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PUBLIC UTILITIES — DEPRECIATION RESERVE AS AN ELEMENT OF FAIR VALUE IN ASCERTAINING RATE BASE — The New Hampshire Public Service Commission valued the property of a water works company at \$450,000 and fixed a rate by using this figure as a base. Before allowance for depreciation, the reproduction cost was estimated to be \$660,000 and the original cost was \$485,000. Both parties agreed that the amount in the utility's depreciation reserve, twenty-one per cent of cost, was a reasonable figure for depreciation, which the commission deducted from the valuation. On appeal by the company, *held*, while it was proper to deduct depreciation at twenty-one per cent nonetheless reserve for depreciation is an "asset" which should be added to the depreciation value of the property in determining the rate base. *State v. Hampton Water Works Co.*, (N. H. 1941) 18 A. (2d) 765, motion for rehearing denied 19 A. (2d) 435.

Whether the method of valuation is original cost or cost of reproduction, a deduction for the amount of actual depreciation is usually held proper in determining the rate base.¹ But the court in the principal case nullified this deduc-

¹ *Knoxville v. Knoxville Water Co.*, 212 U. S. 1, 29 S. Ct. 148 (1909); *Minnesota Rate Cases*, 230 U. S. 352, 33 S. Ct. 729 (1913); *Plymouth Electric*

tion by adding the depreciation reserve to the depreciated values.² Such a decision is the logical result of treating depreciation reserve as an actual fund on hand with which to finance replacements.³ The court indicates it is under such a misapprehension when it speaks of the propriety of paying dividends out of the reserve, when it refers to the use of the reserve as adding to value, and again when it contends that the rate base will gradually diminish to nothing if the reserve is not considered an asset. Such a conception is a result of the ambiguous nature of the word "reserve."⁴ Depreciation reserve actually represents the mere bookkeeping adjustment for the accounting practice of carrying property at its cost price. Such a reserve is carried as a liability to offset the cash which is accumulated by setting aside a certain portion of each year's gross earnings as a legitimate expense before computing or distributing net profits.⁵ The cash thus set aside each year, whether invested in replacements and new equipment or retained as working capital, is part of the property of the utility, and as such is included in ascertaining original or reproduction cost to determine value. Thus to include also the mere bookkeeping item of depreciation reserve as an asset in computing value would be in effect to count this cash reserve twice. The danger which the court seeks to guard against by treating the reserve in this manner is that the reserve will eventually become so large that the value of the utility would dwindle to nothing unless reserves were treated as an asset. But this argument ignores the fact that the real assets purchased with the money which is represented by reserve on the company balance sheet will compensate for the

Light Co. v. State, 81 N. H. 1, 120 A. 689 (1923); *McCardle v. Indianapolis Water Co.*, 272 U. S. 400, 47 S. Ct. 144 (1926). But see *United Railways & Electric Co. of Baltimore v. West*, 280 U. S. 234, 50 S. Ct. 123 (1929); *Pacific Gas & Electric Co. v. City & County of San Francisco*, 265 U. S. 403, 44 S. Ct. 537 (1924); *Young*, "Depreciation and Rate Control," 28 Q. J. ECON. 630 (1914). Despite the comparative unanimity of the courts in deducting actual or realized depreciation, there is still much conflict over whether accrued or annual depreciation should also be deducted. See *Bonbright*, "Depreciation and Valuation for Rate Control," 27 COL. L. REV. 113 (1927); *Scharff*, "Public Utility Depreciation," 38 COL. L. REV. 1037 (1938); *Haun*, "Inconsistencies in Public Utility Depreciation," 38 MICH. L. REV. 160 (1939), 479 (1940).

² In denying the motion for a rehearing, the court retracted somewhat from its former position by saying that it did not reach its \$560,000 figure by ignoring depreciation or by adding again what it had subtracted, but that it had merely added to cost "other factors affecting value," so that its final figure for the rate base turned out to be no lower than the undepreciated cost. The court also felt it necessary to justify its former position by saying that the "statement . . . that the depreciation reserve is an asset of the utility was made to combat the commission's erroneous theory that it belongs to the customers." 19 A. (2d) 435 at 436.

³ If such an actual fund is set up, it may of course be included in the rate base. Cf. *McCardle v. Indianapolis Water Co.*, 272 U. S. 400, 47 S. Ct. 144 (1926).

⁴ PATON, *ESSENTIALS OF ACCOUNTING* 185 (1938). See note on principal case, 54 HARV. L. REV. 1411 (1941).

⁵ *Kansas City Southern R. R. v. United States*, 231 U. S. 423, 34 S. Ct. 125 (1913); *Knoxville v. Knoxville Water Co.*, 212 U. S. 1, 29 S. Ct. 148 (1909); *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Comm. of Missouri*, 262 U. S. 276, 43 S. Ct. 544 (1923); *Columbus Gas & Fuel Co. v. Public Utility Commission of Ohio*, 292 U. S. 398, 54 S. Ct. 763 (1934).

increasing size of the reserve. In any event there is a limit to the size of the depreciation reserve,⁶ since after steadily mounting during the formative years before many replacements are needed, it will soon level off as annual replacements approach equality with annual depreciation.⁷ It only continues to grow if too large a depreciation annuity is used, in which event the excess represents concealed earnings rather than a genuine operating expense.⁸ In the principal case, the court apparently predicates its decision on the unconventional theory that depreciation reserve is built up out of earnings rather than out of money deducted as operating expenses before earnings are ascertained; for it makes a distinction between "ordinary repairs," which it calls operating expenses, and "extraordinary repairs" and replacements, which it calls mere deductions from depreciation reserve.⁹ But the result arrived at by the court is less shocking than

⁶ But in a few cases the reserve has reached 30% or more of the rate base. *Telephone and Railroad Depreciation Charges*, 177 I. C. C. 351 at 399 (1931). And in *Re Mondavi Tel. Co.*, P. U. R. 1933B 319 (Wis. Pub. Serv. Comm. 1932), the rate was found to be in excess of 60% of book cost. See Goddard, "The Interest of Public Utility Ratepayers in Depreciation," 48 HARV. L. REV. 721 (1935).

⁷ Some have gone so far as to say that no reserve at all is needed, that undepreciated cost should be taken as the rate base, and that the depreciation problem should be met by simply charging all maintenance and replacement costs to operating expenses the year when made. But this so-called "plant immortality" theory, whereby the value of a plant never depreciates, has never been accepted by a court. 2 BONBRIGHT, VALUATION OF PROPERTY 1128 (1937).

⁸ It has been suggested that in determining the rate base the amount in the company's depreciation reserve should be deducted from cost as actual depreciation even though it is too high, on the theory that the company is estopped from contesting it since it resulted in hidden earnings in the past at the ratepayers' expense. *Re Mondavi Tel. Co.*, P. U. R. 1933B 319 (Wis. Pub. Serv. Comm. 1932); *Wisconsin Tel. Co. v. Public Service Commission*, 232 Wis. 274, 287 N. W. 122 (1939); *New York Tel. Co. v. Prendergast*, (D. C. N. Y. 1929) 36 F. (2d) 54. But most courts have rejected this argument, considering it unjust to deprive a utility of the right to a reasonable return in the future on the ground of its having made excessive earnings in the past. *Board of Public Utility Comms. v. New York Tel. Co.*, 271 U. S. 23, 46 S. Ct. 363 (1926); *McCardle v. Indianapolis Water Co.*, 272 U. S. 400, 47 S. Ct. 144 (1926). It is particularly unjust to those who have become stockholders only recently and who have consequently received none of the benefits of the supposedly high return in the past. *Lindheimer v. Illinois Bell Tel. Co.*, 292 U. S. 151, 54 S. Ct. 658 (1934), is often cited as authority for deducting the amount in the reserve; but since that case dealt only with the reasonableness of past rates and so required primarily a determination of past earnings, it can hardly be called real authority for deducting depreciation reserve in computing the rate base to determine future earnings.

⁹ The court also ignores the usual distinction made between actual, accrued, or observed depreciation and depreciation reserve, saying that the reserve annuity was "reasonable" and for that reason should be the proper figure to subtract from cost. But the more customary approach has been to subtract the actual, functional, or realized depreciation and to ignore the depreciation reserve, however reasonable, since the latter only represents a prospective estimate of future depreciation. *McCardle v. Indianapolis Water Co.*, 272 U. S. 400, 47 S. Ct. 144 (1926). According to this view, depreciation reserve has no relation to fair value but only to fair return, since it is a charge to operating expense and consequently bears on the amount of return under any proposed rate.

the means by which this result was reached, for it has occasionally been argued that undepreciated cost is the more desirable figure to use as the rate base.¹⁰ While the result in the principal case is the same as that which would be reached if undepreciated cost were used as a measure of value, the New Hampshire court does not follow this theory. It rather admits that depreciation should be deducted and then, by adding the depreciation reserve, it arrives at the same end as if it had taken undepreciated cost as the rate base.

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¹⁰ See *United Railways & Electric Co. v. West*, 280 U. S. 234, 50 S. Ct. 123 (1929); *Pacific Gas & Electric Co. v. City and County of San Francisco*, 265 U.S. 403, 44 S. Ct. 537 (1924); Young, "Depreciation and Rate Control," 28 Q. J. ECON. 630 (1914). See also note 7, *supra*.