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## Has Government Regulation of Utilities Proven a Failure?

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## COMMENTS

### HAS GOVERNMENT REGULATION OF UTILITIES PROVEN A FAILURE?

The case of *United States Railways and Electric Company of Baltimore v. West*<sup>1</sup> is another pronouncement of the United States Supreme Court upon the subject of rate regulation. The United Railways of Baltimore applied to the Public Service Commission of Maryland for an increase in fares. The United Railways had \$24,000,000 of common stock, \$38,000,000 of ordinary bonded indebtedness, and \$14,000,000 of redeemable income bonds. The commission fixed the present value of the property of the company at \$75,000,000, but this valuation included an item of \$5,000,000 for easements in the streets given by Baltimore. The reason for the inclusion of this item was a decision of the Court of Appeals of Maryland that easements were subject to taxation. The commission at first allowed \$883,544 for depreciation which was 5% of the gross earnings; but later after the Court of Appeals of Maryland had ordered the commission to base depreciation on the present value of the depreciable property, the commission added \$755,116 for depreciation, or 1.08% on a rate basis of \$70,000,000. The rates finally allowed by the commission would earn 6.26% on a rate base of \$75,000,000 after the allowance of \$1,638,660 for depreciation, and they would have earned 7.78% on a rate base of \$70,000,000 with a depreciation of \$883,544. On appeal from a decision of the Court of Appeals of Maryland in favor of the commission, the United States Supreme Court held that rates should have been granted which would yield a return of "not far from" 8% on a rate base of \$75,000,000 with a depreciation of \$1,638,660, and reversed the Court of Appeals of Maryland. The rate of return authorized by the United States Supreme Court would have amounted to nearly 10% on the \$70,000,000 rate base and the lower estimate of depreciation.

The Supreme Court overlooked the fact that over two-thirds of all the money invested in the business was borrowed money. The evidence does not show what interest was being paid on this

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<sup>1</sup> 50 S. Ct. 123 (1930).

money. It certainly was not over 7%. It probably was not over 6%, and some of it may not have been over 5%. The difference between this interest rate and the 8% rate of return allowed by the Supreme Court on the entire value of the property would, of course, go to the common stock-owners, who, as a result, might get upwards of 15% on the \$70,000,000 rate base and the 5% allowance for depreciation (after allowance for taxes and operating expenses).

This decision raises three interesting questions. First, the question of whether depreciation should be figured according to present cost; second, the question of whether the easements granted the company ought to be included in the rate base; and third, the question of whether the proper rate of return was allowed.

The majority of the court thought that because the rate base is required by the latest decisions of the United States Supreme Court to be figured according to present value, depreciation should be figured on the same basis. Mr. Justice Brandeis, dissenting, took the position that the purpose of the depreciation allowance is to restore the cost of value of the original investment. He contended that it was a mere bookkeeping device, and that the depreciation charge had uniformly been based on the original cost, both by business men and by official practice. Mr. Justice Stone, dissenting, added that even if the replacement of the plant rather than the restoration of the cost was the function of the depreciation account, the commission and the courts were not dealing with present replacements, but those to be made at uncertain dates in the future of articles purchased at different times in the past at varying price levels, and, therefore, that there was no reason for applying the doctrine of present reproduction value. It would seem as though the dissenting justices had made points hard to meet, especially in the view of the fact that the law permits public utilities both to deduct from income for depreciation and to add to rate base for appreciation without additional payment.<sup>2</sup>

The majority opinion evidently was inclined to include the value of the easements in the rate base, although it intimated that the objection came too late. Justice Brandeis points out that calling the privileges given to the company easements would not differentiate them for rate purposes from ordinary corporate

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<sup>2</sup> 30 *Col. L. Rev.* 330.

franchises, and in deciding the rate base, the Supreme Court follows Federal law rather than state law, and that the question of its allowance was properly before the court on appeal because the fact appeared in the record and it affected the question of whether a proper rate of return had been allowed. On this point clearly Justice Brandeis would seem to be right.

The majority took the position that the company was entitled to a net return of not far from 8% upon the valuation fixed by the commission. The dissenting judges did not take issue with the majority on this point. Evidently, both of them overlooked the fact that the common stockholders could appropriate to themselves the difference between what they could borrow money for and what the Supreme Court was allowing upon the entire valuation. Of course, it is impossible to foresee what the position of the Supreme Court would have been if it had discussed this point, but it would seem self-evident that if 8% is a reasonable rate of return and the owners are entitled to no more, the problem should be solved so as to give them no more. Without this possibility, it is hard to understand why the Supreme Court put the rate of return so high as even 8%. It is a well known fact that investors generally are satisfied with a return of six per cent and even five per cent in the case of safe investments, often before not after the payment of taxes.

The case of the *United Railways and Electric Company v. West* is in accord with recent decisions of the United States Supreme Court. In the case of *McCardle v. Indianapolis Water Company*<sup>3</sup> the Supreme Court practically adopted reproduction cost as a basis for determining the rate base, including going value, and in *St. Louis and O'Fallon Railway v. United States*<sup>4</sup> it held that the phrase "the law of the land" in the Transportation Act of 1920 required consideration of reproduction cost in a way to give it special emphasise in the determination of the rate base (according to present value). Now the case of *United Railways and Electric Company v. West* has decided that the item of depreciation must be figured on the same basis and even that property in the way of easements donated to the company may be included in the rate base. All of the cases have more or less agreed upon the rate of return, although recently the rate of return has been pushed up from around 6% to around 8%.

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<sup>3</sup> 272 U. S. 400.

<sup>4</sup> 49 S. Ct. 384.

Yet such decisions as these are raising the question of whether or not governmental regulation has not proven a failure and now might as well be abandoned.

In the case of businesses where there is a virtual monopoly in an indispensable service, which, according to the most recent test of the United States Supreme Court,<sup>5</sup> are classified as businesses affected with a public interest, there are four courses open:

1. Allow the business to continue as a virtual monopoly, but under private ownership without being affected with a public interest, and therefore free from all regulation;
2. Break up the monopoly and enforce competition;
3. Regulate on the theory of the law of public callings; and
4. Adopt the policy of government ownership, either (a) with government operation, or (b) private operation under contract.

The first course is probably the course which would be preferred by the private owners and the course which governs them in their own relations to the problem, but it is a course which probably they do not hope to get and which the people of the country certainly would never allow them to get. Under these circumstances, it may be wondered why the public utility owners are pursuing the course which they do pursue. However, history often affords an explanation. It is hard now to understand the position of the Bourbons. People ought not to hope that what has happened in the past may not continue to happen in the future.

The second course was that favored by such men as former President Woodrow Wilson and many others with his viewpoint, but it is coming to be believed that this course is unworkable. The conflict between political theory, even if universally adopted, and economic laws, on one hand, and business practice, on the other hand, is too great. Competition cannot be adequately enforced in the realm of public utilities.

The third course has been the theory under which public utilities and big businesses have been governed throughout most of our history. It became a pronounced policy in the United States with the Granger Movement and the decision of the case of

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<sup>5</sup> *Charles Wolfe Packing Co. v. Court of Industrial Rel's.*, 262 U. S. 522; *Tyson v. Banton*, 47 S. Ct. 426; *Ribneck v. McBride*, 48 S. Ct. 545; *Williams v. Standard Oil Co.*, 49 S. Ct. 115; *Tagg Bros. v. U. S.*, 50 S. Ct. 220.

*Munn v. Illinois*<sup>6</sup> by the United States Supreme Court in 1876, and it has been growing in extent and importance ever since that time. This was the position of former President Theodore Roosevelt, although in this and in championing the prosecutions under the Sherman Anti-Trust Act, he, in true cowboy fashion, tried to ride two horses going in opposite directions. Under the law of public callings any business which is affected with a public interest must (a) serve all (b) with reasonably adequate facilities (c) without discrimination (d) for reasonable compensation (e) either with an insurance liability for the safety of goods, or with a negligence liability for other matters; and government has the right and power to regulate such businesses for the purpose of enforcing all of these obligations. The businesses which under the test of virtual monopoly and indispensable service are affected with a public interest include such companies as railroads, street railroads, express, motor transportation, sleeping car, telegraph, telephone, gas, electric, and public utility companies generally. Some of these businesses are intrastate in scope, and others are interstate. Most of them are extensive and powerful. Those which are interstate come under the regulation of the Federal government and those which are intrastate under the regulation of state governments, except, insofar as the Federal government may regulate intrastate businesses as an incident to the regulation of interstate business.<sup>7</sup> These businesses are so numerous and so great and the problems involved in their regulation are so complicated that the problem of regulation is one which requires the highest intelligence and special aptitude. It would not have been difficult to solve the problem if the public utility owners had cooperated in every way in helping to make the solution possible. Since their attitude has been antagonistic it has made the problem doubly difficult. Perhaps it would be better to say that the public utility companies have defeated public regulation. They have got around the provision in regard to the rate of return by the device of obtaining for the common stockholders the difference between what is paid preferred stockholders and bondholders and what the courts uphold as a reasonable rate, and by the device of having the common stock owned by a holding company financed

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<sup>6</sup> 94 U. S. 113.

<sup>7</sup> *Shreveport Case*, 234 U. S. 342; *Interstate Pub. Serv. Comm. v. Attleboro Co.*, 273 U. S. 83; *Buck v. Kuykendall*, 267 U. S. 306.

by the issuance of preferred stock and bonds.<sup>8</sup> By the device of padding the rate base, through excessive estimates and allowances for payment of bonds, and purchase of additional equipment and extensions out of earnings, and by the adoption of the theory of reproduction cost by the United States Supreme Court, the public utilities have obtained a rate base which is nearly double what the original cost of most of the plants in the country was.<sup>9</sup> Many other promotion schemes and schemes of high finance, shown by Professor Ripley,<sup>10</sup> have been resorted to. As a consequence of the opposition of public utility men, the personnel of commissions, and the inherent difficulty of governmental regulation of public callings, the people of the country are beginning to come to the conclusion that governmental regulation has proved a failure. They feel that what they want is cheap gas, cheap electricity, and other services of public utilities at a cheaper price than they are now getting them. They see what cheap electricity, for example, would do to transform our social and economic life. They see how all of the homes in the South could be cooled in summer time in that case, just as now the houses in the North are heated in the winter time. They know from the history of other experiments that if the matter were managed differently it would be possible to obtain cheap electricity and other services at cheaper prices. Yet they see that the day of cheap electricity, for example, has apparently forever passed away in the United States.

Because of this fact, the theory of government ownership, either with government operation or with private operation under government contract, instead of under the police power and the due process clause, is coming into prominence. This method of handling the problem has been championed by former Governor Smith and by Governor Roosevelt. It is thought by these and other men who champion government ownership that it would be easier to solve the problem of obtaining the services

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<sup>8</sup> Cohen: *Confiscatory Rates and Modern Finance*, 39 *Yale L. J.* 151.

<sup>9</sup> *Excess Income of St. Louis & O'Fallon Ry. Co.*, 124 *I. C. C.* 4.

<sup>10</sup> From *Main Street to Wall Street*, *Atl.* 137; 94-108, Jan. '26; *More Light—and Power*, too, *Atl.* 138: 667-87, Nov. '26; *More Power to the Bankers*, *Nation* 121: 618-19, Dec. 2, '25; *On with Railway Consolidation*, *World's Work* 52: 41-8, May '26; *Railroads: Recent Books and Neglected Problems*, *Q. J. Econ.* 40: 152-66, Nov. '25; *Remedies for Eradicating Big Business Evils*, *World's Work* 53: 128-38, Dec. '26; *Stop, Look, Listen*, *Atl.* 138: 380-99, Sept. 26.

needed by society from the businesses now classed as public callings in one of these two ways. In favor of government ownership and operation, the Ontario experiment is cited, where electricity is obtained at nearly one-fourth of the cost which the people in many of the United States have to pay.<sup>11</sup> In favor of government ownership with private operation, under contract with the government, it is argued that all of the relations between the private business and the government—the people whom they would have to serve, the facilities they would have to furnish, the freedom from discrimination, and their rates and their liability—could all be determined by contract, and that in this way the constitutional difficulties and technicalities which have developed in connection with the regulation of public callings under the due process clause would be avoided, and that once all these matters were provided for in a contract the contract would be protected by the constitution itself against impairment by subsequent legislation. Of course this argument rests upon the assumption that the contract for the government would be made not only by men who were legal experts, but by men who were honest and incorruptible, and that the Supreme Court will not further modify the doctrine of the Dartmouth College case.<sup>12</sup>

It will have to be admitted that the choice is either between government regulation under the law of public callings or public ownership with either public operation or private operation under contract. Governmental regulation is at the cross-roads. If utility men had tried as hard to obey the law of public callings as public utility commissioners have tried to enforce it, governmental regulation might by this time have proven a wonderful success. Since this has not been the case, now either a more colossal effort must be made on the part of government, or government regulation must be abandoned as a governmental policy. If governmental regulation is abandoned, nothing remains but government ownership, either with government operation or with private operation under a contract with the government. There are no other courses open to the American people.

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<sup>11</sup> *State Service Magazine*, Albany, N. Y. Jan. 1930.

<sup>12</sup> 4 Wheat. 518.