The Regulation of Public Utilities

Nathaniel T. Guernsey
THE REGULATION OF PUBLIC UTILITIES*

NATHANIEL T. GUERNSEY†

THE FIRST THING IS TO DEFINE CLEARLY WHAT WE ARE TALKING ABOUT

(a) What is a public utility?

For our purposes, it is a person or corporation engaged in rendering a public service which it is bound to render at reasonable rates, without discrimination, to any member of the public demanding it in the locality served.

A state cannot, by a statute declaring a business to be affected by a public interest, make it a public service if it is not one in fact. The determining factor is the character of the business itself.¹

A franchise authorizing a special use of the streets is not an essential characteristic of a public utility. Note as utilities without such franchises express companies and radio telegraph companies.

Nor is the right of eminent domain. Telephone and telegraph companies, both clearly public utilities, have this right in some states and in others are without it.

The fact that public utilities are subject to regulation, and that they serve the public, is not infrequently taken as distinguishing them from other businesses. This is a mistake. It is to be doubted whether there is any business or any vocation which is not subject to regulation. Pure food laws, those relating to narcotics, those relating to the hours of labor and to the employment of women and children, those relating to mining, those relating to many classes of manufacturing, those related to inn keepers, those relating to automobiles, illustrate the extent of regulation.

And in Compañía General de Tabacos de Filipinas v. Collector, 48 Sup. Ct. Rep. 100, Chief Justice Taft said:

"Taxation is regulation, just as prohibition is."

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† Vice-President and General Counsel of the American Telephone & Telegraph Company.

Public utilities are not unique because they serve the public. They would be unique if they did not. There is no one else to serve. They serve the same people who are served by grocers, by druggists, by automobile manufacturers, by practically every kind of business.

The business of public utilities is like every other business in that it is governed by the same fundamental economic laws.

The conditions as to steam railroads are such as to make them in many respects a class by themselves. In what follows no attempt is made to deal with the railroad situation. What is said is with reference to the other utilities. Of course much of it is applicable in principle to railroads.

(b) What is regulation?

The *Century Dictionary* defines the word "regulation" as follows:

1. The act of regulating, or the state of being regulated or reduced to order.
2. A rule or order prescribed by a superior or competent authority as to the actions of those under its control; a governing direction; precept; law; as police regulations; more specifically, a rule prescribed by a municipality, corporation, or society for the conduct of third persons dealing with it, as distinguished from (a) by-laws, a term which is generally used rather with reference to the standing rules governing its own internal organization and the conduct of its officers and members, and (b) ordinance, which is generally used in the United States for the local legislation of municipalities.

For our purposes "regulation" may be defined as the establishment of general rules to govern the operation of public utilities and the provision of machinery for their enforcement.

What we are talking about, then, is (1) the establishment of general rules to be observed by public utilities in the transaction of their business and (2) the enforcement of these rules through the operation of the machinery provided by law for that purpose.

II

THE POWER OF THE STATES TO REGULATE IS THOROUGHLY ESTABLISHED

(a) Basis of this power.

This power is frequently said to be based upon the fact that one who devotes his property to a public use thereby consents to its supervision through the exercise of the regulatory power. More or less stress is also sometimes put upon the fact that most utilities enjoy special rights called franchises with reference to the use of streets and other public
places, as well as the fact that in some cases utilities have been granted the right of eminent domain.

It has been noted that not all utilities have such franchises or have the right of eminent domain.

These reasons seem to be more or less legal fictions. These services intimately affect the entire public; and the public has never hesitated to assert the power to protect its interests wherever it has deemed this necessary. As has been stated, every individual and perhaps every business is regulated more or less.

(b) Extent of power to regulate.

The extent of the power to regulate varies with the character of the business—it is not a matter of legislative discretion solely, but depends upon the nature of the business and how and to what extent it touches the public.

In general, the utility "is entitled to the privilege of managing its business in its own way so long as it does not injuriously affect the health, comfort, safety and convenience of the public."\(^2\)

The public power to regulate "and the private right of ownership of such property coexist and do not the one destroy the other."\(^3\)

(c) Regulation is old, not new.

The Puritans in New England regulated the price of beer and bread. The Cavaliers of Virginia regulated the price of tobacco. They prescribed rules as to how it should be planted and harvested, and how it should be prepared for market. Fees of lawyers were regulated.\(^4\)

III

THE POWER TO REGULATE IS NOT UNRESTRICTED

This power is a legislative power and is subject only to such restrictions as are imposed upon legislative action by the Federal Constitution and by the constitution of the state in question.

In the Fourteenth Amendment to the Federal Constitution, it is provided, among other things: "Nor shall any state deprive any person of life, liberty, or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Most, if not all, of the state constitutions contain like provisions.

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\(^3\) Atlantic Coast Line Railroad Co. v. North Carolina Corporation Commission, 206 U.S. 1, 20.

Two of the most important limitations upon the power to regulate grow out of this amendment.

(a) It is the established law of the United States that this amendment prohibits the states from imposing upon public utilities schedules of rates which will not afford a fair return on the present fair value of the property used or useful in the rendition of the service for which the rate in question is charged.

1. This rule was originally established by a very narrow margin.5
2. But it is now settled by an overwhelming weight of authority.6
3. With proper safeguards for the consumer, the rule may be applied to prevent temporary confiscation while a suit is pending.7
4. An injunction may be granted where a rate regulating body having taken jurisdiction, delays action for an unreasonable length of time.8
5. Although its earnings as a whole afford it a fair return, a utility may still invoke the rule against confiscation when it is sought to compel it to charge a confiscatory rate for a particular class of traffic, or for a particular branch of service, or in a particular territory.9

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5 Chicago, Milwaukee & St. Paul Railway Co. v. Minnesota, 134 U.S. 418 (March 24, 1890).
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6. Note that this constitutional provision is not a guaranty of any return. It is not the basis of the right to earn. This right is an incident of ownership. What the constitution does, and all that it does, is to limit the power of the states to interfere with this right to earn by prohibiting them from imposing confiscatory rates.

(b) The state, through the exercise of its regulatory powers, may not encroach upon the domain of management.

1. The property of the utilities is their property and is private property.10

2. The right to manage this property inheres in its ownership. To deprive its owners of this right of management even under the guise of regulation is a taking of property in violation of the Fourteenth Amendment.11


(c) What distinction will accurately draw the line between regulation and management?

Regulation has already been defined. Management covers the use and operation of the property by its owners. In operating the property, its owners must not disobey the rules which have been established for its regulation.

To illustrate, the rate of speed of street cars through a city, or the candlepower of gas furnished to a city, or the quality of the transmission to be furnished by the telephone company, may be prescribed by general regulations. The means to be adopted and the methods to be used in carrying on the business and meeting these requirements are matters of management to which the power to regulate does not extend.

In *Harvey v. Corporation Commission of Oklahoma*, 229 Pac., 428, the Oklahoma Supreme Court decided that the commission could not interfere with a rule requiring men to wear coats in railway dining-rooms, and without deciding whether the commission was given any jurisdiction over the dining-room company, said:

> It must be remembered that, while much power is by law given to the Corporation Commission in the regulation of public utilities, yet the utility is not the property of the Commission or the state, but belongs to the company and its stockholders, and the officers and directors by them selected must, under proper regulation, be permitted to manage the property in such proper way as to earn and pay, if they lawfully can, just dividends to the stockholders. *Regulation must not be so far extended as to constitute management or operation.*

It was not intended by the writers of our organic law that the funds of our state, raised by the taxation of our people, should be expended by the Corporation Commission in the conduct of extensive and expensive hearings upon just what rules of style and fashion should be followed by a great public utility. *Law-makers must not completely destroy personal liberty.* It would be unwise to leave matters like this to the discretion of inexperienced public officers, selected by the vote of the people, and whose policies and rules would likely change at every election. It is well, ordinarily at least, that we be slow to abrogate rules in such regard, made by those whose successful life’s experience well qualify them to formulate such internal policies. The rule is not unreasonable.

In *State Corporation Commission v. Atchison, Topeka & Santa Fe Ry. Co.*, 255 Pac. 394 (N. Mex.), the court held improper an order of the commission which required a railroad company to re-establish a discontinued agency; the commission saying that the company had failed to show cause sufficient “to warrant the commission” in closing
the station. The court remarked that the commission was not “created to manage railroads,” but that its function was to protect the public against unjust and unreasonable deficiencies in service.

A very recent case involving this question is New England Telephone and Telegraph Company v. Department of Public Utilities et al., 159 N. E. 743 (Mass.).

The Hotels Statler Company, Incorporated, was erecting a large building in Boston to be used in part for offices and in part as a hotel. It entered into negotiations with the telephone company, as a result of which the hotel company was to install conduits for telephone wires in the building; these conduits to be the property of the hotel company. The telephone company was to provide the necessary cables, switchboards, wires, etc., and was to string these wires in these conduits; this telephone property to remain the property of the telephone company and subject to its control. The only payment to be made the telephone company was the usual service charge for service and installation of the telephones in the building, to be paid by individual subscribers, of whom the hotel company was one.

When occasion arose for the pulling of wires from the feed cables, already laid by the telephone company, through conduits to the rooms where the telephones were to be installed, workmen employed by the subcontractor for all wiring other than that to be installed by the telephone company insisted that the pulling of these wires should be done by union workmen affiliated with the American Federation of Labor. The employees of the telephone company were not so affiliated. “Strikes, first of the employees of the wiring subcontractor and later of all workmen employed on the building, were inaugurated to compel compliance with this demand. There was no trade dispute between the wiring subcontractor and his workmen, nor between the other workmen on the building and their several employers, nor between the telephone company and its employees. There were, however, strikes.” Both the hotel company and the telephone company were threatened with great loss.

“The situation was deliberately brought about by the union men either to force the employment of union labor affiliated with the American Federation of Labor by the telephone company, or to compel it to abandon its policy of having all telephone wiring pulled by its employees.”

Wires were pulled by union employees to room 727, and the hotel company requested the telephone company to install its service at that room and, upon the refusal of the telephone company, applied to the commission to compel service over these wires. The commission ordered the telephone company to furnish service by connecting with
these wires that had been pulled to room 727, requiring that the title to these wires be transferred to the telephone company. The proceeding was to reverse this order. The court held that the order infringed upon the power to manage and was beyond the commission's power, saying, among other things:

The telephone company insists that the proper performance of its function in the transmission of speech requires that it shall own and control the wires over which the transmission of speech takes place. See *Gardner v. Providence Telephone Co.*, 23 R.I. 262. The commission confirms this claim by requiring in its orders that one insisting on service shall convey title to the wires and surrender control of them to the telephone company. The company further insists that such proper performance also necessitates that the wires be pulled or put in place by workmen subject to its control; for only thus can it be assured that they are proper and properly installed. The commission denies this claim, and by its order required that, without regard to who has selected the wires and put them in place, the company shall connect with them if they are properly installed and suitable for the service applied for. The commission declares that if experience should demonstrate that the service over the wires to room 727, to which it orders the telephone company to connect, cannot be given without impairing its general service, it would be justified in discontinuing the service until it could remedy the defect. See *Northern Pacific Railway v. Department of Public Works*, 268 U.S. 39, 45. Thus it requires the telephone company to become owners of property which later it may be called on to reject because it is incompatible with performing the service which it undertakes to give. This is an unreasonable interference with its right of property. The determination whether certain wires are suitable and are properly installed is a detail of management in the administration of the business of the telephone company. To substitute the judgment of others for that of the telephone company in that matter is an interference with the right of management which goes beyond the reasonable limit of public control. It is similar to the control attempted to be exercised by the State of Wisconsin in requiring the upper berths in sleeping cars to be kept closed when not in use, which was held to be unconstitutional in *Chicago, Milwaukee & St. Paul Railroad v. Wisconsin*, 238 U.S. 491. See also *Southwestern Telephone Co. v. Public Service Commission*, 262 U.S. 276; *Banton v. Belt Line Railway Corp.*, 268 U.S. 413; *Great Northern Railway v. Minnesota*, 238 U.S. 340. No general conditions of public necessity are shown to make the orders appropriate and essential for the adequate and equal performance of the service for the public. The decision of the department discloses that the action is taken to put an end to a particular instance of hardship.

The fact that cases may be presented where it will be difficult to draw the line between regulation and management does not militate
against the soundness of this proposition, any more than the difficulty in some cases in distinguishing between negligence and due care militates against the fact that there is a well recognized distinction between them.

(d) This discussion does not embrace questions as to the Federal power to regulate.

IV

THE JURISDICTION OF COURTS AND REGULATORY BODIES

(a) Regulation is the exercise of a legislative function.

(b) The functions of the courts are purely judicial.

(c) All but two of the states, Virginia and Oklahoma, have constitutions which divide the functions of governments into three classes, legislative, executive and judicial, and prohibit each class from exercising any of the functions of the others.

It follows, therefore, that except in the two states noted the courts are without jurisdiction to review the legislative acts of regulatory bodies acting within their jurisdiction. For a court to substitute its judgment for that of the legislative body in a legislative matter would be for the court to exercise legislative functions. *Knotts et al. v. Nollen et al.*, 218 N.W. 563.

A court, finding the existing rate illegal, will not establish a rate in lieu of it (*Emporia Telephone Company v. Public Utilities Commission*, 154 Pac. 262).

The courts, however, exercise a very important jurisdiction in determining whether the regulatory body has acted within its jurisdiction and in setting aside actions which are found to be outside of it.

Illustrations are:

1. Rates which are confiscatory. Here the limit of jurisdiction fixed by the Fourteenth Amendment is exceeded.
2. Interferences with management, which also are prohibited by this amendment.
3. Arbitrary orders or actions unsupported by any proof. These are beyond the power of the commissions and are illegal.\(^{12}\)

Under the usual constitutional provisions no appeal to the courts will lie upon the ground that rates fixed by legislative authority are excessive.

V

THE GENERAL SCOPE OF THE COMMISSION LAWS

At present forty-seven states have established state boards or commissions exercising regulatory powers over utilities or some classes of utilities. These are sometimes designated as railroad commissions, sometimes as public utility commissions, and sometimes by other titles. In some states, as Iowa and Texas, there are broad regulatory powers vested in cities.

Commissions were created after the practical obstacles in the way of regulation by direct legislative enactments had become obvious.

The four things that the public is interested in are: (1) good service, (2) reasonable rates, (3) freedom from discrimination, and (4) adequate service; that is, good service at reasonable rates, the service to be broad enough to provide for the demands of all who desire it and who are so situated that it is commercially practicable to serve them.

An examination of these laws discloses that substantially all of their material provisions may be ascribed to one of these four things. Generally, their scope covers:

(1) Rates, with provisions authorizing the utilities to establish and change rates, and for an examination into rate schedules by the commission on its own motion, or upon the complaint of the public and the establishment of reasonable rates by the commission where, upon such an examination, the rates in question are shown to be unlawful for some reason.

(2) Service, with provisions for maintaining proper standards and adequate facilities.

(3) Capitalization, which largely goes to the question of rates.

(4) Accounting, which also goes to the question of rates.

(5) Prohibition against discrimination.

The outstanding characteristic of these laws is that they are not intended to create any new fundamental rights in either the public or the utility, or to take away from either the public or the utility any substantial pre-existing rights. It has always been the right and duty of the utility to charge reasonable rates. The public has always been

entitled to them. It has always been the duty of the utility to furnish good service. The public has always been entitled to such service. Unjust discrimination on the part of the utility has always been illegal. There has always been an obligation on the part of the utility to furnish adequate facilities.

These laws do not create fundamental new rights or take away old ones; what they do is to provide the machinery for the enforcement of the old rights of both the public and the utilities.

VI
THE PRIMARY POWER TO MAKE RATES HAS REMAINED IN THE UTILITY

The popular idea that the commission laws have taken away the power of the utilities to establish rates is a misconception. Before the commission laws were enacted the utilities had the right to establish just and reasonable rates and the law prohibited rates not just and reasonable. This is the situation under nearly all of the commission laws.

Generally, under the commission laws, the power of the commissions to make rates arises only where it appears, after a hearing, that the rates made by the utility itself are for some reason unlawful.

In general, in determining the lawfulness of existing or proposed rates the commission must confine itself to the experience of the utility in the matter of revenues and expenses and cannot base its action on estimates of what they should have been.

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State v. Boyd Transfer & Storage Co., 209 N.W. 872 (S. C. Minn., 1926), is instructive. In setting aside an order holding that a bus company operated "between fixed termini" within the meaning of a statute imposing a duty on companies so operating to secure a certificate of convenience and necessity, the court said:

The statute does make it a question of fact to be determined by the commission, but the finding is not conclusive. As applied to this case the fact goes to the jurisdiction of the commission, and would be open to judicial review even though the statute declared to the contrary, which it does not.\footnote{These cases are readily distinguishable from the following decisions, holding that where a commission is acting within its jurisdiction a court may not substitute its judgment for that of a commission, and can only annul an order of the commission when it violates some rule of law: Interstate Commerce Commission v. Illinois Central R. R. Co., 215 U.S. 452, 470; People v. McCall, 219 N.Y. 84, 87; 113 N.E. 795, (affirmed 245 U.S. 345); Pennsylvania Railroad Co. v. Towers, 94 Atl. 330, 336, 126 Md. 59, (affirmed 245 U.S. 6); Mangum Electric Co. v. City of Mangum, 179 Pac. 26, 27; 72 Okla. 166.
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Except where the commission law expressly provides to the contrary, the burden of proof in a commission proceeding is upon the person assailing existing rates as unlawful.\(^{18}\)

In the exercise of their rate-making powers the commissions are not unrestricted. The laws make the regulation that rates shall be just and reasonable apply to the commissions exactly as it does to the utilities.

VII

WHAT IS A JUST AND REASONABLE RATE?

Since the laws require rates, whether made by the utilities or by the commissions, to be just and reasonable, and since generally the jurisdiction of the commissions to establish rates only arises where, after a hearing, upon notice to the utility, the evidence justifies a finding that the rate proposed or complained of is unjust and unreasonable, or otherwise unlawful, it is of paramount importance to understand clearly what a just and reasonable rate is.

(a) There is no synonymity between unjust and unreasonable rates, and confiscatory rates.

A rate which returns more than enough to escape the charge of confiscation is not on that account extortionate or unreasonable. A determination that a rate is not so low as to be confiscatory is not a determination that it is not so low as to be unreasonable.\(^{19}\)


(b) The words "just and reasonable" are to be taken in their established sense at the time the laws in question were enacted.

When in a statute the legislature uses words or phrases which have acquired a well-understood and defined meaning, the legal presumption is that they are used in this sense in the statute.

The words "just and reasonable" are regarded as practically synonymous.20

(c) A just and reasonable rate is one which justly and reasonably divides the spread between the cost of rendering the service, and the value of the service to the patron.

The basis of all businesses is that, upon the average, sound trades are beneficial to both parties to them. Where the benefit goes solely to one party to the transaction, the business cannot continue. Public utilities are no exception to this rule.

The just and reasonable rate is the rate that justly and reasonably, that is, that fairly and equitably divides the spread between the cost of furnishing the service, including the cost of the capital used, and the value of the service to the patron.

Judge Swayze's definition of a just and reasonable rate is:

On the one hand a just and reasonable rate can never exceed, perhaps can rarely equal, the value of the service to the consumer.

On the other hand, it can never be made by compulsion of public


authority so low as to amount to confiscation. A just and reasonable rate must certainly fall somewhere between these two extremes, so as to allow both sides to profit by the conduct of the business and the improvements of methods and increase of efficiency. Justice to the consumer, ordinarily, would require a rate somewhat less than the full value of the service to him; and justice to the company would, ordinarily, require a rate above the point at which it would become confiscatory. To induce the investment and continuance of capital there must be some hope of gain commensurate with that realizable in other business; the mere assurance that the investment will not be confiscated would not suffice.20-a

*Cotting v. Kansas City Stock Yards Company et al.,* 183 U. S. 79, 95, holds that the states' regulation of charges "is not to be measured by the aggregate of his profits determined by the volume of business, but by the question whether any particular charge to an individual dealing with him is, considering the services rendered, an unreasonable exaction."

(d) The foregoing assumes the value of the service to be greater than what it costs to produce it.

That this is true is demonstrated by the fact that people not only buy but demand these services. The fact that to some individuals the service would be worth less than its cost does not affect this rule. They are the persons who do not buy the service. The requirements of a few do not measure the necessities of the community.21

If a community should become stationary or begin to retrograde, this would not affect the right of the utility to insist that rates established by public authority should at least non-confiscatory.22

VIII
THE FUNCTION OF THE COMMISSIONS IS TO REGULATE RATES—NOT EARNINGS

No state commission law attempts to limits the amount which any utility may earn. What these laws regulate is the rates. They authorize and require just and reasonable rates, and by direct inference recognize the right of the utilities to earn whatever they can under such rates. Any other doctrine would fail because it would be directly opposed to sound economic principles.

20-a *Public Service Gas Co. v. Board of Utility Commissioners, etc.,* 87 Atl. 651; affirmed 95 Atl. 1079.


There is a radical distinction between the regulation of rates and the regulation of earnings.²³

IX

THE VALUATION OF THE PROPERTY OF A PUBLIC UTILITY

In proceedings for the regulation of rates, the present fair value of the property used, or useful, in the rendition of the service is always material and presents many questions.

(a) What is meant by present fair value?

The world "value" is used in its ordinary sense. "Value" is defined in the Century Dictionary, as follows:

Worth; the property or properties of a thing in virtue of which it is useful or estimable, or the degree in which such a character is possessed; utility; importance; excellence; applied to both persons and things.

The importance of a commodity measured by the amount of other commodities (commonly represented by money) for which it can be exchanged in open market; the ratio in which one thing exchanges against others; the command which one commodity has over others in traffic; in a restricted (and the popular) sense, the amount of money for which a thing can be sold; price.

This is what is protected by the Fourteenth Amendment.²⁴ This is equitable. It is a protection of the actual existing property, no more, no less.

It is an error to talk about value for rate making purposes as if it were something other than the actual value.²⁵

The value of any specific property at any particular time is a fact. There is but one value.

(b) How is value to be ascertained?

It must be determined by the application of sound judgment to all of the material facts. (Minnesota Rate Cases, vide 24).

Smyth v. Ames (vide 24), and all of the subsequent cases list as material factors, capitalization, as evidenced by stocks and bonds outstanding, revenue, original cost, and cost of reproduction.

Footnotes:
²⁵ Los Angeles & Salt Lake Railroad Company v. United States, 8 F (2d) 747, 749, 756; Havre de Grace & Perryville Bridge Co. v. Towers, 103 Atl. 319, 132 Md. 16.
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The value of a utility may not be fixed with complete mathematical accuracy. But this does not discredit such valuations; this is true as to the value of everything else, and as to many other matters which we call facts.

X

CAPITALIZATION

Following the leading case of Smyth v. Ames, (vide 24), practically all of the authorities recognize this as a factor. They do not attempt to determine the weight which should be given to it, or in fact to any factor, in any particular case.

It is desirable to prove capitalization because of this rule laid down in the authorities. As a matter of fact, this evidence usually has but very little influence in arriving at value.

Willcox v. Consolidated Gas Co., 212 U. S. 19, presents an exceptional situation, due to the peculiar circumstances under which the franchises involved there had been capitalized.

XI

REVENUE

This means future revenue, or potential earning capacity, and not past revenue.

The cases, including commission cases, which hold that in a rate proceeding this factor is not to be taken into account are not well considered. The factors which affect value are not determined by the action of courts, or by legislative action, but are determined by the public which deals in the property in question. The ability of a public utility to earn has always been the most important factor affecting its value. It actually affects value in every purchase and sale of such property. If what is to be ascertained is value, it must therefore be taken into account.26

XII

ORIGINAL COST

Evidence showing original cost is always competent. Smyth v. Ames (vide 24), and the long line of subsequent cases citing it with approval.

All that these cases determine is that evidence upon this question is material. They do not attempt to determine what weight should be given to the cost evidence in any particular case.

Ancient costs, where there is doubt as to whether they can be accurately ascertained and where the facts as to the prices of material, wages and labor when the costs were incurred were radically different

from like facts at the date of the valuation, have but little weight, for reasons entirely analogous to those that give little weight to what a piece of real estate cost fifty years ago in determining its value today.

On the other hand, if the costs are recent and the conditions are the same as, or approximate the conditions prevailing at the date of the valuation, cost is a factor entitled to great weight so that the custom is to take the cost of property actually under construction at the date of the valuation as the estimated cost of reproducing it.

With us both cost and value are measured in dollars. Obviously, variations between the value of the dollar at the time the cost was incurred and at the date of the valuation must be taken into account in arriving at the weight to which cost evidence is entitled.23

XIII

Cost of Reproduction

(a) The estimated cost of reproduction is the estimated cost of reproducing the property with all its attributes in its condition as it existed at the date of the valuation.

The use of this factor in arriving at value is nothing new. It is an application of the universal practice of checking the value of something offered for sale by ascertaining what it would cost to obtain it from some other source or in some other way28.

It is a conservative factor because it is based upon the idea of competition.

(b) Every utility located where there is a demand for its services, assuming conditions of normal stability, is worth at least what it would cost to reproduce it.

This proposition presupposes reasonable skill and economy in the construction and operation of the utility and that the service furnished by it is worth to its users more than it costs to produce it, this cost including a fair return on the value.

The value of the property at any time normally cannot be less than what it would then cost to reproduce it.

The users must either pay this cost of producing the service or do without it. If they pay less, the utility will ultimately be bankrupted and the service will necessarily be discontinued.

They will pay this cost of the service because it is less than the


value of the service to them; they would lose money if they did not buy the service.

Therefore, the property always has a potential earning capacity of at least a fair return on what it would cost to reproduce it, and so is worth at least this amount.

(c) The authorities are giving increasing weight to reproduction cost as a factor affecting value.30

(d) What should be taken into account in making such an estimate?

So far as possible, each step involved in the reproduction of the property should be taken into account and its cost estimated, beginning with the inception of the idea and including every preliminary and incidental expense as well as the expense more directly attributable to the construction of the physical property. Generally, in the practical work, these items are divided along broad lines into five classes, namely:

1. Preliminary expenses, including cost of organization, obtaining franchises, preliminary investigations with reference to the enterprise and some other general expenses.

2. The direct cost of reproducing the physical property, including cost of real estate, construction of the buildings and the construction and installation of the remainder of the plant. There should be included the present value—not the purchase price—of patents owned by the utility and used in the business.31

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31 Pacific Gas and Electric Co. v. City and County of San Francisco, 265 U.S. 403.
3. Undistributed structural costs. These are expenses which cannot be assigned to any particular item of the plant because they are general in their character. Therefore, they are generally estimated in percentages. Usually they include interest during construction, taxes during construction, engineering, and contingencies.


5. Going concern value.

XIV

Depreciation of Plant

This must be taken into account in order to ascertain the cost of reproduction of the property in its condition at the date of the valuation.

(a) The distinction between depreciation and depreciation charges.

Depreciation of plant is a lessening in value due to wear and tear, storms, obsolescence, public requirements and many other factors. It is a physical fact and must be considered.

The depreciation charge is a charge made to provide for the expense due to the depreciation of the various items of depreciable plant. This expense must be finally treated as part of the expenses of operation.

The depreciation fund is the property of the utility. Adequate provision of this kind is necessary to keep its investment unimpaired.

The determination of what is a proper charge to operating expenses on account of depreciation is a matter of management, and if made in good faith is probably not subject to review by regulatory bodies. Their function should be to determine whether or not adequate provision for depreciation is being made, and if it is not being made, to require that this be done.

(b) The best and only accurate method of ascertaining the amount of depreciation is by inspection.

NOTE: The cost of reproduction, less depreciation, when ascertained, is not a measure of value. It is a factor of great importance in


33 McCardle et al. v. Indianapolis Water Company, 272 U.S. 400; Pacific Gas and Electric Co. v. City and County of San Francisco, 265 U.S. 403; Southern Bell Tel. & Tel. Co. v. Railroad Commission of South Carolina, 5 F. (2d) 77,
ascertaining value. Normally, value cannot be less than this amount. See XIII (b), supra.

(c) It is error to treat the amount of the depreciation reserve as the measure of the actual depreciation of the property, and so to deduct it to determine value.\(^3\)

**XV**

**THE PRACTICAL APPLICATION OF THE REPRODUCTION THEORY**

(a) An inventory of the property is the first step.

(b) The reproduction period.

This must be accurately estimated as a basis for the determination of: (1) interest during construction, (2) taxes during construction, (3) unit prices, and (4) going concern value.\(^4\)

(c) Unit prices.

1. These should be based upon the prices which it is estimated will prevail during the reproduction period.

   Actual units deduced from the experience of the company in question, the units prevailing at the date of the valuation and the trends of such units during terms of years, are important factors in properly fixing unit prices but do not actually fix them.

2. Unit prices usually include all costs of labor and material up to and including the foreman in charge of the work, including freight on material, and the expense incident to storing it and delivering it upon the work.

Unit prices and the undistributed structural cost item of contin-

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gencies are somewhat interdependent and as to some items there is no fixed rule or practice among estimators governing the class to which they should be assigned.

3. Cutting and replacing paving is in fact a part of the cost of reproduction, though it has generally been disallowed by the courts up to this time. It is merely excavation and back-filling.

(d) Undistributed structural cost items.

1. Interest during construction.

Interest upon the money invested in the property prior to the date when the property is put into service and begins to earn, is an element of its cost.

This interest should be computed at the rate prevailing for loans upon good security at the time and place of the reproduction. This interest rate is not affected by what the fair return rate may be.

2. Taxes during construction.

The property is subject to taxes during the construction period and these taxes are an element of its cost.

3. Engineering.

Engineering service is essential to the construction of any utility property.

It is generally measured by a percentage upon the cost of the structural property.

4. Contingencies.

It is almost inevitable that in any inventory there will be some omissions, and it is impossible to anticipate all of the contingencies which may affect an undertaking usually extending over a period of several years. It is, therefore, necessary to cover this factor by an estimate, which is usually shown by a percentage upon the estimated cost of the structural property.

(e) Working capital.

Every going business, in addition to its physical plant, requires a certain amount of money to enable it to efficiently and economically transact its business. This is called its working capital.

The amount of it will vary with the variations in the businesses of the utilities. It should be ample to enable the utility to make current payments arising out of operation without borrowing money in anticipation of its receipts and to provide for the stock of materials and supplies which is necessary to meet current operating conditions, with a reasonable cash balance to cover unexpected expenditures and to sustain the utility's credit.
Material and supplies on hand may be carried as a separate item or taken in as a part of the working capital. Which is the better practice, in any particular case, will probably depend upon the circumstances of the case.

(f) Going concern value.
This, also called going value, is the element in the value of the property representing the difference between the value of the mere physical structure sometimes called the bare bones of the property, and the value of the property as a going concern with customers attached to it and a developed earning power, and with the trained organization and the records and routines which are incident to the efficient transaction of its business.

This is an attribute of the physical property and a factor in its value.\(^3\)

The cost of reproducing this factor may be estimated by the comparative method through a comparison of the net earnings of the hypothetical plant and of the actual plant during the period necessary to bring the earnings of the hypothetical plant up to the level of those of the actual plant; the present worth of the difference representing the estimated cost of reproducing this attribute of the property.

Another method has been to attempt to estimate in detail the expenses that would be incurred in reproducing this element of value, estimating separately each item such as preparing routines, training employees, securing customers, etc.\(^6\)

Where the cost of creating this element of value has been paid out of earnings, this does not justify the disallowance of going value.\(^7\)

XVI
Determining Value

The determination of the foregoing factors does not determine value. Value is deduced by applying to them, and every other material factor, trained judgment.


Where past operations under existing rates are involved, there is here relatively little basis for dispute. Where past operations under existing rates are involved, there is here relatively little basis for dispute. Federal income taxes are undoubtedly a proper expense item. Where rates, not yet tried out, are in controversy uncertainties as to future conditions afford room for debate. Abnormal expenses, large in amount, may be spread over the period covered by the results attained through them. Instances of expenses which may be so amortized are bond discounts, expenses of strikes and those pertaining to rate regulation. Charges to provide for depreciation are expense items, and must be included in the operating expenses. The present necessary depreciation charges cannot be reduced in estimating expenses because such charges have been more than ample in the past. Some courts are recognizing the propriety of including as an expense item an amount for the amortization of past losses which the utility may have sustained under inadequate rates imposed upon it by the regulatory body. While commissions not only may, but should do this, courts cannot allow such an expense item in a confiscation case.

A fair return is, as the words indicate, a return that is equitable. A fair return is a return commensurate with the return upon other investments, taking into account differences in the risk and other material factors affecting the situation. The market for money is highly competitive and the return must

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be such as will enable the utilities to secure in this market the new money necessary for their business.\textsuperscript{43}

In City of Elizabeth v. Board of Public Utility Commissioners, (123 Atl. 358) the New Jersey Court of Errors and Appeals said:

The Policy of the law is and should be to aid utilities to properly function and to render adequate service to the public by permitting rates to be charged for the service rendered, which will yield an adequate return upon the capital invested, maintain the property, and attract capital. The policy should never be one of destruction. . . . A starved utility is in no better position to render proper service than a starved horse or a motor car without fuel.

Every utility in a growing community must, if it is to maintain its service, constantly make additions to its property and so is constantly required to obtain new capital.

What is fair return is a question of fact to be determined from the proof on this question, which will vary with different localities and different utilities as well as with different conditions at different times in the same locality.

It is important to realize that neither the regulatory body nor the utility can control what shall be a fair return. This is determined by the investor.

XIX

A SUIT ATTACKING RATES AS CONFISCATORY

(a) The general scope of the allegations in such a suit.

To sustain such an action, the allegations must cover the facts necessary to establish the ultimate fact that the rates in question are insufficient to earn a fair return upon the property in question.

Each material fact must be established by clear and satisfactory evidence.

(b) The material facts are the value of the property, its net revenue under the rates in question, and what rate of return is fair.

(c) Property not used or useful.

The value of such property cannot be included. The words "used or useful" and the words "used and useful," frequently found in this connection, authorize the inclusion of the value of property acquired in advance of present requirements and reasonably necessary to provide for the near future, where this upon the whole is consistent with reasonably good management.

XX

A RATE PROCEEDING BEFORE A REGULATORY BODY

The same factors of value, net revenue and fair return are to be determined; but they are not the only factors and they are not subject to the rule that each fact must be shown by clear and satisfactory evidence.

The first thing which the commission should determine is whether the rates in question, whether they be existing rates or proposed new schedules, are lawful. Unless they are unlawful, there is no occasion or authority for action upon the part of the commission, other than a formal approval. The fact that rates produce more than a fair return is not enough to warrant the conclusion that they are unreasonable or unlawful (See authorities, supra 19). If they are found to be unlawful, the commission should determine what are reasonable rates. Such rates are to apply to future operations so that necessarily neither the operating expenses nor the return from the proposed schedule can be determined with entire accuracy.

In performing its duty, the commission is exercising a legislative or business, rather than a judicial, function. It should take into account all of the circumstances and should endeavor to establish a schedule which, in the aggregate, will afford return far enough above the actual cost of transacting the business to furnish the company a fair profit, with rates far enough below the value of the service to insure a profit to its users which will be attractive to them.

As between themselves, rates for different classes of service should be adjusted, not rigidly with reference to the cost of the respective services, but with reference to an equitable division in each instance of the spread between the cost of rendering the service and its value to its user.44

XXI

OTHER PROCEEDINGS BEFORE COMMISSIONS

- Discrimination.
- Service.
- Capitalization.
- Other matters.

XXII

THE FUNCTION OF THE LAWYER IN MATTERS OF REGULATION

The fundamental questions which determine the jurisdiction of the regulatory body and the proper basis for its action upon questions presented to it, as well as the validity of its action upon any particular question, are questions of law; so that the general responsibility for the proceedings should devolve upon the lawyer. The lawyer must, in a particular case, determine what the material questions are and, as to the material questions of fact, must determine what evidence is material to their solution and then must marshal and present it.

He must secure thorough co-operation between himself and the engineers, who will produce most of the testimony as to the cost of reproduction; and the accountants, who will produce most of the testimony as to revenue and financial matters; and the other witnesses. Such co-operation cannot be effected unless the lawyer thoroughly understands the facts covered by the testimony of these witnesses and they thoroughly understand the theory upon which he is presenting it. The best results cannot be obtained without this kind of cooperation.

So far as possible, the spirit of controversy should be eliminated from regulatory proceedings. The common interests of the public and the utilities should be emphasized. The regulatory body and the utility should work together to bring about results which are reasonable and so are just, both to the public and to the utility. Such results are essential to sound regulation and to efficient and economical service; they cannot be readily accomplished unless both the regulatory body and the utilities appreciate this and work in harmonious co-operation.

It goes without saying that all material facts should be presented to the regulatory body frankly and fully. This is necessary as a basis for the mutual confidence which is essential to the best results.

It is hardly possible to overestimate the tremendous importance of this work. The statisticians estimate that between one-seventh and one-eighth of the wealth of the country is at present invested in its utilities. This investment is growing daily. In itself, it is of tremendous importance; but it is relatively unimportant as compared with
the value of these various services to the community. They have be-
come essential parts of the business and social machine. Wise regula-
tion facilitates the economical and efficient operation of the machine;
unwise regulation hinders it, involving enormous losses to the public.

The whole matter is in a formative state. The opportunity of
the lawyer is to do constructive work of highly important character.