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PUBLIC UTILITY VALUATION FOR RATE MAKING PURPOSES

PUBLIC UTILITY VALUATION FOR RATE MAKING PURPOSES.—Ever since *Munn v. Illinois* (1876) 94 U. S. 113, which first decided that the charges to be made for services rendered by public utilities were to be subject to governmental regulation, the courts have been confronted with a problem, so elusive and indefinite, that over five decades of litigation and wrangling have failed to provide a satisfactory solution. The so called "rule" of *Smyth v. Ames* (1898) 169 U. S. 466, specifying the elements to be considered in ascertaining the value of public utilities for the purpose of rate-making, has only served to submerge the problem further in its fog of uncertainties and difficulties. In the *Minnesota Rate Cases,* 230 U. S. 352, 434, it was stated by Mr. Justice Hughes, that "the ascertainment of that value is not controlled by artificial rules. It is not a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts." With this statement being reiterated continually, and the courts purporting to apply the rule of *Smyth v. Ames,* legal writers throughout the country busied themselves in denouncing the principles and methods employed by the judicial tribunals and solutions for the problem were suggested. Although they differed as to the proper doctrine to be adopted, many adhering to the prudent investment theory, while others were supporting the cost of reproduction view, all were in accord in expressing dissatisfaction with the rule of *Smyth v. Ames* and clamored for some sound workable rule as a guide. Judicial decisions, however, indicated very little change in the views of the bench, and the courts clung tenaciously to *Smyth v. Ames,* while vagueness and indefiniteness characterized their results.

In 15 MICH. L. REV. 205, 19 MICH. L. REV. 849, and 22 MICH. L. REV. 147, the important developments have been traced to the close of 1923. The conclusion drawn from the decisions rendered in the *Southwestern Bell Telephone* case, 262 U. S. 276, the *Bluefield Water Works and Improvement Co.* case, 262 U. S. 679, and the *Georgia Ry. and Power Co.* case, 262 U. S. 625, all decided in 1923, was, that weight must be given to cost of reproduction, but that it is not alone controlling. The weight to be given to this element, was characterized as being "subject to the same disconcerting uncertainty that envelopes the whole rule." Cases cited in 22 MICH. L. REV. 147 demonstrate the divergence of opinion that existed among the courts. It was with much interest and anxiety that those concerned with the problem, awaited some expression of the Supreme Court of the United States clarifying the situation and removing the doubts.

In *McCardle v. Indianapolis Water Co.* (Nov. 22, 1926) 47 Sup. Ct. 144, 71 L. Ed. 154, there seems to be a declaration of the amount of consideration to be given the cost of reproduction element. The Supreme Court, affirming

the decision of the District Court, *held* that the rates stipulated by the commission were confiscatory, on the ground that in adjusting the rates to take effect Jan. 1, 1924, the price level adopted—average of ten years ending with 1921—was too low and did not properly reflect the actual value of the property at the time of the investigation. The court, speaking through Mr. Justice Butler, says that "if the tendency or trend of prices is not definitely upward or downward and it does not appear probable that there will be a substantial change of prices, then the present value of lands plus the present cost of reconstructing the plant, less depreciation, if any, is a fair measure of the value of the physical elements of the property." This appears to be a wholehearted adoption of the cost of reproduction theory, eliminating entirely the other elements specified for consideration in *Smyth v. Ames*. The court went on to say that "prices and values have so changed that the amount paid for land in the early years of the enterprise and the cost of plant elements constructed prior to the great rise of prices due to the war, do not constitute any real indication of their value at the present time." Although quite evident that the present cost of reproduction was considered dominant if not the controlling factor, the court hesitated to admit that such course has been pursued and remarks, that "while some expressions of the district judge indicate that he was of the opinion that dominant or controlling weight should be given to cost of reproduction based on spot prices, it is clear that the $19,000,000 fixed by him as the minimum value could not have been arrived at on that basis."

Mr. Justice Brandeis, however, in whose dissent Mr. Justice Stone concurred, stated that since both the commission and the lower court purported to adopt the rule of *Smyth v. Ames,* the soundness of that rule was not involved, as it was in the *Southwestern Bell Telephone* case (in which case he proposed the prudent investment theory as the correct basis). The Supreme Court was therefore of the opinion that "the learned judge (of the Dist. Ct.) assumed that spot reproduction cost is the legal equivalent of value." When in the opinion of the lower court, we read that "dominating consideration should be given to evidence of reproduction value and if that means anything, it means that evidence of reproduction value spot at the time of the inquiry must be considered as evidence of a primarily different character from either of the other three kinds of evidence, (historical cost, reproduction cost upon a certain price level, prudent investment value)"; and when we read further "can the court now rationally say that the commission ... can, by any sort of examination of the evidence, reach a conclusion that upon unimpeached evidence showing a minimum of spot reproduction value at $19,000,000, it will still find reasonable value at $15,260,000?", it is obvious that the minority was correct in its conclusion that spot reproduction cost was taken as the practical equivalent of value. Regardless of the court's reluctance to make an express admission, the *McCardle* case does mark a step of progress in that it does remove one uncertainty from the field of uncertainties. The *Georgia Ry.* case while holding that reproduction cost must be considered, allowed only the enhancement of land values, a small item, in considering the existing prices. Now the cost of reproduction is to be dominant. The case represents an important development in the law; it is a clear departure from the rule of *Smythe v. Ames;* it brings us closer to "rules and regulations" and further away from "judgment and discretion."

Following the *McCardle* case, in *Waukesha Gas and Electric Co. v. RR. Comm. of Wis.* (Jan. 11, 1927) 211 N.W. 760, the supreme court of Wisconsin held that "a valuation which does not, as to tangible property, substantially reflect the then cost of reproduction less depreciation, does not meet the requirements..." of the *McCardle* case. This decision is especially signifiicant in view of the fact that in the former *Waukesha Gas Co.* case, (July 14, 1923) 194 N.W. 846, which followed the *Georgia Ry.* case, it was held that "no great weight is to be given to the cost of reproduction new". Now, the court rules that "expressions to the contrary in the former *Waukesha* case are modified to conform to the rule announced in the *McCardle* case."

In reviewing the cases of the past three or four years, it is noticeable how much conflict of opinion existed as to the degree of consideration to be given to the element of reproduction cost. Many courts have applied the doctrine now confirmed by the Supreme Court. In *Monroe Gaslight and Fuel Co. v. Mich. P. U. C.* (U. S. Dist. Ct., Feb. 27, 1926), 11 Fed. (2nd) 319, the court held that the value of $350,000 was obviously too low, since the commission's own reproduction cost exclusive of intangibles was $337,500, the court saying "at least, in the absence of special circumstances controlling otherwise, the dominant element ... is the reproduction cost less depreciation of the property involved". That present value in terms of present dollars is the goal of the investigation, and that while not exclusive of other elements, the reproduction cost less depreciation is the dominant factor, was decided in *Consolidated Gas Co of N. Y. v. Pendergast,* (U. S. Dist. Ct., April 22, 1925), 6 Fed. (2nd) 243. The court in *N. Y. Telephone Co. v. Prendergast* (U. S. Dist. Ct., July 26, 1924), 300 Fed. 822, also held that reproduction cost is the dominant element in rate base ascertainment. That this element was the "chief consideration" was ruled in *Van Wert Gaslight Co. v. P. U. C. of Ohio,* (U. S. Dist. Ct., Nov. 3, 1924), 299 Fed. 670, where a 1918 valuation was rejected in establishing the base for 1921. On the other hand, we find courts restating the rule of *Smythe v. Ames* and granting varying degrees of importance to the cost of reproduction factor, but denying that it is to be dominant or controlling. In *Western Oklahoma Gas and Fuel Co. v. State* (Okla., June 23, 1925) 239 Pac. 588, it was held that original cost as well as reproduction cost and all other factors was the test for value. Fair value was found to be $140,700 instead of the $271,583 claim of the utility which was based on cost of reproduction. In *City of Huntington v. P. S. C.* (W. Va., April 13, 1926), 133 S.E. 144, the court decided that it was proper not to take reproduction cost as the standard of value, saying "it is not the standard, but merely one of the elements". In *Reno Power, Light and Water Co. v. P. S. C.* (U. S. Dist. Ct., June 4, 1923), 298 Fed. 790, the court upheld the $324,000 valuation set by the commission rejecting the company's spot reproduction figure of $545,290. The court listed all the elements mentioned in *Smythe v. Ames* and added several others for good measure, which were to be taken into consideration. These cases could be multiplied in showing how greatly the courts have differed as to the weight given to the cost of reproduction. Now, with the *McCardle* case as a guide, it may be expected that all the jurisdictions will, as did the Wisconsin court, recognize that factor as dominant and controlling.

The proponents of the prudent investment theory, however, are not to be silenced, and they will continue to demonstrate the ailments of the cost of reproduction theory and to urge the superiority of the prudent investment doctrine. In *Van Wert Gas Light Co. v. P. U. C.* (supra) where the 1918 valuation was held not sufficient to establish the base for the 1921 rates, and it was declared that the "duty is imposed upon the commission of determining *de novo* the valuation of the company's property in each rate controversy", there is effectively demonstrated one of the serious objections to the cost of reproduction theory. Before one valuation has completely run the judicial gauntlet, another controversy has arisen with its resulting waste of enormous sums of money, time and efforts. So long as rates shall be determined from "value" and not from "prudent investment", we may also expect to hear complaints such as are voiced in *Pressure Oil and Gas Co. v. Tri-City Gas Co.,* (Okla., April 28, 1925), 236 Pac. 41: "It will be seen that the testimony of the engineers on both sides is in such hopeless and irreconcilable conflict that we must, of necessity, look elsewhere for evidence upon which to base a just and correct finding as to the present fair value of the property." Even with it settled that cost of reproduction is to be the equivalent of value, there still remains much difference of opinion as to the items to be included and a vast divergence as to the value of each, depending on the judgment and interest of the particular witness.

It is also noteworthy that the commissions, bodies which are much more closely in contact with the problem and better fitted to solve it most intelligently, stubbornly prefer the prudent investment theory, in spite of repeated reversals by the courts who are not so well acquainted with the situation. In *N. Y. Telephone Co. v. Prendergast* (supra) the court set aside the rates fixed by the commission, because book-cost was taken as the leading element. The court, in *Southern Bell Telephone & Teleg. Co. v. R.R. Comm.* (U. S. Dist. Ct. April 30, 1925), 5 Fed. (2nd) 77, rejected the strenuous contentions of the commission that a fair return should be allowed only on capital honestly and prudently invested, stating that "there is much to be said for the adoption of the prudent investment basis" but in none of the cases since *Smythe v. Ames* has it been adopted. Likewise, in *Boise Artesian Water Co. v P. U. C.* (Idaho, April 28, 1925), 236 Pac. 525, the order of the commission was set aside with the statement that "however convincing his argument may seem, Judge Brandeis was unable to prevail on the Supreme Court of the United States to concur in his view." And again it was held that the method of valuation adopted by the commission which considers only prudent investment is erroneous, in *Pacific Teleph. & Teleg. Co. v. Whitcomb,* (U. S. Dist. Ct., April 22, 1926), 12 Fed. (2nd) 279. And so repeatedly the court lays aside the orders of the commissions, and so too the commissions tenaciously adhere to the doctrine they consider sound.

In reviewing the recent cases, it is also to be noted, that in addition to holding that "present value in terms of present dollars is the goal of the investigation", *Consolidated Gas Co. of N. Y. v. Prendergast* (U. S. Dist. Ct., April 22, 1925), 6 Fed. (2nd) 243, the courts also take the "deflated dollar" into consideration when determining the fair and adequate return to which the utilities are entitled. Instead of the customary six per cent allowance of the

past, now an eight per cent authorization is the usual rate. The *McCardle* case held that a reasonable rate of return is not less than 7% and there were cited numerous recent decisions permitting a much higher rate of profit. In *N. Y. Teleph. Co. v. Prendergast* (U. S. Dist. Ct. 1924) 300 Fed. 822, a 7% return was held not justified since the usual rate is 8%. In *Consolidated Gas Co. of N. Y. v. Prendergast* (supra) it was held that a reasonable rate of net income is not less than 8%. We even find that a 16% return is "fair and reasonable" in a case decided on the appeal of the corporation, the representatives of the public not having complained, in *Western Oklahoma Gas & Fuel Co. v. State* (supra). If any allowance is made for the "deflated dollar" in ascertaining the base, then there is absolutely no justification for a second acknowledgement of the decreased purchasing power of the dollar, in determining the rate of return. It is obvious that where the value of the utility is taken at one-third more than its original cost because of the general rise in prices, and the income is also increased one-third, (from 6% to 8%) because of the same circumstances, then the company will be permitted to earn much more than an additional one-third—all without having invested one additional dollar. Moreover, investment house reports today show that the average utility need pay only 4% to 5% for loans made on its bonds. With bonds representing from one-third to two-thirds of the money used in financing public utilities, in the ordinary case, it is apparent that an 8% return is in effect a profit of 14% to the common shareholders. Because of this double allowance for the "deflated dollar" and the fact that the shareholders return is increased greatly because of the smaller rate of interest paid on utility bonds, the public is being burdened with an unreasonable sum as compensation for the services rendered, and the utilities are reaping a profit exceeding their just due—a greater amount than is at first apparent on the face of the decisions.

An interesting and perhaps the final skirmish in the battle between the cost of reproductionists and the prudent investment supporters is being staged in the railway valuation proceedings conducted by the Interstate Commerce Commission. Under the valuation amendment of March 1, 1913 (sec. 19a) to the act to regulate commerce, the commission is required to ascertain the value of common carrier property. In the *Texas Midland R. R.* valuation (July 31, 1918), 75 I. C. C. Rep. 1, 108, the statement of the methods employed in finding the valuations is presented in detail and has been followed by the commission in every valuation case since. The utilities' clamor for the cost of reproduction doctrine has been unheeded, and in its stead the rate base is arrived at by estimating the cost of reproduction new at unit prices of 1914, allowing for the actual cost of property installed after June 30, 1914. This method is not a complete adoption of the prudent investment principles as to structures erected before 1914; but because of the practical difficulties in ascertaining the honest investment in the early history of railroad construction and the fact that the unit prices adopted, fairly represent the price level of about twenty years preceding 1914, the scheme employed may be considered an adoption of prudent investment so far as it is possible. Despite the leanings of the Supreme Court in favor of the cost of reproduction view, the commission refuses to alter its methods, feeling that what that court "decides in one case to be the law may with further light and under certain conditions

be superseded in a subsequent case by a modified or different conclusion." The enormous stake involved in the settlement of this controversy is appalling. In 1920, the time of the general rate increase, the aggregate value of property used for transportation purposes was taken as over eighteen billions of dollars. As pointed out by the commission in *Excess Income of St. L. & O'Fallon Ry. Co.* (I. C. C. Feb. 15, 1927), if at that time the cost of reproduction theory had been adopted, the value of the same property would have been over forty-one billions—an increase of twenty-three billions of dollars (more than the present national debt), on which the public would have been required to pay a fair return. All, "without the investment of a single dollar by those who would reap the benefits." It is estimated that today, in the case of privately owned railroads and utilities, the current cost of reproduction doctrine would increase the public burden by upwards of thirty billion dollars.

The *San Pedro, Los Angeles, and S. L. R. Co.* case, first submitted to the Interstate Commerce Commission Feb. 7, 1922, has eventually been carried through the Supreme Court (75 I. C. C. Rep. 463; 4 Fed. (2nd) 736, 8 Fed. (2nd) 747,—U. S.—Feb. 21, 1927), but without an opinion rendered as to the correctness of the methods employed in these valuation cases. The railroad's bill to set aside the value found was dismissed because of lack of jurisdiction, it being held that the commission's report of value, under the Congressional act, is an exercise solely of the function of investigation and is not a step in any judicial proceeding. Only after the valuation so found is actually used in the fixing of rates, will the commission's scheme of ascertaining value, be passed on by the Supreme Court.

Meanwhile, the commission is quite definitely determined to stand by its guns until forced to withdraw by a decision of the highest court in the country. In *Excess Income of St. L. & O'Fallon Ry. Co.* (*supra*), we have the latest expression of opinion of that body. Commissioner Meyer, in a very able and lucid opinion, speaking for the majority, effectively demonstrates the evils, fallacies, difficulties, and consequences that will accompany the acceptance of the cost of reproduction theory. Saying that "a system of valuation for rate making purposes based on actual legitimate investment would have many appealing features," it is explained that the "complete lack prior to 1907 of the definite and dependable records which would be essential" prevents the complete adoption of that theory so as to apply it to property installed before 1914. Four commissioners concurred fully with Commissioner Meyer. Two others concurred in the results, but were of the opinion that the prudent investment theory should have been adopted to the fullest extent. Two of the four dissenting commissioners argued solely on the ground that the decisions of the Supreme Court restrain the action of the commission, and that the remedy for the situation lies in the hands of Congress and not in those of the commission. Only two of the eleven commissioners favored the cost of reproduction view on theory, and one of these, Commissioner Woodlock, is no longer a member of the group. What will be the outcome of this stand, so far as it applies to railways, in view of the decisions of the court and especially the recent *McCardle* case which stresses to an extreme the importance of present prices, still remains a matter of interesting speculation. Many would agree with Commissioner Eastman, who in the *O'Fallon Valuation,* after calling at-

tention to the important considerations involved, stated, "as to such matters, it (the commission) occupies a daily front seat upon the stage, while the Supreme Court of necessity is only an occasional visitor in the balcony."

In a recent Supreme Court decision, *R. R. etc. Comm. of Minn. v. Duluth St. Ry. Co.* (April 11, 1927) there has been eliminated some of the red tape that now delays the final determination of rate and valuation controversies. It was held that the state court remedies provided by the statutes need not be exhausted, before the litigation may be removed to the courts of the United States. S. L. R.