇐14.6

In ordering refunds after rate increase by seller of imported liquefied natural gas, Federal Energy Regulatory Commission properly held that original rates established by settlement approved by Commission provided floor beneath which seller could not be required to make refunds, despite Commission's conclusion that "just and reasonable" rate for that period was substantially below that floor. Natural Gas Act, § 4(e), 15 U.S.C.A. § 717c(e).

10. Gas ⇐14.6

Where seller of imported liquefied natural gas which had instituted rate increase had stipulated in settlement agreement that Federal Energy Regulatory Commission would have authority to make refund without regard to rate levels previously established, Commission was not bound, with respect to relevant period, by general rule that previously established rates provided floor beneath which refunds could not be made. Natural Gas Act, § 4(e), 15 U.S.C.A. § 717c(e).

Harold Hestnes, Boston, Mass., with whom Paul F. Saba, Kim E. Rosenfield, Hale and Dorr, J. Alan MacKay, Boston, Mass., Sherman S. Poland and Ross, Marsh & Foster, Washington, D.C., were on brief, for Distrigas of Mass. Corp. and Distrigas Corp.

L. William Law, Jr., Boston, Mass., with whom Jennifer L. Miller, Boston, Mass., was on brief, for Boston Gas Co.

Michael W. Hall, Gary E. Guy, Cullen & Dykman, John W. Glendening, Jr., and Glendening & Schmid, Washington, D.C., on brief for intervenors, the Brooklyn Union Gas Co. and Bay State Gas Co., et al.

Joshua Z. Rokach, Atty., Washington, D.C., with whom Stephen R. Melton, Acting Gen. Counsel, and Jerome M. Feit, Sol., F.E.R.C., Washington, D.C., were on brief, for respondent.

Before CAMPBELL, Chief Judge, BREYER, Circuit Judge, and GIERBOLINI,* District Judge.

BREYER, Circuit Judge.

Distrigas Corporation, a subsidiary of the Cabot Corporation, imports liquefied natural gas (LNG) from Algeria. It sells the LNG to Distrigas of Massachusetts Corp. (DOMAC), another Cabot subsidiary, which pumps it through a terminal, stores it, and resells it to Boston Gas Company and other customers. In September 1976 the Federal Energy Regulatory Commission (then called the Federal Power Commission) determined, contrary to its prior view, that it had authority to regulate DOMAC and Distrigas sales under the Natural Gas Act. 15 U.S.C. §§ 717 *et seq.; see Distrigas Corp. v. Federal Power Commission*, 495 F.2d 1057 (D.C.Cir.), *cert. denied*, 419 U.S. 834, 95 S.Ct. 59, 42 L.Ed.2d 60 (1974).

The Commission did not immediately set rates. Rather, it allowed DOMAC and Distrigas to negotiate rates with their customers, *see Distrigas Corp.*, 58 F.P.C. 2589 (1977), *"clarified" in Distrigas Corp.*, 1 FERC ¶ 61,163 (1977); and it then approved a 'settlement' agreement governing rates between 1978 and 1979, *see Distrigas of Massachusetts Corp.*, 5 FERC ¶ 61,296 (1978), *modified*, 6 FERC ¶ 61,253 (1979). In 1979, DOMAC (and Distrigas) applied for a rate increase under section 4 of the Natural Gas Act, 15 U.S.C. § 717c. The Commission began to consider whether these proposed rate increases were "just and reasonable." *Id.* As section 4 provides, the Commission suspended the new rates for several months; they then took effect upon DOMAC's request, subject to refund after a final determination of their 'reasonableness.' (*See* Appendix for text of section 4.) An ALJ found that major portions of the proposed increase were not justified. And the Commission, for the most part, affirmed that decision. DOMAC and Distrigas now appeal the Commission's decision to us for review. *See* 15 U.S.C. § 717r(b).

We note that in 1981, while the 1979 proceeding was still pending before the Commission, Distrigas and DOMAC filed for a further rate increase. The interested parties reached a settlement concerning this 1981 increase, conditioning its size on the resolution of several specified issues in dispute in the 1979 proceedings. The Commission has approved this settlement. *Distrigas of Massachusetts Corp.*, 20 FERC ¶ 61,073 (1982). Thus, the rate decision that we here review governs only the period from 1979 to 1981 (which the parties call the "locked-in" period) with the exception of one issue concerning post-1981 refund levels to which we will turn in Part IV.

I

For the most part Distrigas and DOMAC are asking us to set aside certain subsidiary Commission findings—findings that, in part, led the Commission to its final conclusion about what rate was "just and reasonable." We are asked to review these findings under traditional principles of administrative law. We must determine whether the findings of fact are supported by "substantial evidence," 15 U.S.C. § 717r(b); *see* 5 U.S.C. § 706(2)(E); and we must make certain that the Commission's policy judgments are not "arbitrary, capricious" or an "abuse of discretion." 5 U.S.C. § 706(2)(A). As the Court of Appeals for the District of Columbia Circuit has stated in a rate case such as this one, applying these standards often comes down simply to insuring

> that the Commission's judgment is supported by substantial evidence and that the methodology used in arriving at that judgment is either consistent with past practice or adequately justified ....

* Of the District of Puerto Rico, sitting by designation.

City of Batavia v. FERC, 672 F.2d 64, 85 (D.C.Cir.1982) (quoting *Public Service Commission v. FERC*, 642 F.2d 1335, 1351 (D.C.Cir.1980), *cert. denied*, 454 U.S. 879, 102 S.Ct. 360, 70 L.Ed.2d 189 (1981)).

The case before us involves the application of classical public utility cost-of-service ratemaking principles. In applying these principles, a regulator traditionally will proceed as follows:

1. He selects a test year (t) for the regulated firm.
2. He adds together that year's operating costs (OC), taxes (T), and depreciation (D).
3. He adds to that sum a reasonable profit determined by multiplying a reasonable rate of return (r) times a rate base (RB). The rate base typically consists of total historical investment minus total prior depreciation. The rate of return typically reflects the coupon rate for long-term debt plus a 'fair' return to shareholder equity.
4. The total equals the firm's revenue requirement (RR). The regulator then allows prices that will equate the firm's gross revenues with this revenue requirement.

These four steps can be reduced to three formulae:

1. RR = OC + T + D + Profit
2. Profit = r(RB)
3. Price = RR/quantity sold

See generally A.E. Kahn, *The Economics of Regulation* (1970). This general account of ratemaking may help the reader understand to which of these formulae's terms the petitioner's claims and arguments relate and thus how they fit within the larger context of the ratemaking process. We now discuss each challenge in turn.

II

"Extra" Tax Expenditures

During the years 1979–81 (and thereafter) DOMAC will have to pay certain extra taxes (T) because it previously chose to take advantage of specially favorable tax code provisions in the early 1970's, before it became regulated. Its early 1970's tax choices (accelerated depreciation of plant and equipment, expensing instead of capitalizing of certain items) in effect deferred a portion of DOMAC's current tax liabilities into later years. Who should pay these "deferred" taxes? Should they be included as part of the firm's current revenue requirement and passed on to customers in the form of higher rates? Or should they be left out of the revenue requirement, effectively making DOMAC's shareholder (Cabot) pay the extra tax liability out of the ordinary profit that the Commission will allow DOMAC?

The Commission answered these questions here by referring to an approach known as tax "normalization." It treated DOMAC—which first became regulated *after* obtaining tax benefits—as it would have treated a firm always subject to regulation. It refused to include the extra tax expense in DOMAC's revenue requirement; it required the shareholder to bear the cost; and it also required DOMAC to take an amount equal to the entire "extra" tax payment that it would eventually have to make, subtract it from its rate base, and attribute it to several special accounts representing "Accumulated Deferred Income Taxes." *See* 18 C.F.R. Part 201, General Instruction 18 and Accounts 281–283. In determining rates, DOMAC, like other utilities, was not entitled to any return on the funds in these special accounts.

DOMAC and Distrigas challenge these decisions. We can best analyze their challenge by taking DOMAC's "accelerated depreciation" liability as a representative example, by explaining how regulatory commissions typically treat this liability, and by then examining DOMAC's argument for different treatment. The conclusions we reach concerning accelerated depreciation apply to the other deferrals here at issue as well.

1. *The tax "normalization" problem.* The tax normalization problem arises out of Congress's decision to allow firms to

depreciate plant and capital equipment at a specially fast rate for income tax purposes. *See* 26 U.S.C. §§ 167–68. Suppose, for example, a firm buys a piece of equipment for $1 million; it has a twenty-year life. If the firm depreciates the equipment on a "straight line," it will assume a depreciation expense of $50,000 each year for twenty years. Accelerated tax depreciation rules, however, allow it to depreciate over fewer years, taking a larger "depreciation" expense in the early years, but a correspondingly smaller depreciation expense in later years. If tax rules, for example, allow the firm to take a $100,000 expense (instead of the straight-line $50,000) in year one, the firm will keep whatever taxes it would otherwise have paid on the extra $50,000 (say, $25,000). The firm, however, will have to pay more tax in future years, when the depreciation expenses available for tax purposes will be correspondingly diminished. Assuming a stable tax rate, the lower early-year tax payments will be exactly counterbalanced by higher tax payments in later years; but, of course, firms find this system highly advantageous nonetheless, for they obtain the use of the "saved tax" money until the time it falls due.

Regulators have generally had to decide whether the advantages of this "loan" from the government should accrue to the regulated firm's shareholders or to its customers; they have had to choose between "flow-through" methodologies, which pass the immediate tax benefits on to the ratepayers, and "normalization" methodologies, which preserve more of the immediate tax benefits for the owners. *See Federal Power Commission v. Memphis Light, Gas & Water Division,* 411 U.S. 458, 465–67, 93 S.Ct. 1723, 1728–29, 36 L.Ed.2d 426 (1973); *Public Systems v. FERC,* 709 F.2d 73 (D.C. Cir.1983); *Memphis Light, Gas & Water Division v. FERC,* 707 F.2d 565, 567–69 (D.C.Cir.1983). *But see* Economic Recovery Tax Act of 1981, Pub.L. No. 97–34, § 201(a), 95 Stat. 172, 203, 208 (codified at 26 U.S.C. § 168(e)(3)) (requiring normalization approach as condition for accelerated depreciation by public utilities of post-1981 properties); 26 U.S.C. § 167(*l*) (imposing similar condition on use of accelerated depreciation for some post-1969 utility properties).

Flow-through: Under the flow-through approach, the firm is not allowed to collect from the ratepayer on account of tax expenses any more than the actual amount of tax that it will have to pay in the current year. In other words, if the firm saves $25,000 in taxes in equipment year 1 because of accelerated tax depreciation, it is to collect $25,000 less from its ratepaying customers. Of course, in, say, year 18, when it has a tax bill that is $25,000 higher than it otherwise would be, the firm can collect the additional $25,000 from its customers by charging them higher rates. The Commission in essence gives the customers the government "loan" to use as they see fit until the time the deferred taxes come due. Then the customers will have to pay the deferred bill.

Normalization: By contrast, the normalization approach allows the firm to collect the same tax money from its customers in early years that it would have collected in the absence of any accelerated tax advantage. The firm keeps the $25,000 that its use of accelerated tax depreciation saved it in equipment year 1. The firm then pays the money that it has kept to the government in, say, year 18 when taxes are higher. In the meanwhile, it may use the funds it has already collected from the ratepayers as it sees fit.

This system does not usually allow the firm to obtain full advantage of the "loan," however, for the regulator typically deducts from the firm's rate base the amount of the funds that the firm has collected from the ratepayers "early." This prevents the firm from charging the ratepayers to generate a return on the funds that it has, in effect, borrowed at no cost from them. The firm then adds the deducted amount back into the rate base in later years as the extra tax owed is paid to the government.

Suppose, for example, that a firm possesses $10 million in undepreciated plant, equipment, and working capital. And assume that it receives $25,000 from its ratepayers reflecting tax liabilities that (because of accelerated depreciation) are not currently due. Suppose that it invests this $25,000 either in a new machine or in added working capital. Were no further adjustment made, the firm's rate base would now stand at $10,025,000; and the firm would be allowed to earn a reasonable return (say 13 percent) on that amount. But instead the regulator deducts $25,000 from the rate base and attributes it to a special account for deferred tax receipts ("Account 282" under FERC's system of accounts). So, the firm is allowed to earn 13 percent only on $10 million, not on $10,025,000. (This adjustment has no impact on the *depreciation* charges that the company is allowed to include in its revenue requirements; although it is only entitled to a *return* on a part of its plant and equipment, it is nonetheless entitled to current, straight-line depreciation on all depreciable assets.) Later, when the $25,000 is paid to the government, the rate base is increased to reflect the fact that the firm has now made the $25,000 investment out of its own funds. (*See* Figure 1.)

FIGURE 1

Assets		Liabilities	
Plant and other utility-related capital	$10 Million	Shares (Investment)	$10 Million
New Machine (utility-related)	$25,000	Deferred Tax Account	$25,000

(Rate Base = $10,025,000 - $25,000 = $10 Million)

Of course, the firm may take the extra $25,000 and simply invest it in a savings account or a municipal bond, or put it to some other non-utility related use. In that case, the firm's rate base, absent further adjustments, would remain unchanged at $10 million, but the shareholders would be earning an extra return from the non-utility use of the $25,000. So, in this case, too, the rate base is reduced by subtraction of the $25,000 (leaving $9,975,000 in our example), and the return that the firm earns on the bond or savings account is assumed to compensate the shareholders for their "missing" $25,000 of plant and equipment. (*See* Figure 2.)

FIGURE 2

Assets		Liabilities	
Plant and other utility-related capital	$10 Million	Shares (Investment)	$10 Million
Municipal Bond (not utility-related)	$25,000	Deferred Tax Account	$25,000

(Rate Base = $10,000,000 - $25,000 = $9,975,000)

In a nutshell, the adjustment to the rate base reflects the fact that, under the normalization approach, the $25,000 was given to the company by its customers to pay taxes not yet due. One might alternatively view the $25,000 as being "loaned" to the company by the Internal Revenue Service. Either way, the firm at no cost to itself has obtained funds which it can invest as it chooses. The return the company is usual-

ly allowed to recover on its rate base compensates it for its costs in obtaining the requisite capital. So, in the regulators' view, the company should not be allowed to charge the ratepayers for a "return" on this $25,000 (temporary) addition to the firm's capital, because it was obtained by the company without cost.

In the thirty years since Congress introduced accelerated depreciation, the choice between flow-through and normalization has been the subject of much controversy, and the regulatory agencies, including FERC, have not held to consistent positions. *See, e.g., Public Systems v. FERC, supra.* The advocates of normalization have pursued the issue before both Congress and the agencies. They argued to Congress that flow-through compounds the tax revenue losses attendant upon accelerated depreciation and convinced Congress to condition accelerated depreciation for public utilities on the use of normalization. *See* Tax Reform Act of 1969, Pub.L. No. 91-172, § 441(a), 83 Stat. 487, 625-28 (codified at 26 U.S.C. § 167(*l*)), *discussed in Federal Power Commission v. Memphis Light, Gas & Water Division, supra; see also* 26 U.S.C. § 168(e)(3). And they have argued to the regulators that utility shareholders should receive the benefits of accelerated depreciation, since Congress enacted it as an incentive to company owners to induce companies to increase investment. While FERC for a time required use of flow-through, *see Alabama-Tennessee Natural Gas Co.*, 31 F.P.C. 208 (1964), *aff'd*, 359 F.2d 318 (5th Cir.), *cert. denied*, 385 U.S. 847, 87 S.Ct. 69, 17 L.Ed.2d 78 (1966), for the past decade the Commission has mandated the use of normalization. *See Texas Gas Transmission Corp.*, 43 F.P.C. 824 (1970), *vacated sub nom. Memphis Light, Gas & Water Division v. Federal Power Commission*, 462 F.2d 853 (D.C.Cir. 1972), *reversed* 411 U.S. 458, 93 S.Ct. 1723, 36 L.Ed.2d 426 (1973), *and affirmed on remand*, 500 F.2d 798 (D.C.Cir.1974); *Public Systems v. FERC, supra.*

2. *The Commission's decision here.* The Commission followed its normalization principles in this case. The amount of "extra" future tax liability that DOMAC has accrued as a result of accepting tax benefits in the early 1970's amounted, not to $25,000 as in our example, but to $4.6 million. The Commission held that DOMAC would not be allowed to raise revenues from its ratepayers to satisfy this liability; it would have to pay these "extra" taxes from money that would otherwise go to its parent corporation as part of its profit. The Commission also held that DOMAC's rate base would be reduced by $4.6 million; that amount would be allocated to separate deferred tax accounts on which DOMAC would not be allowed to earn a return. If we imagine, for example, that DOMAC's rate base—the land, equipment, working capital, and so forth—was valued for rate-making purposes at, say, $30 million when it first became regulated (we do not have the exact figures before us), the Commission in effect required that the $30 million be reduced to $25.4 million. The "profit" that DOMAC would be allowed to raise from its customers would amount, not to 13 percent of $30 million (or $3.9 million), but 13 percent of $25.4 million (or roughly $3.3 million) instead, reducing the company's return by something over half a million dollars per year. In essence, the Commission has treated DOMAC as if DOMAC, in the years before it became regulated, had already collected from its customers the $4.6 million tax bill it will have to pay in coming years.

3. *The reasonableness of the Commission's approach.* DOMAC argues that the Commission's decision is unreasonable both in requiring its shareholder to pay the $4.6 million future tax liability and in deducting that sum from its rate base until the deferred taxes become due. In DOMAC's view, this unreasonableness stems from the fact that it is not an ordinary regulated utility whose rates have been regulated throughout the period subject to normalization. Rather, it is a utility that first *became* regulated in 1976, *and* it incurred the $4.6 million tax liability *before* it became regulated. In evaluating DOMAC's argu-