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Public Utility Valuation - Cost of Reproduction Theory and the World War

Edwin C. Goddard

University of Michigan Law School

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NOTE AND COMMENT

PUBLIC UTILITY VALUATION—COST-OF-REPRODUCTION THEORY AND THE WORLD WAR.—The very grave objections to the cost-of-reproduction theory of valuation of public utilities was pointed out at large in 15 MICH. L. REV. 205. The violent price changes following the World War have greatly increased the weight of these objections to calling anything a base which rests on such uncertainties and fluctuations as cost-of-reproduction. A base should be stable, but this has the stability of a flying machine. There had been a rising curve of costs from 1893 to 1916, but since that date the rise has been almost vertical. The public utilities by the thousands desire to take advantage of it. They are as fond of cost-of-reproduction now as they were of original cost in 1893, while for the public the transfer of affections has been reversed. Cost-of-reproduction has not proved a friend that either party can trust, and if the present flight of prices comes back to earth the utilities will have a revulsion of feeling to the efficient investment theory of valuation for which the public just now exhibits a touching fondness. "The amusing, although regrettable," changes in attitude toward the cost-of-reproduction rule have been stated with great clearness by the Indiana Commission in *Re Indianapolis Water Co.*, P. U. R. 1919 A 448, 464. In general, it may be said that the Commissions, being in more constant and

intimate touch with conditions, are much more impressed by this than are most of the courts.

Two recent decisions in this field have attracted wide attention and excited great interest. In *Lincoln Gas & Electric Light Co. v. Lincoln*, 250 U. S. 256 (June, 1919), Mr. Justice Pitney said the company should be allowed another application for relief, if it can show "upon evidence respecting values, costs of operation and the current rates of return upon capital as they stand at the time of bringing suit and are likely to continue thereafter, that the rate is confiscatory in its effect under the new conditions. It is matter of common knowledge that, owing principally to the World War, the costs of labor and supplies of every kind have greatly advanced. * * * And it is equally well known that annual returns upon capital and enterprise the world over have materially increased, so that what would have been a proper rate of return for capital invested in gas plants and similar public utilities a few years ago furnishes no safe criterion for the present or for the future." The complications of determining cost-of-reproduction, and rates based thereon, may be seen from the fact that in considering the problem for this lighting plant in a comparatively small city the Master had "an enormous mass of evidence produced before him, and analyzed in his report. In abridged form, it occupies nearly 2,000 pages of printed transcript in this court, besides numerous tabular exhibits." Its bulk is not at all unusual in valuations by the cost-of-reproduction method.

Fluctuations in wages, cost of materials, and money rates are inevitable, but the amount of such fluctuations, and their effect upon a utility, are easily capable of simple determination. It is only when the value of the whole plant is thrown into this sea of uncertainty that the Master finds swimming difficult and safe landing impossible. If, owing to the World War, the value of the utility has greatly advanced, then there is no firm base, no sure adjustment even for a day.

If value has greatly advanced, the next query is, has it kept pace with the increase in prices of materials? Shall the utility be allowed added value for materials actually put into the plant, and also for materials, composing most of the plant, and which were purchased at the far lower prices prevailing when the plant was built or enlarged? In other words, shall rates be based on the efficient investment representing the capital devoted to the public use, with a rate of return equal to that prevailing today, or shall they be based on the cost-of-reproduction today, at present prices of materials? There is no doubt as to how the public will respond when asked to pay rates on possibly double the capital actually invested simply because if the plant were to be built today, which it is not, it would cost twice as much as it did. Still, if it be an unchangeable rule of property that the owner of a public utility is entitled to such appreciations of value, then the feeling of the public has nothing to do with the question of right, and cost-of-reproduction should be rigidly applied. On the other hand, if there is here a question of policy and police power, and not a fixed rule of property, then each case may be considered by itself, to be decided on reason and judgment and all the circumstances of the case, past as well as present.

That is what Charles E. Hughes, the Referee, concluded in a recent and very much quoted opinion by him. This opinion, of course, derives great force from the fact that Hughes as Justice of the Supreme Court of the United States rendered the opinion in the *Minnesota Rate Cases*, 230 U. S. 352. In *Brooklyn Borough Gas Co. v. Public Service Com.*, P. U. R. 1918 F 335 (July, 1918), Referee Hughes said: "While it is important to consider the cost of reproduction in determining the fair value of a plant for rate-making purposes, it cannot be said that there is a constitutional right to have the rates of a public service corporation based upon the estimated cost of the reproduction of its property at a particular time, regardless of circumstances. To base rates upon a plant valuation simply representing a hypothetical cost of reproduction at a time of abnormally high prices due to exceptional conditions would be manifestly unfair to the public, and likewise to base rates upon an estimated cost of reproduction far lower than the actual bona fide and prudent investment because of abnormally low prices would be unfair to the company." This is not to be confused with recognition of actual costs of operation, even though abnormal.

If the quotation justifies the conclusion that fairness to the utility and to the public must be a determining factor in rate making, and that there is no constitutional property right to prevent, then there seems no serious obstacle to the contention that efficient investment and not cost of reproduction may be made the base, if not by judicial, then by legislative act. Many commissions, at all events, seem minded to come to that basis. In the *Brooklyn Borough Gas Case* itself the New York Commission in 1914, by computing the cost of reproduction as of that date, arrived at a base figure "covering the amount at which every unit of property stands in the capital account. This inventory or appraisal can easily be kept up to date, so that an investigation as to the rates or prices charged for gas can be made very expeditiously. The company on its part will be able to present to banking houses and investors a balance sheet virtually approved by the Public Service Commission." In other words, the commission seems to have approved the efficient investment theory. The amount of such investment up to 1914 was incapable of ascertainment from the books, and so a basing value was necessarily secured in another way. But this once agreed upon, and a system of accounting adopted, the value at any future date could be taken from the books. (See also to this point, *Biddeford & Saw Water Co. v. Itself*, P. U. R. 1920 B 580, 592.) The value at any day will be this 1914 base, plus capital investment added since. This is the method urged in 15 MICH. L. REV. 205. The board of directors, refusing to "admit the right of the Commission to impose the conditions above mentioned," "as matter of policy" accepted them and for the time acted upon them.

The merry tangle of learned referees, learned justices and commissioners, of legislature, commissions and courts, of Special Term, Appellate Division, First Department and Second Department, as the litigants vainly scurried through the labyrinth of the New York courts and commissions, may be followed by the curious reader in 171 N. Y. S. 937, 175 N. Y. S. 28, 176, 918, 178 N. Y. S. 94, 179 N. Y. S. 912, 180 N. Y. S. 48. But the parties are not

yet out. The rate to be charged for gas has not been finally passed on even by the Supreme Court, which in New York is not supreme, and the Court of Appeals has not yet had a chance at the case, not to speak of the possibilities if the parties should start traveling through the Federal Courts. Meantime the "learned Referee," ex-Justice Hughes, notwithstanding some injuries suffered at the hands of at least one "learned justice," is still in fair condition, though it does not yet appear with certainty how his opinion will look when the courts get all done with it. Meantime it has been so much quoted elsewhere as almost to attain the influence of an authority.

Re Capital Traction Co., P. U. R. 1919 F 779, 898, in an elaborate opinion of 160 pages, adopts the 1914 before the war value, plus added costs at the higher prices paid since that date. The D. C. Commission declined "to hold that the users of the service of a public utility at the very time when called upon to make great sacrifices because of a world-wide war should also be required to pay higher rates merely to enable such a utility, without the corresponding expenditure of a single dollar by way of increase of its pre-war investment, to reap a profit from the high level of prices which the very conflict has brought about." Is not this statement of conditions in time of war equally applicable to conditions at any time? The Minnesota Commission, in *Re Tri-State Tel. & Tel. Co.*, P. U. R. 1919 C 5, in passing on a petition for emergency relief, held that corporations, as well as individuals, must bear their share of the burdens of the war and sustain some loss of income without flinching. That a company or its employees should be asked "to make sacrifices that car riders may get service at less than cost" did not impress the court in *Doherty v. Toledo Railways & L. Co.*, 254 Fed. 597.

A very interesting statement of present situations is made by the Indiana Commission in *Re Indianapolis Water Co.*, P. U. R. 1919 A 448, 464. Admitting cost-of-reproduction-less-depreciation "is now the prevailing method of evaluation in Indiana," it adds that "a continued disposition toward this method would rapidly lead into unfathomable depths of speculative regulation, and create a thoroughly artificial and unjust basis for property values," unfair in these times to the public, in times of depression to the utilities. "There can be no better guide to or basis for rate making valuations than honest and prudent investment." Cost-of-reproduction is too well entrenched to permit a sudden and violent change, but there should be a gradual turning toward prudent investment as the controlling factor. The commission flatly refused to arbitrarily add an appreciation of \$1,500,000 due to the rising prices of real estate. See also *Re St. Joseph Ry. L. H. & P. Co.*, P. U. R. 1920 A 542, 546. The Michigan Commission well expressed the same in *Holland v. McGuire*, P. U. R. 1920 B 149, 164, quoting at length from Referee Hughes's opinion, *supra*. The Commission admitted great changes caused by war prices, but did not think it "logical that the customers of a public utility should be required to pay higher rates merely to enable a utility, without the corresponding expenditure of a single dollar towards an increase in its capital investment, to profit from a higher level of prices."

That present-day, or war, prices cannot be taken as a proper basis for valuation has been held by many commissions and some courts. See, for examples, *District of Columbia*,—*Re Capital Traction Co.*, P. U. R. 1919 F 799, 901, quoting "a most eminent jurist, ex-Justice Hughes, as referee"; *Illinois*,—*Re Springfield Gas & E. Co.*, P. U. R. 1920 A 446, 455, *Re Freeport Gas Co.*, P. U. R. 1920, B 726, 741, *Re Champaign & Urbana Water Co.*, P. U. R. 1919 E 798, 817, all quoting from the opinion of Referee Hughes; *Massachusetts*,—*Re Boston Consolidated Gas Co.*, P. U. R. 1919 A 699, 702; *Michigan*,—*Holland v. McGuire*, P. U. R. 1920 B 149, 164; *Missouri*,—*Re St. Joseph Ry. L. H. & P. Co.*, P. U. R. 1920 A 542, 546; *Nebraska*,—*Re Omaha & C. B. St. R. Co.*, P. U. R. 1919 A 845, 849; *New York*,—*N. Y. I. Water Co. v. Mt. Vernon*, 180 N. Y. S. 304; *Utah*,—*Re Utah Light & T. Co.*, P. U. R. 1920 B 262, 270; *Vermont*,—*Re Colonial P. & L. Co.*, P. U. R. 1920 A 215, 218; *Wisconsin*,—*Racine Water Co. v. R. Com.*, P. U. R. 1919 A 913, 926.

Such decisions are far from showing an adoption of the efficient or prudent investment theory, but they insist cost of reproduction must have relation to reasonably permanent cost prices. Often they base value on costs on averages for a five-year or a ten-year period. *Racine Water Co. v. Railroad Commission*, *supra*, while in other cases the price curve is "smoothed out" by taking 1912 or 1914 valuations as a base and adding betterments since that date at actual cost. *Re Wisconsin Traction, L. & H. P. Co.*, P. U. R. 1919 B 224, 229, and *Milwaukee v. Wisconsin R. Com.*, P. U. R. 1920 B 976, 991, expressing a preference for investment cost as a basis when there are adequate and reliable records, Cf. *Re Bloomer Electric L. & P. Co.*, P. U. R. 1919 B 481, 483; *Brooklyn Borough Gas Case*, P. U. R. 1919 F 335, per Hughes, Referee, quoted with approval in *N. Y. I. Water Co. v. City of Mt. Vernon*, 180 N. Y. S. 304; *Re Kansas City Gas Co.*, P. U. R. 1920 C 41, 50; *Re Capital Traction Co.*, P. U. R. 1919 F 779, 899.

The recent cases in the courts, as contrasted with some by the commissions, in general continue to insist that neither cost-of-reproduction nor original cost can be taken as the only basis for valuation, but every element must be considered, with sound business judgment, to determine what is fair and just to consumer and utility. However, chief emphasis is given to cost-of-reproduction in most courts. *State Pub. Utilities Com. v. Springfield Gas & Elec. Co.* (Ill., Dec. 1919), 125 N. E. 891; *Ben Avon v. Ohio Valley Water Co.*, 260 Pa. St. 289; *Detroit v. Michigan R. Com.* (Mich., April, 1920), 177 N. W. 306. See *Re Iroquois Natural Gas Co.*, P. U. R. 1919 D 76, 85, in which the utility vainly sought to submit only reproduction costs, and *Milwaukee v. Wisconsin Railroad Com.* (Wis., Jan. 1920), P. U. R. 1920 B 976, 990, expressing a strong preference for considering "investment prudently made," especially at a time of very widely fluctuated costs and abnormal conditions. With this may be contrasted the opinion of Booth, J., in the U. S. Dist. Ct., March 4, 1920, in *Winona v. Wisconsin-Minnesota L. & P. Co.* The opinion objects to the use of the words "normal," "abnormal," and seems to rely wholly on cost-of-reproduction at the time the value is

being fixed, with rates based thereon, "even though this adjustment may fit a comparatively short period of years." There seems to be no other decision going this length, unless it be the opinion on which Judge Booth relies, that before referred to, of Justice Pitney in the *Lincoln Gas Case*, 250 U. S. 256. Whether the language of that case will bear this interpretation is open to doubt.

The opinion written by White, C. J., in *U. S. ex rel. Kansas City So. Ry. Co. v. Interstate Com. Com.* (U. S. Sup. Ct., Mar. 8, 1920), has been thought to show an inclination of the court to disapprove the *Minnesota Rate Cases* in so far as they refused to base land values on the "present cost of condemnation and damages or of purchase in excess of such original cost or present value." The point involved was this: Congress in 1913 ordered the Interstate Commerce Commission "to investigate, ascertain and report the value of all property owned or used by every common carrier subject to the provisions of this act." The Commission was directed to ascertain, among other things, the cost of reproduction, with the original cost of all lands, rights of way, etc., "and the present value of the same, and separately the original and present cost of condemnation and damages or of purchase in excess of such original cost or present value." Following the *Minnesota Rate Cases*, the Commission held that because of the impossibility of making the self-contradictory assumptions such a theory requires, this could not be done. Mandamus was asked to compel the Commission to make such valuations. The trial court and Court of Appeals denied relief. But the Supreme Court reversed this on the ground that the only question involved was "the non-action of the Commission in a matter purely ministerial." There was the direct and express command of Congress and the unequivocal refusal of the Commission to obey. The court found it impossible to conceive how the *Minnesota Rate* ruling could furnish ground for such refusal. This does not show that the *Minnesota Rate Cases* are in any point overruled, but it may mean that the court does not understand them as they have been understood by the Commission, and possibly by the public. What this means as to the cost-of-reproduction theory does not yet appear. In any event, the Commission's answer "Impossible" to a command of Congress does not pass.

On the whole, it can hardly be said that the present high prices have induced the courts to turn from the "fair value" theory of *Smyth v. Ames*, 169 U. S. 466, with all its speculative uncertainties, but many of the commissions have flatly expressed a preference for "prudent investment" as a basis for valuation, and more and more the courts are recognizing that the legislatures have endeavored to make utility commissions to which these problems can safely be trusted for final settlement in all but a few exceptional cases calling for judicial interference. The office of commissioner is "an office of dignity and great responsibility," and the courts should regard his work as that of an expert that should not be "closely restricted by the courts." *Pub. Utilities Com. v. Springfield Gas & E. Co.* (Ill., 1919), 125 N. E. 891, 895; *Detroit v. Mich. R. Com.* (Mich., 1920), 177 N. W. 306, 318.
E. C. G.