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The Rate Base for Rate Regulation

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COMMENTS

THE RATE BASE FOR RATE REGULATION

What is the correct rate base for the regulation of the rates of public utilities, railways and other public callings?

According to the common law of public callings, which was formulated by the great English judges, Hale,¹ Holt² and Mansfield,³ and which has been witnessing great development in recent times,⁴ a business affected with a public interest (public calling) is entitled to a reasonable return for its services⁵ and is bound to render such services for reasonable compensation.⁶ It has been suggested that there is a spread, or margin, between the (non-confiscatory) return to which the business is entitled and the (non-monopolistic) compensation which the consumer may be required to pay,⁷ but this does not seem to be the view of the United States Supreme Court as announced when interpreting and upholding the recapture clause of the 1920 Transportation Act.⁸ Any rates which do not yield the reasonable return to which the business is entitled (and apparently any rates which yield more than the consumer should pay) are a taking of property without due process of law, as that term is now defined by the United States Supreme Court,⁹ and may be set aside by the Supreme Court,¹⁰ or recaptured.

In the determination of whether or not a business or the public is being deprived of its property without due process of law, the courts must find: (1) what is the proper rate, and (2) what is the proper rate base. If the charges of the business bring enough return to give what the courts regard as a proper rate on a proper rate base they are not confiscatory and the business cannot complain; if they bring in no more than this, the customer cannot complain. The courts have been inclined to hold that the rate of return should in a general way conform

¹ *Allnut v. Inglis* (1810), 12 East 527.

² *Coggs v. Bernard* (1703), 2 Ld. Raym. 909.

³ *Forward v. Pittard* (1785), 1 T. R. 27.

⁴ *Munn v. Illinois* (1876), 94 U. S. 113.

⁵ *Railroad Commission Cases* (1886), 116 U. S. 307.

⁶ *Brass v. North Dakota* (1894), 153 U. S. 391; *German-Alliance Ins. Co. v. Lewis* (1914), 233 U. S. 389; *Block v. Hirsh* (1921), 256 U. S. 135.

⁷ 12 Iowa Law Rev. 268.

⁸ *Dayton-Goose Creek Ry. v. United States* (1924), 263 U. S. 456.

⁹ 74 U. of Pa. Law Rev. 331.

¹⁰ *Chicago etc. Ry. Co. v. Minnesota etc. Com.* (1890), 134 U. S. 418; *Reagan v. Farmers Loan and Trust Co.* (1894), 154 U. S. 362; *Allgeyer v. Louisiana* (1897), 165 U. S. 578.

to the interest rate, and six or seven per cent has generally been allowed. If a rate lower than six per cent, say four per cent (because of the stability characteristic of utilities), would induce a flow of such investment money as is necessary in the public utility field, such a rate would seem to be reasonable and proper.¹¹ But this rate of return must be a rate upon something which we call a base.

What is the proper rate base for this rate? Is it the capitalization of the business? Is it the original cost? Is it the value of the plant for purposes of taxation? Is it the prudent investment? Is it the reproduction cost? Is it the fair value? The courts have found it more difficult to agree upon the rate base than upon the rate. Capitalization,¹² original cost and value for taxation¹³ have all been used by different commissions, but the three rate bases which have met with the greatest approval by commissions, courts and law writers have been the prudent investment, reproduction cost and fair value. The prudent investment theory, which makes the rate base the amount which would be normally paid for all the property devoted to the public service (that is, the original cost if wise and prudent), has been adopted by some state commissions, notably Massachusetts,¹⁴ been advocated by Justices Brandeis and Holmes in a strong dissenting opinion in the case of *State of Missouri ex rel Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*,¹⁵ and has had the almost unanimous support of legal writers.¹⁶ The reproduction cost theory as to the rate base has been the most widely adopted by commissions¹⁷ and courts.¹⁸ The fair value theory as to the rate base has been promulgated and adhered to until quite recently by the United States Supreme Court.¹⁹

¹¹ 25 Jour. of Pol. Ec. 544; 124 I. C. C. 30, 54.

¹² (1923) 262 U. S. 302 n. 14.

¹³ (1916D) Pub. Util. Rep. 725.

¹⁴ (1923) 262 U. S. 302 n. 15.

¹⁵ (1923) 262 U. S. 289.

¹⁶ Edward C. Goddard, "Public Utility Valuation," 15 Mich. Law Rev. 205; Robert L. Hale, "The Physical Value Fallacy in Rate Cases," 30 Yale Law Jour. 710; Donald R. Richberg, "A Permanent Basis for Rate Regulation," 31 Yale Law Jour. 263; Robert H. Whitten, "Fair Value for Rate Purposes," 27 Harv. Law Rev. 419; Henry W. Edgerton, "Value of the Service as a Factor in Rate Making," 32 Harv. Law Rev. 516; Gerard C. Henderson, "Railway Valuation and the Courts," 33 Harv. Law Rev. 902.

¹⁷ (1923) 262 U. S. 301, n. 14.

¹⁸ *Steenerson v. Great Nor. Ry. Co.* (1897), 69 Minn. 353.

¹⁹ *Smyth v. Ames* (1898), 169 U. S. 466; Minnesota Rate Cases (1913), 230 U. S. 352.

The history of the attitude of the United States Supreme Court upon this subject is interesting.

In the celebrated case of *Smyth v. Ames*²⁰ the Supreme Court first announced fair value as its choice of a rate base, saying that:

"And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvement, the amount and market value of its bonds and stocks, 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 the case. We do not say that there may not be other matters to be regarded in estimating the value of the property."

In the equally celebrated Minnesota Rate Cases,²¹ the Supreme Court seemed to continue to wallow in the uncertainties of the kaleidoscopic rule of *Smyth v. Ames*, but made fair value fair present value and required depreciation to be considered along with reproduction cost.

In the case of *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*,²² a majority of the Supreme Court still held that fair value should represent the rate base, but held that in computing it some consideration must be given to the cost of reproduction at the present time, and that where a commission had given no weight to this a case must be reversed; but two justices dissented in favor of prudent investment.

In the case of the *Georgia Railway and Power Co. v. Railroad Commission of Georgia*,²³ the Supreme Court again held present fair value the rate base and sustained a commission and lower court where they had given careful attention to reproduction cost but had refused to make this any part of the measure of value.

But, in the *Bluefield Water Works and I. Co. v. Public Service Commission of West Virginia*,²⁴ a majority of the Supreme Court, while adhering to the present fair value rule, reversed the Supreme Court of West Virginia because it had not accorded the proper if any weight to the cost of reproduction new (at the then enhanced costs over those which had prevailed before the war) less depreciation.

This was the state of the law, so far as concerned the United

²⁰ *Supra*.

²¹ *Supra*.

²² (1923) 262 U. S. 276.

²³ (1923) 262 U. S. 625.

²⁴ (1923) 262 U. S. 679.

States Supreme Court up to the decision of the case of *McCardle v. Indianapolis Water Co.*²⁵ During all of this time but especially since the World War constant pressure had been brought to bear upon the court to adopt reproduction cost less depreciation as the sole test of fair value, evidently on the theory that reproduction cost can always be found—since it is a pure guess—while original cost and the other items named in the rule of *Smyth v. Ames* cannot always be found—since they are facts; and at least two justices already accepted or were won over to this view.²⁶ But the rest of the court either adhered to the original fair value rule or to the prudent investment rule.

Then came the case of *McCardle v. Indianapolis Water Co.*²⁷ in November, 1926. This case began with a petition by the Indianapolis Water Company for an increase of rates. Thereupon the Public Service Commission of Indiana valued the property of the Indianapolis Water Company as of May 31, 1923, at not less than \$15,260,240, fixed seven per cent as the reasonable rate of return, and granted a new schedule of rates higher than the old rates but not as high as asked by the Company. The Company then sued for an injunction against the Commission to restrain the enforcement of the order of the Commission on the ground that the rates prescribed were confiscatory. The trial court found the fair value of the property to be not less than \$19,000,000, that the rates were confiscatory, and enjoined the enforcement of the order, evidently on the theory that spot reproduction cost is the legal or conclusive evidence of value. At any rate, on appeal by the Commission and the City of Indianapolis, the Supreme Court, in an opinion by Justice Butler, adopted this view, held that spot reproduction cost of all the Company's properties, including the present value of land and water rights and the cost of constructing the plant at prices for material and labor prevailing on the calendar day of valuation (and an honest and intelligent forecast of future wages and prices), together with a going concern value of nine and one-half per cent of the value of the physical property, was the proper rate base, seven per cent a fair rate, so as to give a reasonable return at the time and for a reasonable time in the future, and affirmed the decree.

Thus, in this case, a majority of the United States Supreme Court seems to have gone entirely over to the theory of repro-

²⁵ (1926) 47 Sup. Ct. 144.

²⁶ *Ga. R. R. & P. Co. v. R. R. Com. of Ga.*, supra (dissent); *Bluefield Water Works & I. Co. v. Pub. Ser. Com. of W. Va.*, supra.

²⁷ Supra.

duction cost as the correct rate base, and to have defined this as reproduction cost new on the day of valuation, not the period of time it would require to construct the plant to have it in operation on the valuation date, less depreciation, and with a going concern value—not measured by the usual physical overheads for assembling the plant and organization expenses, as the Supreme Court had previously done²⁸—but an intangible measured by a fixed percentage of the physical value added to the physical value of the property. Of course the court did not actually say that it repudiated prudent investment for all time and in all cases, and there is a bare possibility that a majority of the Supreme Court may feel that it is not bound by the opinion of Justice Butler in a similar case.²⁹

In spite of the decision in the Indianapolis Water case given above, the Interstate Commerce Commission, in what has been called “the greatest lawsuit in history,”³⁰ the St. Louis and O’Fallon Railroad case,³¹ declined to abide by the latest decision of the Supreme Court when told to do so only once and refused to apply reproduction cost as the rate base for the regulation of the rates of the railways of the United States, but instead adopted the prudent investment as the rate base (modified by the split inventory rule so as to apply the reproduction cost up to the time of the World War and prudent investment since that time). The railroads have appealed from the decision of the Interstate Commerce Commission to the United States Supreme Court.

Will the Supreme Court stand pat on its Indianapolis Water Co. decision and apply it to the railroads, or when confronted with this larger application of its rule will it, appalled, change its mind as to the correctness of its rule? If it follows the Indianapolis Water case as a precedent it will thereby authorize the railroads of the country to raise their rates so as to require the people of the United States to pay to them a billion dollars a year more than at present. If it overrules the Indianapolis Water case, not only will the railroads not obtain this income but many of the railroads will have to turn back to the Government under the recapture clause of the Transportation Act of 1920³² enormous sums of money already earned in excess earn-

²⁸ *Des Moines Gas Co. v. Des Moines* (1915), 238 U. S. 53; *Galveston Elec. Co. v. Galveston* (1922), 258 U. S. 388.

²⁹ *Excess Income of St. Louis & O’Fallon Ry. Co.*, 124 I. C. C. 52.

³⁰ 147 Outlook 149.

³¹ *Excess Income of St. Louis & O’Fallon Ry. Co.*, 124 I. C. C. 3.

³² Sec. 422, 15a (3), (4), (5), (6); Comp. Stat. U. S. 1916, 1923 Sup., 8583a (3), (4), (5), (6).

ings. The Supreme Court will either have to apply the doctrine of the Indianapolis Water case to the railroads or overrule it, for we cannot have for rate regulation purposes one rate base for one public calling and another rate base for another public calling.

Hence, perhaps the most important legal question before the people of the United States today is, what is the correct rate base for the regulation of the rates of public callings? What should be the final decision of the United States Supreme Court on this question?

Clearly the rate base cannot be either capitalization, or original cost, or value for taxation. Too much capital stock has been watered. Too much original cost has been padded for promoters and insiders. Value for taxation would make rate regulation square with tax administration, but it has too little support in authority and public opinion.

Fair value as a rate base cannot be adopted if it is to be compounded of all the diverse elements in the rule of *Smyth v. Ames*. To determine fair value by considering the cost of producing the utility, what it should have cost, what it would cost to reproduce it, and other as diverse elements, is to determine the impossible. Justice Brandeis³³ has conclusively pointed out that "value cannot be a composite of all these elements." They are mutually exclusive. They "lead to widely different results." If fair value is to be determined solely by any one of these elements, as prudent investment, or reproduction cost, one of these terms should be employed. Railways and other utilities do not have a market value, so that this method of appraising value cannot be pursued. Hence unless the Supreme Court can make fair value something less than a composite of a lot of mutually exclusive things or something more than some one of other rate bases, fair value as a rate base is not worthy of consideration, and should be relegated forever to the limbo of legal curiosities.

Reproduction cost as a rate base has three very fundamental objections, its unfairness, its uncertainty, and its impracticality. After a period of inflation such as has followed the World War, this rate base would hand the public utilities wealth unearned and undreamed of (probably a sum greater than our present national debt—about 19 billions).³⁴ It would probably treble all the investments they ever put into the enterprises, and guarantee them a reasonable return thereon. Huge profits would occur without any change in property but simply from a shifting

³³ *Southwestern Bell Case*, supra.

³⁴ *Excess Income of St. Louis & O'Fallon Ry. Co.*, 124 I. C. C. 32.

of general price levels. No wonder utility men are for such a money-making scheme. They urge that they should not be forced to make earnings based on dollars originally invested in property when those dollars have since declined to a value of one-third. Yet, if they had loaned those dollars they would not expect to get back three times as many with interest thereon, and where they have borrowed money they do not expect to pay back more than they borrowed. Reproduction cost now favors the railways and other public callings. Consequently they are for it, and the public is against it. If the situation were reversed, as after a period of deflation, they would be against it, and the public would be for it. The question is not what either wants, but what is right. Reproduction cost is sure to be unfair either to the public or to the public calling, and the chances are it will be unfair to the public. But the chief objection to reproduction cost is its uncertainty. It is nothing but a guess.³⁵ The engineering estimates required are airy calculations on impossible assumptions. The accounting studies used are unethical. The economic principles underlying it are antagonistic to established economic laws. Judicial opinions in regard to it have been loquacious nothingness, or curt fallaciousness. And now, in addition to the usual imaginative guessing involved in it, the Supreme Court has added guessing upon the forecast of prices in the future, spot, and a new going concern value. The rate must be more or less guess-work, since it must vary with the market investment rate. If the rate base also is to be guess-work, both the rate and the rate base are uncertain, and the matter of rate regulation will be too much a matter of guess-work.

³⁵ Reproduction cost is determined by including "percentages for engineering services never rendered, hypothetical efficiency of unknown labor, conjectural depreciation, opinion as to the condition of property, the supposed action of the elements, whether superintendence is wise or foolish, and the investment improvident or frugal. It is based upon prophecy instead of reality; it depends upon half truths instead of upon reliable data; it rises at best only to the plane of dignified guessing." *Re Michigan State Tel. Co.* (1921C), Pub. Util. Rep. 545, 554. "The theory is not of reproduction of an equally efficient plant but an identical plant, under present conditions, not conditions when the plant was built. Much of the property (abandoned and obsolete) no one would want to reproduce. Items of expense never incurred are included in reproduction new. In reproduction cost we have to depend entirely upon conjecture and assumptions which may have never in reality existed and never will." *McGregor-Nees H. Co. v. Springfield Gas & El. Co.*, 1 Pub. Ser. Com. 468, 528 (Mo. 1914). "Each step in the process of estimating the cost of reproduction or replacement, involving forming an opinion, or exercising judgment, as distinguished from ascertaining facts." *Brandeis in State of Missouri v. Public Service Commission*, *supra*.

Reproduction cost is so impractical and cumbersome it is almost unworkable, as witness the difficulty of making an inventory of the railways. These three objections are fatal to reproduction cost as a rate base.

Prudent investment as a rate base is a reasonably fixed quantity, and it also is fair to the public as well as to the public callings. It escapes the evils of reproduction cost on the one hand and of capitalization and original cost on the other. Accounting problems are simplified, for the prudent original cost once found always stands and thereafter only the cost of new additions and improvements have to be found. Of course public callings, even if housing were generally made a public calling,³⁶ would not under this theory be able to capitalize the unearned increment, but public callings—whatever may be true of other businesses—have never been entitled to do this; they are only entitled to reasonable compensation upon the property they have devoted to a public use. When they devote their property to a public use, taking over a function of the state and gaining unusual favors, they do so upon the implied condition that in return therefore they shall get only such reasonable return. If they do not wish to become a public calling upon this condition they should not become a public calling. Business is only too willing to become a public calling upon this condition. After having done so, it should be willing to play fair thereafter.

It would seem, then, that the Interstate Commerce Commission is right and the United States Supreme Court has been wrong as to what is the correct rate base for the regulation of the rates of public callings; that the decision in the case of *McCardle v. Indianapolis Water Co.* was erroneous and that the United States Supreme Court should now adopt for the rate base in rate regulation cases the prudent investment theory either in its true form, or where that cannot be done for lack of evidence as to the past in some modified form.³⁷

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³⁶ *Block v. Hirsh* (1921), 256 U. S. 135.

³⁷ If the United States Supreme Court does not do this, but adopts reproduction cost as the rate base for the regulation of the rates of all public callings, including the railways, its decision will be liable to stir up so much opposition as to result in all cases in the substitution for governmental regulation of business affected with a public interest under the due process clause of either, (1) government ownership and operation, or (2) government ownership with private operation, or (3) governmental regulation by private contract between governmental subdivisions and different public callings under the contract clause of the constitution, as now advocated in connection with Boulder Dam, Muscle Shoals and the Lakes to Ocean waterway.