PUBLIC UTILITIES-SMYTHE v. AMES AGAIN

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PUBLIC UTILITIES—Smythe v. Ames Again—The suit arose in 1893 over railroad freight rates prescribed by an act of the legislature of Nebraska approved April 12, 1893 which went into effect August 1, 1893. The claim was that the rates prescribed were so low that the plaintiff stockholders' railroads were deprived of property in contravention of the Fourteenth Amendment to the Constitution of the United States. The state officials showed "that the railroads of Nebraska can be reproduced completely for about $20,000 per mile."¹ Eleven railroads were concerned. The lowest funded debt was $12,324 per mile with four over $20,000 per mile. The par value of the capital stock per mile of one railroad was $5,021 and of five was more than $20,000 per mile each. The act of Congress under which the Union Pacific (one of the railroads) was constructed reserved a second lien of $16,000 per mile for loans made by the government and authorized a prior lien of $16,000 per mile for loans to be made by private parties and the funded debt was $70,468 per mile. It was found that if the rates prescribed had been in effect for the test year with the same volume of business some of the railroads would not have earned operating expenses and some would have made some earnings—Union Pacific $55,596 and Burlington $77,617. It thus became necessary to determine whether the decrease of rates to such amounts of "net earnings" had deprived the railroads of their property.

As is well known, 1893 was at the end or well toward the end of a long period of falling prices. The railroads had been built during that period. From 1861 to 1879 the whole economy of the nation was on a paper money basis—specie payments were suspended. Then too during this period the art or "know how" of building railroads was being developed and made a part of the fund of common knowledge. Due to this last mentioned cause alone, beyond question the railroads could have been reproduced in 1893 for much less than their cost no matter how high a degree of skill, prudence and judgment had been exercised in their actual construction according to the means, methods and knowledge of the days in which constructed. Thus there were two factors which had worked against the interests of the investors in railroads; namely, falling prices in general arising from an increase in the value of money and falling costs in building railroads arising from an increase in experience and knowledge in such building.

Confronted with this situation, counsel for the state argued:

"... the present value of the roads, as measured by the cost of reproduction, is the basis upon which profit should be computed.

¹ Smythe v. Ames, 169 U.S. 466, 18 S. Ct. 418 (1898).
"In endeavoring to establish a reasonable rule we are bound to consider the conditions which surround other occupations. Railroads are built, owned and operated by corporations; corporations are fictitious persons created by law; laws are made by the people through their representatives. It cannot be assumed that natural persons would intentionally create fictitious persons and endow them with rights and privileges greater than they themselves enjoy. Neither can it be assumed that the natural persons who make the laws desired to exempt corporations, the creatures of law, from the vicissitudes which surround themselves. The ordinary business man cannot avail himself of watered stock or fictitious capitalization, nor can he protect himself from falling prices. If his property rises in value, he profits thereby; so do the owners of a railroad under similar conditions. If his property falls in value, he loses thereby; so must the owners of a railroad under similar conditions, unless it can be shown that railroad property deserves more protection than other forms of property."  

"That railroads should be placed upon the same footing as ordinary business enterprise" was argued further at length.

The Court did not wholly go along with the argument of counsel for the state but in an opinion written by Justice Harlan unanimously concurred in by all the justices who heard the case—two did not—made the well-known statement:

"We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience."  

Thus was enunciated the proposition that "the basis of all calculations as to the reasonableness of rates . . . must be the fair value of the property being used . . . for the convenience of the public" and in determin-

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3 Smythe v. Ames, 169 U.S. 466 at 546-547, 18 S. Ct. 418 (1898).
ing such value one factor to be considered is “the present as compared with the original cost of construction.”

The several factors mentioned in the above quoted excerpt from the opinion “are to be given such weight as may be just and right in each case,” or as earlier said in the Court’s opinion “each case must depend upon its special facts.” The decision was rendered March 7, 1898.

When in the teens of the present century rate regulation came to be applied to the utilities, electric street and interurban railways, electric power and light, gas and telephone, a very different situation was presented. They had been constructed except in relatively very minor part during a period of rising prices and prices were continuing to rise during the teens and twenties and the end was not then foreseeable. Also the street and interurban railways started with the full benefit of the general knowledge developed from the pioneering experience of the railroads, and the other utilities had the benefit of such knowledge in so far as analogous and capable of application. During this period reproduction cost was practically always substantially in excess of the original cost in so far as correct original cost was ascertainable from books and records. The only exception was the sudden disappearance of the street and interurban railways in the twenties.

A circumstance persistently ignored by those who have been the authors of most of the discussion on the subject is that the regulators are human beings, the representatives of the public who appear before the regulatory authority are human beings and the public using the service of the utility are human beings. And all just as much so as those who own and operate the utilities. And all behave as human beings. Accordingly, confronted with the situation here outlined, the representatives of the public and the regulators set about to overturn, avoid or emasculate what other representatives of the public in another day and under other conditions had urged the courts to declare and apply as the law.

It was argued that those who invested in a utility in effect lent their money to the public, and the securities they received and held as representing the investment were to be likened to the bonds received and held by those who lent their money to the state, county or municipality for building roads or other improvements for public use. This argument was even developed to the point of contending that the investors in the utility had been guaranteed by the public both the integrity of their dollar investment (prudently made) and a reasonable return thereon. At about that point the electric interurban railways disappeared and with great suddenness. An investment prudently made and prudently managed, rendering to the public over a generation most convenient and valuable service, was wholly lost. It was found there was no public guaranty of a prudent investment.
Another line of attack was that the Supreme Court had said that fair value was to be determined from a number of factors. "The original cost of construction" was named as one just as well as "the present as compared with the original cost of construction." All factors "are to be given such weight as may be just and right in each case." Therefore it was urged upon the regulatory authority that, if evidence bearing on all the factors were developed in the record and the regulatory authority then made its determination, it thereby gave all matters such weight as was just and right in the particular case. The circumstance that the fair value thus determined might happen substantially to coincide with original cost was declared of no significance. This process was carried to the point where the regulatory authority would carefully get before it all such evidence, then mouth with the strictness of a ritualistic incantation the formula of the factors listed in Smyth v. Ames, and pronounce a determination of fair value at or below original cost less depreciation. As one member of long experience on a commission said to the writer during a recess in a hearing in which the member was sitting, which hearing had then extended over several weeks and in which the writer was representing the utility, "You know as well as I do that the proofs you put in before us have nothing to do with the order that we make." The hearing continued for several weeks after this remark and after the conclusion the order made was precisely what I had learned (from outside sources) on the third day of the hearing (several weeks before the remark) it would be. The remark was not intended as having relation to the particular hearing then in progress, but as a statement applicable to all rate matters coming before the commission and as being typical of the action of all regulatory authorities.

But while this line of attack was still continuing prices were continuing to hold their level and the trend continued upward. This circumstance finally impelled the Supreme Court to declare in the Bluefield case\(^4\) that the relation between the value determined by the regulatory authority and reproduction cost "clearly shows" that the regulatory authority "did not accord proper, if any, weight to the greatly enhanced costs of construction" of the time of the controversy over those prevailing in the earlier years of the utility, and in the Indianapolis Water Company case,\(^5\) "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." In the Monroe Gas case, a lower federal court stated:\(^6\) "the reproduction cost is the dominating

\(^4\) Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 at 689, 43 S. Ct. 675 (1923).
element in the fixing of the rate base; and if a Commission, which leaves it substantially unimpeached, fails to give it that dominating effect, there is error of law which the court must correct."

A third line of attack pursued was that, if costs of reproduction as of the time of the inquiry had to be considered, the representatives of the public would do their utmost to make it appear ridiculous and to render it unworkable in practical administration. Accordingly, the making of inventories and appraisals was forced to be carried to an extreme which was an absurdity. The inventory was required to be carried to the minutest piece or part of a piece of physical property used. Every such item used by the utility had to be counted and recorded and separately appraised. This was carried to the point where valuation engineers of high standing and experience expressed their judgment that ninety per cent of the time and expense was put on the inventoried and appraising of ten per cent of the property. Anyone having any appreciable experience in such matters would readily concur in this statement. Months of time and unbelievable thousands of dollars were spent in so doing. It is perfectly obvious to anyone who desires to approach the matter on a basis of reason and practicality that complete justice could readily be done and actual fair value determined by ignoring any field inventory or appraisal of the ten per cent and merely letting that percentage take a like relation to original cost as the ninety per cent readily inventoried and appraised. But the utilities were not permitted to do this. If they attempted it the regulatory authorities would take the position that a full and adequate showing of reproduction cost had not been made and all evidence which had been produced on the subject must and would be disregarded. Then, too, this quite fit in with the purposes of the representatives of the public during this period of the upward trend of prices. This upward trend forced the utilities to take proceedings to increase rates. The cue of the public representatives was to delay a final determination as long as possible, drawing out the proceeding, consuming time in inconsequentials of the inventory and appraisal and pushing the inquiry up every possible blind alley.

In this way the contention has been kept alive that a utility (railroads included) should have its rates tested judicially (if open to substantive test at all) by the prudent investment (in dollars) therein rather than by the fair value of the property used by the utility for the convenience of the public. Under such a rule it is at once obvious, as stated by counsel for the state in *Smyth v. Ames*, that utility property has been made to be something other and different from the property of natural persons. And there is not equal protection of the laws as between property of utilities and property of natural persons. The investor in a utility is placed in the status of a lender of money invested—but a lender who holds no obligation upon which to be repaid. The
return on the investment is strictly limited. Both the return and the investment may be wholly lost, as happened in the case of the interurban railways. But by no possibility can the investor ever get more than the number of dollars put in plus the very limited return permitted by the regulatory authority. Of course it is only too patent that if before any of the utilities were built there had been a provision of constitution or statute of such effect no private individual endowed with any sense would have become an investor in a utility. The investment has, however, been made in reliance on a rule of property and the investment now exists. If the rule is now abolished or disregarded the investment remains nevertheless. Not only is the investor in, but in the ordinary course he must invest more to protect the investment already made. It is clear beyond question that if the rule is changed the investor does not have what on the assurance of the established rule of property he was to have.

Nor would abandonment of fair value and adoption of so-called prudent investment in any appreciable degree simplify or facilitate the administration of rate regulation. It would merely change the battle ground. As before pointed out, the determination of reproduction cost for all practical purposes of finding fair value can readily be simplified and shortened by omitting the field inventory and appraisal of the approximately ten per cent of the property which takes the most time.

The Pennsylvania Railroad some years since, coincident with, if not because of, public clamor, expended large sums in electrifying its railroad between Washington and New York. Other railroads between the same cities refrained from making the same expenditure. More recently these other railroads have been able to purchase a few Diesel engines and render substantially equivalent service. Who was prudent? Here is opportunity for raising an issue upon which weeks of testifying and arguing could be expended. Bus companies operating on city streets first put on large, heavy, two-deck buses with a driver and a conductor. More recently the buses are smaller, single deck, with one man acting as both driver and fare collector. The latter is a much more economical means of transportation. Did the companies which purchased the large buses make a prudent investment? The public representatives could clamor for days on that issue.

The writer has been forced to devote hours and days spread over many weeks to preparing and producing testimony and examining witnesses as to whether several millions of dollars of well-built plant, for which the public need had not developed as estimated when built and had in fact receded about twenty-five per cent from the greatest use at any time made, had been a prudent investment or should not be excluded from the rate base. Within a relatively short time after this extended hearing and well within the construction cycle of the utility, the
entire capacity existing at the time of the hearing had been absorbed and as much more capacity required to be provided as was unused at the time of the hearing.

More recently the "original cost of construction" and the "present cost of construction" have tended to approximate one to the other. This has resulted, first, from the great extensions required to be made by the utilities to meet and serve the increased demands of the public in the decade of the twenties and since the middle of the decade of the thirties, and, second, from extensive replacements necessitated by the required increase of the capacity above mentioned. Many facilities are of a nature that cannot simply be added to but, to be enlarged, must be wholly reconstructed. Other construction is necessitated by the utilities having attained an age where replacements must be made in normal course. All such extensions and replacements have been made at higher cost levels than when the utilities were started in the period before the first World War. It is therefore rather easy at the present time for the regulatory authority to slide from fair value to prudent investment without seeming to do any harm to anyone. So long as the rates fixed by the regulatory authority will pass the test of fair value, the utility cannot complain that some other method was used in arriving at such rates. But if such course is acquiesced in by the utilities they will be laying up trouble for themselves in the future. In the long run the investor in a utility cannot help but suffer unless the investment is continually tested and protected by the standard of the cost of construction of the period current from time to time.

From 1837 to 1933, a period of ninety-six years, a dollar was defined to be 23.22 grains of fine gold. Silver and other dollars were at times provided by law and attempted to be tied to the gold dollar. But for reasons obvious to anyone conversant with monetary questions the tie did not hold. The price or value in the market of 23.22 grains of fine gold is affected by the same factors as the price of 2,322 pounds of coal. Experience over the centuries has shown that gold is not subject to as great fluctuation up and down as coal and other commodities. For that reason gold has been adopted as the base or common denominator for measuring relative value. It has been and is the most stable of commodities. Yet as before stated it is subject to the action of the same factors as any other commodities. No one questions that the discovery and production of gold in California and Australia at the middle of the nineteenth century, in Alaska and the Yukon toward the end of the nineteenth century and in South Africa at the beginning of the present century affected by reason of the increase in the available quantity the price of gold, i.e., the quantities of other commodities for which 23.22 grains of fine gold would exchange. Why, then, when the investor in a utility exchanged his right to a certain number of grains of fine gold for
a certain quantity of steel, copper, wood or whatnot placed at the service of the public, should it be the law that the investor's right continued to be to the grains of gold and not to that which the public was using? On the contrary, as said by counsel for the state in *Smyth v. Ames*, justice and fairness (and it might well have been added "common honesty") requires that the owner of steel, copper, etc., placed at the service of the public have the same (no greater, other or different) property rights therein as any other person has in steel, copper, etc., and subject to all the vicissitudes thereof in the hands of others.

If the dollar were of constant value and would over any extended period of time exchange on the average for the same quantities of commodities, there might be some fairness in an arrangement whereby the investor could always exchange his steel, copper, etc. (with proper provision for physical and functional depreciation) placed at the service of the public for the same number of dollars for which he gave up his right when acquiring the steel, copper, etc. and placing the same at the service of the public. A person of sense and reason might openly go into such a transaction even with the limited earnings permitted to a utility because thereby he puts his investment to the hazard only of prudent management.

But the dollar is not of constant value. Index numbers have been constructed and applied in an endeavor to show the fluctuation of the dollar. The idea behind these index numbers is that if a sufficient number of basic commodities are used in making up the index number the day to day or short wave changes in the commodities one toward another will offset each other and any change in the group as a whole in relation to the dollar will indicate and measure a change in the dollar. From this has evolved the idea of making the dollar constant by providing for a compensated dollar; that is, changing the quantity of gold in the dollar by adding or subtracting as the case may be so that the relation of the dollar to the composite group will always be the same. But this has a patent defect. It makes no provision for changes in the cost (effort or whatnot) of producing and making available any of the quantities in the group used in making up the index. It assumes that such cost will always be the same. If an index number had been set up many years back with aluminum as one of the commodities (it certainly is basic today), the knowledge, means and methods of producing and using aluminum developed since would have so greatly reduced the effort (cost) in production that it obviously must have changed in relation to other commodities in general and to the dollar. So, too, if a new variety of wheat is developed which will grow fifty per cent more per acre, or if by reason of improvements in plowing, harrowing, harvesting and threshing, the cost of producing an acre of wheat is reduced one-third, there can be no doubt that the value of a bushel of wheat
must have changed in relation to other commodities. Some commodities probably have gone the other way. But this feature of the discussion need not be pursued further. What has been said should make the point clear.

Since 1933 the dollar is no longer of 23.22 grains of fine gold but 15 5/21 grains (.9 fine) only. This is a decrease below sixty per cent. The Act of Congress of 1933 which authorized this devaluation authorizes a further devaluation to one-half its former content. More than this, the dollar is now only theoretically a gold dollar. Specie payment has again been suspended. A person who has a right to a dollar can neither get nor have gold. The devaluation of the dollar having been thus entered upon, it will be as easy to further devalue the dollar as it has been and is to increase the public debt limit. As often as a pretext arises (for avoiding some immediately inconvenient consequence), further devaluation will be enacted. A course substantially like that of the French franc to the time of the present war is as inevitable as was that course. It is to be hoped that the dollar will not be devalued as far as was the franc.

From all of this it results that a dollar now is what the politicians of the day in their own interests of the day say it is. Such is the “dollar” which is to be “protected” for the investor under the prudent investment theory. The investor is to be assured that he will always have the same number of “dollars,” but what are the “dollars” to be?

What, then, is the fair and just treatment of the citizen (or group) who constructs and places at the service of the public a plant and property commonly known as a public utility? What the public gets is the use from day to day of that plant and property, not the dollars which were given in exchange for the material, labor and effort which went into the construction of the plant and property. The only fair measure of the value of that use is a reasonable return on the fair value of that which is being used. The basis and dominant element in determining fair value over a substantial period of time is reproduction cost.

The theory of value has occupied the attention of the most learned of economists for more than a century. There are two theories of value—one going back to Ricardo as its originator and the other to Malthus. These two great classic economists were contemporaries and close friends. Each put forth his theory of value at about the same time—in the early part of the nineteenth century. Every economist since of any recognized ability has taken his position behind one or the other of the two theories.

The theory of Ricardo was and is that of embodied value. Value is embodied in the article. The source of value is labor. Commodities take on value as labor is bestowed upon them. The flow of value is from labor to the commodity. To quote his own words—
"The value of a commodity, or the quantity of any other commodity for which it will exchange, depends upon the relative quantity of labor which is necessary for its production.
"It is the cost of production which must ultimately regulate the price of commodities, and not, as has been often said, the proportion between the supply and demand. . . ."

To supplement: In the long-run the values of all commodities will be governed by cost of production and the economic system will gravitate towards equilibrium.

The theory of Malthus was and is that of commanded value. Value means exchange value and every commodity gets its value from its power to command other goods or services in exchange. The power in exchange possessed by any commodity is determined by demand and supply. Demand and supply are synonymous with consumption and production. Demand is the will combined with the power to purchase, and supply consists of production of commodities combined with the intention to sell them. In this state of things the relative values of commodities are determined by the relative demand for them compared with the supply of them.

Alfred Marshall, the greatest of later day economists, well sums up the matter with these words:

"As a general rule, the shorter the period which we are considering the greater must be the share of our attention which is given to the influence of demand on value; and the longer the period, the more important will be the influence of cost of production on value."

A recent writer, Professor McCracken of the University of Minnesota, has well observed:

"Economists and business men are still under a debt of gratitude to Ricardo for focusing attention upon the long-run forces. He was writing in the midst of a severe depression following the Napoleonic Wars. As usual under such conditions people were despondent, pessimistic, and fearful lest depression would be chronic and perpetual. In the midst of this gloom it was most refreshing and assuring to follow the keen analysis of Ricardo and be assured that for every industry operating at a loss, because market price was below cost of production or natural value, an overpowering force was incessantly operating to bring exchange values up to natural values, and profits to normal."

Except scarcity value, which may be ignored as property subject thereto is not used or properly usable in public utilities.
Now it is or should be obvious that in public utility valuation it is
the long period and not the short period to which consideration is to be
given. A public utility is an enduring service for the people, presum-
ably without end so far as it is given to the human mind to foresee.
Although the electric interurban railway came and went in less than a
generation, none foresaw its going. The valuation of utility properties
has therefore been well placed upon present fair value as measured by
cost of reproduction new as the preponderant or basic underlying factor.

There is nothing fairer to all concerned. Nothing else is fair to the
investor.

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