Marquette Law Review

Volume 11
Issue 4 *June 1927*

Article 7

1927

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Repository Citation
Charles L. Goldberg and H. William Ihrig, *The Valuation of Public Utilities*, 11 Marq. L. Rev. 242 (1927).
Available at: https://scholarship.law.marquette.edu/mulr/vol11/iss4/7

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THE VALUATION OF PUBLIC UTILITIES

CHARLES L. GOLDBERG AND H. WILLIAM IHRIG

IN A JOINT resolution introduced in the Wisconsin Assembly the valuation of public utilities for rate making purposes has been designated "as perhaps the greatest and most accute issue before the Nation." Valuation of any nature has always been a question of uncertainty, fraught with the dangers of averages, and the "thin ice" of psychological and sociological bases.

The spirit of the times and that guaranteed by the State and Federal Constitutions is that men are entitled to protection of property. Property in and of itself is a barren conception of material things. Its value results from the desires of men; and those desires result from the utility of property. A valuation of property, therefore, in a true sense must be a conception in terms of utility, i.e., "real value." Unfortunately for the practicability of the system above indicated, our social institutions are built up around a concept of "price." It is not necessary for us to go into a detailed discussion of the effects of price on "real value." We merely intend to indicate the difficulties surrounding the problem. These considerations of "utility," "price," and "real value," being present, we are confronted with the consideration of how to harmonize them all so that we may reach a working basis that will conform to the requirements of the law.

All valuations of property, under our present economic system must be arbitrary to a large degree. We cannot hope to arrive at a method which will be infallible to economic attack. What we want to do is to establish a gauge, a yard stick, that will enable us to work with some degree of accuracy and equity.

The theory of the law is that we are not so anxious to be completely right at all times as we are to be reasonably certain. Yet, the element of justice weaves its way through all legal problems, and especially those that have to do with the purses of men.

The legislatures have enacted, and the courts have decreed that public utilities, including railroads, water companies, gas companies, etc., are entitled to a reasonable return on their investment (estimated at or about 7 per cent).[1] What is an investment? As of what time do we calculate the money (or price) value of the investment in question? Is it of the time of production? Is it of the time of the investigation?

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[1] *McCardle* v. *Indianapolis Water Co.*, 47 Sup. Ct. Rep. 144, 71 Law. Ed., 154 at 162 and cases cited in note 4 thereto.

Is it as of any other time? What elements are to be considered as constituting this investment?

To fix rates at a level which does not net the owner a fair return on the investment is illegal and confiscatory.[2] Here there arises the analogy between taking private property for a public use or eminent domain and making compensation therefore, and the netting of a return on the investment of public utilities which must be reasonable so as not to be confiscatory. In both instances, private property would be taken for public use, and in each instance the same measure should be used in determining reasonable compensation. An examination of the measures of value in one, should form the basis for the other.

The rule laid down and upheld in assessing values under the eminent domain statutes are generally set forth in Corpus Jurus, Eminent Domain, Vol. 20, Sections 186-268. See page 725. Also see *New York* v. *Sage* (U.S. Sup.),[3] *Esch* v. *Chicago etc. R. Co.* (Wis.)[4] and *Hubbell* v. *Des Moines* (Iowa).[5]

The rule in arriving at valuations in condemnation proceedings has been held to be particularly related to the circumstances of each case, although there is a general similarity in arriving at the fair value. Regarding public utility valuations the circumstances are more limited but there is the especial aspect of values as affected by the quasi-public nature of the property, activities and rights which give use to the difficult questions which face us herein.

It is economically sound to approve of the oft-stated principle that public utilities are by nature monopolistic. However, there are two aspects of the case, one, the social consequences of the fact that it is a monopoly, and by law so allowed and approved of, and secondly, the private rights and duties in being granted the exercise of such monopoly. Society profits in allowing monopolies in that society avoids wasteful competition in the fields covered by the industries in question. But by virtue of the very grant of monopoly there are present the dangers of the absence of competition. Likewise the monopolist has his property values safeguarded from those upsetting factors to which competition always subjects its participants. This is a very vital factor and must not be lost sight of. Social good doubtless does come from large, well organized protected companies, supplying the community

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[2] U. S. Constitution Fourteenth Amendment; In re Pub. Service Ry. Co., 276 Fed. 979; *City of Portsmouth* v. *Pub. Utility Com.*, 140 N.E. 604 (Ohio); Economics of Public Utilities, Nash, p. 104 (1925); Railroad Rate Regulation, Beale and Wyman (1st Ed.), Sec. 1331, p. 1143, and cases in notes 1, 2 and 3.

[3] 239 U.S. 57, 61.

[4] 79 Wis. 229, 231, 39 N.W. 129.

[5] 166 Iowa 581, 147 N.W. 908, Am. Cas. 1916 E. 592.

with the essentials of life. But in the monopolistic grant to quasi-public corporations the fact remains, that although the use of the property is dedicated to the public, the property itself remains the private property of the owners.[6] In granting the monopoly, the State has the right to impose reasonable regulations for the control of the granted powers. Where one accepts a franchise as a public utility he does so with the express or implied qualification that the body granting the right, has the right to limit him to no more than a reasonable return upon his "investment."[7] What the basis is in arriving at this investment constitutes our inquiry.

It has been the law in the past that to calculate the "value" of a plant for the purpose of rate-making certain items of evidence shall be considered. Quoting from *Smyth* v. *Ames*[8] at page 546 we have:

The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it. How such compensation may be ascertained; and what are the necessary elements in such an inquiry, will always be an embarrassing question. As said in the case last cited: "Each case must depend upon its special facts. . . . ."

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 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 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. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth.

This case was decided in 1898.

Quoting from *Wilcox* v. *Consolidated Gas Co.*,[9] decided in 1909 at page 52, we find the above rule stated and amplified as follows:

And we concur with the court below in holding that the value of the property is to be determined as of the time when the inquiry is made

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[6] *Simpson* v. *Shepard,* 230 U.S. 352.

[7] Railroad Rate Regulation, Beale and Wyman (1st Ed.), Sec. 1303-6, page 1122; *Attorney General* v. *Railroad Companies,* 35 Wis. 425.

[8] 169 U.S. 466, 18 Sup. Ct. Rep. 418, 42 Law. Ed. 819.

[9] 211 U.S. 19, 52.

regarding the rates. If the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase. This is, at any rate, the general rule. We do not say there may not possibly be an exception to it, where the property may have increased so enormously in value as to render a rate permitting a reasonable return upon such increased value unjust to the public. How such facts should be treated is not a question now before us, as this case does not present it. We refer to the matter only for the purpose of stating that the decision herein does not prevent an inquiry into the question when, if ever, it should be necessarily presented.

A further distinction is pointed out in 1912 in the Minnesota Rate Cases, *Simpson* v. *Shepard*,[10] at page 454 where Justice Hughes says:

It is clear that in ascertaining the present value we are not limited to the consideration of the amount of the actual investment. If that has been reckless or improvident, losses may be sustained which the community does not underwrite. As the company may not be protected in its actual investment, if the value of its property be plainly less, so the making of a just return for the use of the property involves the recognition of its fair value if it be more than its cost. The property is held in private ownership and it is that property, and not the original cost of it, of which the owner may not be deprived without due process of law.

It will be noted that these cases were decided before the great and rapid change in the price level of our country, brought about by the War. Consequently the element of cost of reproduction was not at such great variance from that of the original cost. Faced with the actuality of a greatly increased price level, there are two alternatives: first, that of carrying into full effect the increased valuations on which a reasonable return may be earned due to the greatly increased price level, and secondly, we may recognize fully the suggestions made by the United States Supreme Court in the Consolidated Gas Company case, *supra*,[11] to the effect that these corporations are dedicated to the public, and that in some instances it may be unjust to the public to include in the valuation an enormous increase in "value" resulting from a change in price levels solely. It must never be forgotten in this regard that the property being considered on which a fair return is guaranteed is private property under public control.

The latest authoritative statement as to the method of evaluating the property of public utility corporations is found in *McCardle* v. *Indianapolis Water Co.*[12] At page 148, Mr. Justice Butler says:

Undoubtedly, the reasonable cost of a system of water works, well planned and efficient for the public service, is good evidence of its

[10] 230 U.S. 352, 454.
[11] 211 U.S. 19, 52.
[12] 47 Sup. Ct. Rep. 144, 71 Law. Ed. 154.

value at the time of construction. And such actual cost will continue fairly well to measure the amount to be attributed to the physical elements of the property so long as there *is no change in the level of applicable prices.* And, as indicated by the report of the commission, it is true that if the tendency or trend of prices is not definitely upward or downward and it does not appear probable that there will be a substantial change of prices, then the present value of lands plus the *present* cost of constructing plant, less depreciation, if any, is a fair measure of the value of the physical elements of the property. . . . .

It is well established that values of public utility's property fluctuate, and that owners must bear the decline and are entitled to the increase. The decision of this court in *Smyth* v. *Ames,* 169 U.S. 466 at 547, 18 Sup. Ct. 418, 434 (42 L. Ed. 819), declares that to ascertain value "the present as compared with the original cost of construction" are, among other things, matters for consideration. But this does not mean that the original cost or the present cost or some figure arbitarily chosen between these two is to be taken as the measure. The weight to be given to such cost figures and other items or classes of evidence is to be determined in the light of the facts of the case in hand. By far the greater part of the company's land and plant was acquired and constructed long before the war. The present value of the land is much greater than its cost; and the present cost of construction of those parts of the plant is much more than their reasonable original cost. In fact, prices and values have so changed that the amount paid for land in the early years of the enterprise and 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.

The variation this case makes from the previous rule can be best described as an added recognition and emphasis of the apparent trend in prices of those elements which go to make up the cost of reproduction so as to net a reasonable return on a fair valuation *not only at the time of the date of inquiry but also for a reasonable time thereafter.* This version of the law seems to neglect the fact that there are two variables in determining the ultimate rates; one is the physical property itself, along with going value and working capital; secondly, in addition to this there is "the amount and market value of its bonds and stocks" as set forth in *Smyth* v. *Ames, supra.*[13] This case overlooks the previous concern of the courts on the matter of surpluses arising by way of unearned increment or of rates which must be "excessive" in order to provide for a surplus. Previous courts have held the presence of a surplus which was more than of a passing nature to be evidence that the rates then enforced which allowed such surplus were exorbitant.[14]

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[13] 169 U.S. 466, 546, 18 Sup. Ct. 418, 42 Law. Ed. 819.

[14] *Willcox* v. *Consolidated Gas Co.,* 212 U.S. 19, 52; *Smyth* v. *Ames,* 169 U.S. 466, 546-7, and Economics of Public Utilities, Nash, p. 200 (1925).

This court made no inquiry into the question of a surplus. Throughout the dicision there seems to be an absence of consideration of the fact that the property in question is semi-public property; that the public is entitled to reasonable rates; that there must be some limit to adding unearned increment to the valuations of property on which a "reasonable" return is guaranteed.

While it is very convenient to say that no man shall be deprived of his property without due process of law, yet, there is no statement in the law which says that men shall be *given* property by the operation of the law. As a matter of cold practicality, property that is used for public utility purposes has little value except for public utility purposes; its value, its utility is centered on the monopolistic grant. It is protected from competition and this should be an important element of remuneration.

A further consideration may be made in this regard when we consider the position of public utilities during the course of the business cycle. Granting the basis that it takes considerable time to remake rates to give the oft mentioned reasonable return on the investment, we must acknowledge that in times of depression, public utilities are better placed than industrials. The price levels are low, but their returns remain the same. Thus a return of 7 per cent in periods of depression is very satisfactory. In times of prosperity, this situation is reversed. Thus, quoting from Consolidated Gas Company Case.[15]

A profit based on the enhanced value of the capital adds nothing to the company's wealth. Though its capital be measured in more dollars and so, too, its profit, that profit is still paid in the fallen dollar and has not greater buying power than it had before. The increased valuation of the capital will for the years of the depreciated dollar leave the company exactly as it was. It will merely prevent its being compelled to share its putative fair profit with customers, which by hypothesis it should not be asked to do. The company gains nothing, the customers lose nothing.

In opposition to this point of view one finds the interesting dissenting opinion of Justice Brandeis in the South Western Bell Telephone Case (1923). He says:

The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would give definiteness to these two factors involved in rate controversies. . . . . The rate base . . . . would not fluctuate with market price of labor or materials or money. It would not change with hard times or shifting populations. It would not be distorted by the fickle and varying judgments of appraisers, commissions or courts.[16]

[15] 267 Fed. 231, Affirmed in 258 U.S. 165.

[16] 262 U.S. 276 (dissenting opinion); also Economics of Public Utilities (Nash), p. 166.

On March 31, 1927, subsequent to the decision, in the McCardle Case, the Interstate Commerce Commission, by a vote of 6 to 4, sustained the government's effort to recapture excess income from the St. Louis & O'Fallon R. R. and the Manufacturer's Rwy. Co. The former railroad was held to have had excess earnings in part of 1920, and in 1921, 1922, 1923, on the basis of the valuation fixed by the commission. It was ordered to pay $226,000 to the government. That amount represented one-half of the excess earning in net railway operating income in excess of 6 per cent on the value of the property as found by the commission.

It is the first decision of the commission as to the *basis* for recapture of excess earning since Congress in 1920 passed the transportation act and therein provided for such recapture on the basis of value as fixed by the commission. The railroads contended for much higher valuations on the basis of reproduction costs than were found by the commissions. The values used by the commission were arrived at by estimating the cost of reproduction of the property as of June 30, 1919, on the basis of unit prices of 1914 with some readjustments. After 1919 net costs of additions less retirements were added.

The commission said:

There is here presented in reality a great national problem affecting public policy and welfare in a most profound way.

Insistence of the use of cost production new figures of current prices to the exclusion of everything else, called for the closest scrutiny, the commission said. If the doctrine of current reproduction cost were applied to all railroad property in the United States, on a basis of a valuation of $18,000,000,000 on June 30, 1919, the commission said, the value would have become $41,000,000,000 in 1920; $35,000,000,000 in 1921; $28,000,000,000 in 1922 and $31,000,000,000 in 1923.

The majority opinion said:

These huge profits and losses would have occurred without change in the railroad property used in the public service other than the theoretical and speculative change derived from a shifting of general price levels.

It also declares that the railroads were not suffering confiscation under the existing rates which were established on a total property value of around $20,000,000,000. The argument of the commission was that to base the value on what it would cost to reproduce the property now would make it impossible to fix rates that the traffic of the country could bear. The commission further stated:

The conception of a rate base and returns thereon fluctuating up and down with changes in the level of general prices is a conception

which if carried into an actual operation could have no appeal except to stock market speculators.

But four of the ten commissioners dissented. Commissioner Hall in the principal dissenting opinion said, that the function of the commission was not to act as an arbiter in economics, but as an agency of Congress to apply the law of the land to facts developed of record in matters committed by congress to its jurisdiction. He asserted that the majority had refused to apply the law to the O'Fallon case and contended that the commission was required to give weight to cost of reproduction estimates, and cited the recent McCardle case in support of his contentions.

The proceedings of the commission herein set forth, have been generally regarded as a test case and the valuation principles announced by the commission in its decision will apply to all railroads in the United States. It is regarded as likely that because of its importance generally, it will be carried to the Supreme Court of the United States.

The legal profession awaits with great interest the final adjudication on the application of the above principles to the railroad property, hoping that the decision will finally settle this complicated matter of valuation.