1909

Valuing Property and Franchises of Public Service Corporations for Fixing Rates

Horace LaFayette Wilgus
University of Michigan Law School

VALUING PROPERTY AND FRANCHISES OF PUBLIC SERVICE CORPORATIONS FOR FIXING RATES.—The Supreme Court of the United States has recently decided two important cases relating to the proper valuation of the property of public service corporations for the purpose of fixing rates to be charged for their services. These are *Knoxville* v. *Knoxville Water Company*, 211 U. S. —, 29 S. C. 148, and *Willcox* v. *Consolidated Gas Co.*, — U. S. —, 29 S. C. 192, both decided January 4, 1909.

In the first case a master had found the value of the company's property

to be $608,427, including, in addition to the tangible property, $10,000 for "organization, promotion," etc., and $60,000 for "going concern," because it was in successful operation; the gross income to be $88,481; operating expenses, $34,750; that the new rates would reduce the gross income to $70,857, and leave the net income $36,106, or $400 less than 6 per cent on the total valuation; and that 8 per cent, including 2 per cent for depreciation, was the minimum net return to which the company was entitled.

This finding was confirmed by the trial court, and it was contended that the findings of the master, confirmed by the court, were conclusive in the Supreme Court unless they were without support in the evidence or were founded upon erroneous views of law. The court, by Justice MOODY, says: The purpose of the suit is to arrest the operation of a law on the ground that it is void; the law here is a municipal ordinance, deriving its authority from the legislature, and must be regarded as an exercise of legislative power. While the courts can, on constitutional grounds, refuse to enforce such legislation, such power ought to be exercised only in the clearest cases; and where invalidity rests upon disputed questions of fact, the invalidating facts must be proved to the satisfaction of the court. In view of the judicial power invoked in such cases it is not tolerable that its exercise should rest securely upon the findings of a master, even though confirmed by the trial court. The power is best safeguarded by preserving to the court complete freedom in dealing with the facts, and nothing less than this is demanded by the respect due from the judicial to the legislative authority.

As to the $70,000 for "organization" and "going concern" included in the valuation, the court says: "We express no opinion as to the propriety of including these, * * * but leave the question to be decided when it necessarily arises. We assume, without deciding, that these items were properly added in this case." Deducting these, the value of the tangible property would be $538,427, which was determined by the master by ascertaining what it would cost to reproduce the existing plant as a new plant, and without allowing anything for depreciation. The city claimed there had been depreciation to the amount of $118,000, and the company admitted a depreciation of $77,000. The court said "it is clear that some substantial allowance for depreciation ought to have been made," exactly how much it is unnecessary to determine, for if only $50,000 are allowed, the estimated net earnings would return 6½ per cent on such corrected valuation.

Where the ordinance has not gone into operation, because enjoined, and its effect, if enforced, cannot be certainly known, and the company prefers "to go into court with the claim that the ordinance is unconstitutional," it must be prepared to show to the satisfaction of the court that the ordinance would be so confiscatory in its effect as to violate the Constitution of the United States, citing and affirming to same effect: *Ex parte Young*, 209 U. S. 123, 52 L. Ed. 714, 13 L. R. A. (N. S.) 932, 28 S. C. Rep. 441; *San Diego Land Co.* v. *Jasper*, 189 U. S. 439, 47 L. Ed. 892, 23 S. C. Rep. 571; *San Diego Land Co.* v. *National City*, 174 U. S. 739, 43 L. Ed. 1154, 19 S. C. Rep. 804. Here the company is certain to receive substantially 6 per cent, or 4 per cent after allowing 2 per cent for depreciation, and we do not

feel called upon to determine whether this would amount to confiscation, or not, where the case rests upon speculation as to results, and the valuation was based upon that most unsatisfactory evidence, the testimony of expert witnesses employed by the parties, and where the city authorities acted in good faith and tried, without success, to obtain from the company a statement of its property, capitalization and earnings. The courts should not have the whole burden of saving property from confiscation, but the bodies to whom the legislative power has been delegated ought to do their part, and the companies to be regulated will find it to their lasting interest to furnish freely the information upon which a just regulation can be based.

Further, in considering depreciation, this was stated to be *complete,* or such part of the plant as had, by destruction or obsolescence, perished as useful in operation, and *incomplete,* or such impairment in value as the parts still in use had suffered,—and it was contended that "in fixing the value of the plant, upon which the company was entitled to earn a reasonable return, the amounts of complete and incomplete depreciation should be added to the present value of the surviving parts. The court refused to approve this method, and we think properly refused. * * * Before coming to the question of profit at all the Company is entitled to earn a sufficient sum annually to provide not only for current repairs, but for making good the depreciation and replacing the parts of the property when they come to the end of their life. * * * It is entitled to see that from earnings the value of the property invested is kept unimpaired so that at the end of any given term of years the original investment remains as it was at the beginning. * * * If, however, a company fails to perform this plain duty and to exact sufficient returns to keep the investment unimpaired, whether this is the result of unwarranted dividends upon overissues of securities, or omission to exact proper prices for output the fault is its own, and the true value of the property then employed cannot be enhanced by a consideration of the errors in management which have been committed in the past." With this should be compared: *Redlands L., Etc., Water Co.* v. *Redlands,* 121 Cal. 363, 53 Pac. 791; and *Cedar Rapids Water Co.* v. *Cedar Rapids,* 118 Ia. 234, 91 N. W. 1081.

In the second, the gas case, the court reiterates that, before it will enjoin, the rates must be so unreasonable as to be equivalent, if enforced, "to the taking of property for public use without such compensation as is just, both to the owner and the public. There must be a fair return upon the reasonable value of the property at the time it is being used for the public. The case ought to be a clear one before the courts ought to be asked to interfere. * * * especially before there has been any actual experience of the practical result of such rates."

Prior to 1884 there had been seven companies organized to furnish gas to the city and citizens of New York, each of which had been granted, as a gratuity, extensive and valuable franchises to lay pipes in the streets in certain portions of the city. In 1884 a law was passed permitting the consolidation of these companies, upon terms to be mutually agreed upon, and to issue stock in an amount not more than the fair aggregate value of the property, franchises and rights of the companies to be consolidated. Six of

the companies consolidated, and the other one went out of business. The tangible property was valued at $30,000,000 (round figures) and franchises at $7,781,000, and stock of the consolidated company to the sum of these was issued in exchange for the stock of the various companies, and the property transferred to the new company.

In 1906 the legislature of New York passed a law limiting the price of gas sold to private consumers to 80 cents per 1,000 cubic feet. The company sought to enjoin the enforcement of this rate because it was so low as to be confiscatory. A master found the value of the tangible property of the company to be $47,831,435; franchise, $12,000,000; the net income for 1905, under the old rates, to be $5,881,192; and the probable income under the new rates to be $3,030,000,—or considerably less than 6 per cent on the total value of tangible property and franchises,—$59,831,435. Upon these findings the circuit court entered a decree permanently enjoining the enforcement of the rates.

The master arrived at the value of the franchise by this proportion: $30,000,000 tangible property (in 1884) is to $7,781,000, franchise (in 1884) as $47,000,000 tangible property (in 1905) is to $12,000,000 franchise (in 1905). The Supreme Court, by Mr. Justice PECKHAM, says: "We cannot, in any view of the case, concur in that finding." The court, however, allowed the valuation of $7,781,000 of the franchise at the time of consolidation to stand. In 1885 a senate committee had, after investigation of the consolidation, reported that the companies had, prior to consolidation, earned dividends of 16 per cent upon their capital stock, and 25 per cent upon the money actually paid in; that they had been free from legislative regulation during this period; that they had an agreement among themselves fixing rates; that the people had paid the rates without protest; that the rates may have been too high, but they were not illegal; and that the valuation of the franchises computed upon dividends from these rates was not more than their fair aggregate value.

For more than twenty years the stock had been dealt in, and its validity had always been recognized; so the court held that this valuation ought to be accepted, but this decision "can form no precedent in regard to the valuation of franchises generally, where the facts are not similar to those in the case before us." So, too, "the fact that the state has taxed the company upon its franchises at a greater value than is awarded them here is not material," for those taxes were properly treated as part of the operating expenses to be paid out of earnings before the net amount applicable to dividends could be arrived at, and that value probably will be largely reduced if the new rates go into operation.

The master combined the franchise value with that of "good will" and estimated the total at $20,000,000: the company had a monopoly in fact; the consumer must take gas from it or go without, for he cannot get gas anywhere else. "The court below excluded that item, and we concur in that action," says the Supreme Court.

The value of the property is to be determined as of the time when the inquiry is made regarding the rates; if it has increased in value since it was

acquired, the company is entitled to the benefit of such increase, as a general rule, though there may possibly be an exception where the property may have increased so enormously as to render a rate permitting a reasonable return upon such increased value unjust to the public,—a question left for further consideration when it should arise.

As to the rate of compensation for the use of the property, the court says: "There is no particular rate which must in all cases and in all parts of the country be regarded as sufficient; it must depend greatly upon circumstances and locality; the amount of risk is a most important factor, and the rate usually realized upon investments of a similar nature in that locality is another; the less the risk the less right to unusual returns. The risk here is almost a minimum, for the company monopolizes the gas service of the largest city in America; it seems as certain as anything of the kind can be that the demand will increase; an interest in such business is as near safe as can be imagined with regard to any private manufacturing business. Under such circumstances a return of 6 per cent upon the fair valuation would not be confiscatory; and, still further, where the large mass of the property is real estate, the value of which can be ascertained only by the varying opinions of expert witnesses who differ greatly in their estimates; and where increased consumption at the lower rate might result in increased earnings, without proportionally increasing cost of furnishing; and where the margin between possible confiscation and valid regulation is so narrow as here we cannot say that the rates are insufficient, upon the valuation corrected as indicated. "The company has failed to sustain the burden cast upon it of showing beyond any just or fair doubt that the acts of the legislature of the state of New York are in fact confiscatory;" but if, by the test of actual operation, the company does not obtain a fair return, it ought to have an opportunity of again presenting its case to court, and so the decree below is reversed and the bill dismissed without prejudice. See *Central of Ga. Ry.* v. *R. R. Com. Ala.*, 161 Fed. 925, 992.

The foregoing cases make more definite what perhaps has already been implied in former decisions of the Supreme Court in regard to the method of treating depreciation or increase in the value of property, the rate of compensation, and the uncertainty of estimates of value. They, however, leave the treatment of franchises still uncertain. *Brunswick* v. *Maine Water Co.*, 99 Me. 371, 59 Atl. 537; *Kennebec W. District* v. *Waterville*, 97 Me. 220, 54 Atl. 6, 60 L. R. A. 856; *Spring Valley W. W.* v. *San Francisco*, 124 Fed. 574; *San Diego W. Co.* v. *San Diego*, 118 Cal. 556; 62 Am. St. R. 261, 38 L. R. A. 460; *Consolidated Gas Co.* v. *New York*, 157 Fed. 849, 872. They also proceed along lines that indicate much greater caution in setting aside schedules of rates as confiscatory, based upon the idea that the earnings will be decreased by the same percentage that rates are decreased, without considering the probable effect upon increased patronage. Legislation regulating rates should provide for carefully valuing the property after full disclosure is made; fixing the rates at such a figure as to yield a fair income, considering the risk, upon the value of the property then being used; putting the rates into immediate effect, and testing the effect for a year or

more by actual operation, allowing the municipal corporation fixing the rates, during the test, to give bond to make good any deficit in the amount necessary for fair compensation, with interest, and to raise the sum necessary therefor by tax, or by a charge against the consumers and their property of their proportion of the deficit, after full and complete report by the company. Or in case the company seeks an injunction, on the ground the rates, if enforced, will be confiscatory, the courts should require the company to give bond to refund to those who pay, after the injunction is issued, the amounts improperly collected, in case the court should find after final hearing that the rates established were valid. Only in some such way can such matters be adjusted with fairness to all concerned, and, as the court says, it would be of lasting benefit if public service companies would meet the public officers half way in an effort to secure and consider the exact information necessary to determine with any degree of certainty what is right and fair in the particular case. H. L. W.