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IS UTILITY REGULATION ENCROACHING UPON MANAGEMENT?

FRANCIS X. WELCH*

Among the domestic speculations which inevitably follow in the wake of international tension resulting from the outbreak of war abroad, is the question of the effect of a possible national emergency upon the traditional system of American business enterprise. Obviously, the public utility industries are likely to be the first group to feel the impact of any new assumption of drastic regulatory powers by the central government.

Indeed, recent trends towards a totalitarian government abroad in even so-called democratic countries during periods of stress suggest that the regulatory approach is more likely to be used for the purpose of increasing social control over vital business enterprise than the more forthright frontal attack via the public ownership route. Carried to extremes, bureaucratic control of utility enterprise can give the governmental board virtual powers of management without the responsibility of ownership. It recalls a cynical remark made by a German businessman to this writer in Munich during the spring of 1938. "The management retains title to the properties," he said bitterly, "for purposes of paying the taxes and meeting pay rolls."

This, as suggested, would be an ultra extreme resolution of the regulatory technique, the prototype of which can be found in Europe, but which could hardly be inaugurated in the United States without a reversal of fundamental constitutional principles. In the absence of direct constitutional amendment, this could hardly be validated as a permanent policy. Even under color of "emergency" decrees, it is somewhat difficult to conceive of the complete obliteration of private management in American utility industries. Such an abrupt shift would seem at least to require specific legislation by Congress which would probably insure some device for returning to the *status quo* after the emergency had passed. Such, at any rate, was our federal experience with railroad and telephone control during the last World War.

And yet we have already come quite a way along this route since the original inauguration of utility regulation. The process has been gradual but has gone sufficiently far to warrant a broad re-

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examination of the principles of utility regulation if substantial prerogatives of private management in public utility enterprise are to survive. The problem is even bigger than the fate of privately owned utility industries, since the same process which is imperceptibly absorbing heretofore inviolate managerial powers of these utility industries is already knocking at the door of other vital industrial enterprises. Witness the recent regulatory legislation affecting coal mining, petroleum development, and the marketing of dairy products.

If somebody asked the average attorney engaged in utility law practice whether a federal or a state regulatory commission has any authority to tell a utility what color to paint its buildings, or how to decorate the interior of its properties, he would probably answer "no" without much hesitation. That would be an extreme and therefore a plain example of a government board attempting to interfere with the functions of management.

But it is not the extreme nor the clear-cut case in which the usurpation of management is usually attempted. Rather it is in the border-line case, where the line of demarcation is hard to trace. In this area we witness an unmistakable disposition on the part of regulatory boards to push the boundary of governmental authority further and further into the sphere heretofore occupied by the utility company's owners and directors.

In a recent issue of *Telephony*, a periodical published in the interest of the independent telephone companies, a correspondent referred to the case of *In re Broad River Power Co.*,¹ decided by the South Carolina Public Service Commission in 1933, and stated:

"In that case the commission actually required an electric utility to lower its level of wages (so far as they were chargeable to operating expenses) in order to permit rate reductions."²

The distinction between orders which regulate businesses devoted to public use and orders which result in interference with the internal affairs of such businesses is illustrated by the case cited. The Carolina commission recognized the distinction and it did not directly order the power company to pay lower wages to its employees. This was inferentially recognized as a function of management. However, the commission, acting in pursuance of its delegated power to fix rates, found (in its investigation of the

¹ P. U. R. 1933C 351.

² 116 TELEPHONY (Feb. 4, 1939) No. 13.

company's earnings and expenses) that the company had failed to lower wages during a period when decreases had been effected in other lines of business. Thereupon, the commission lowered the rates to be charged the company's customers for service; and suggested that one of the ways in which the company could recoup its resulting losses in revenue was to lower the wages paid to its employees.

Now this case represents a danger signal. It points to the tendency of the times; namely, that what the people, through their representatives, intended for the public utilities' regulation in the public interest may eventually result in managerial control by governmental agencies.

This tendency has been conceded by noted liberal students of regulatory development. Thus Dr. I. L. Sharfman, in his monumental study on the organization and work of the Interstate Commerce Commission, says frankly that in the railroad field "any clear-cut differential between the sphere of private management and that of public control is largely obliterated."³ He goes on to observe that while the method of private ownership and operation is maintained, the government participates "intimately and extensively in fashioning the character and direction of the railroad's activities."⁴

In a recent volume on rate making, Bauer and Gold declare that while the distinction between regulation and management has never been clearly drawn, "utility companies are constantly striving to make specific efforts of control by commissions appear as interference with management beyond the legal scope of regulation."⁵ Specifically, these authors refer to "property extensions and developments, salaries and wage policies", and other actions concerned with daily operations, as being subjects against which the utilities resist regulatory encroachment.

Dr. Bauer and his collaborator seem to conclude that utilities ought to be treated the same as railroads have already been treated without protest. However, the utilities (using the term in the popular sense as meaning gas, electric, and telephone companies) are not insolvent and are supported by a substantial and articulate group of investors. These investors naturally feel that the management selected by them should be responsible to them.

³ I SHARFMAN, INTERSTATE COMMERCE COMMISSION (1931) 284.

⁴ *Ibid.*

⁵ BAUER & GOLD, VALUATION FOR PURPOSES OF RATE MAKING (1934).

Then, too, there is the obvious consideration that a utility company's management is better qualified by experience and training to operate a business than government administrators. At any rate, unless and until the people of this country indicate their preference for a universal policy of government ownership of utility service, we can expect to witness a continuation of this resistance by management against any inroads upon its function.

This raises the question as to what are the respective functions of regulation and management. As Dr. Bauer has truly stated, "the line of demarcation, if there is one, has never been clearly drawn."⁶ The statutory guides laid down in various federal and state regulatory acts may occasionally point to some distinction but often they are so broad as to be of little use as a conclusive test in a large number of cases.

However, the question has arisen before the courts and regulatory bodies themselves on numerous occasions, and it is in this literature of precedent that we will find, if anywhere, tangible clues to a general working principle for segregating the province of ownership from the province of government control.

It was way back in 1876 in the landmark decision of *Munn v. Illinois*⁷ that the Supreme Court affirmed, as a constitutional principle, the old common-law doctrine that private property, once devoted to public use, is subject to regulation by the state in the protection of the public interest from the possible abuses of otherwise unregulated monopolistic operations.

Does this decision (and the subsequent line of decisions predicated upon it) provide for the elimination of managerial discretion in so-called businesses "devoted to a public use"? In one of the earlier rate cases before the Missouri commission, the Hon. Frederick W. Lehmann, counsel for the Bell Telephone Company, undertook in his brief to explain that point. He took the view that the conferring of regulatory powers upon a state commission was merely enforcing the old common-law rights of the public to the extent to which the public required protection, and that "regulation affects management but does not displace it."

This is, of course, a generality, but if one turns it over in his mind a principle emerges that seems to run like a bright red thread through a number of decisive cases by authoritative tribunals on the broad issue of regulation versus management. This principle

⁶ *Ibid.*

⁷ 94 U. S. 113, 9 S. Ct. 21, 24 L. Ed. 77 (1876).

might be succinctly stated something like this: "Regulation may interfere with the functions of management only to the extent necessary to protect the interest of the public."

To the close student of regulation that statement may seem trite and oversimplified. Yet it challenges the more recent doctrine advanced by some regulatory tribunals to the general effect that a utility company may not, figuratively, move a hand or a foot to better its own corporate position *unless some benefit to the public interest is affirmatively shown*—even in cases where the "public interest" (usually meaning the interest of the utility's customers) is obviously unaffected one way or the other.

As early as 1902 the United States Supreme Court in *C. & P. Telephone Co. v. Manning*,⁸ stated that while a legislature may prescribe regulations for the management of a public business carried on by private enterprise, "The language of such regulations will not be broadened by implication."⁹ The court added that "there is no presumption of an intent to interfere with the management by a private corporation of its property any further than the public interests require."¹⁰ This case involved the construction of a congressional act relating to public expenditures which limited the charge for telephone service in the District of Columbia.

And even in a case where a railroad company had undertaken to change its rates without permission of the Interstate Commerce Commission, the Court held that the commission should first find that the rate was unreasonable before taking action against the railroad.¹¹ Along the same line, Mr. Justice Brewer, in the well-known "upper berth" case, *Chicago, Milwaukee & St. Paul R. R. v. Wisconsin*,¹² said that "the company is entitled to the privilege of managing its business in its own way so long as it does not injuriously affect the health, safety, and convenience of the public." Other ruling cases have applied this general line of reasoning to a number of detailed situations.¹³

⁸ 186 U. S. 238, 22 S. Ct. 881, 46 L. Ed. 1144 (1902).

⁹ *Id.* at 248.

¹⁰ *Ibid.*

¹¹ *Interstate Commerce Comm. v. Chicago & G. W. Ry.*, 209 U. S. 108, 28 S. Ct. 493, 52 L. Ed. 705 (1908).

¹² 238 U. S. 491, 35 S. Ct. 869, 59 L. Ed. 1423 (1915).

¹³ Thus, in *People v. Stevens*, 197 N. Y. 1, 90 N. E. 60 (1909), the Delaware & Hudson Co., acting within its ordinary corporate authority, bought securities of an electric railroad with its own notes. Then, it sought to issue bonds to take up the notes, but the commission refused consent on the ground that the company had made a bad bargain. The court overruled the commission, pointing out that the latter was in effect trying to substitute "the judgment and discretion of the commissioners for that of the directors and stockholders of

The problem of distinguishing between what is regulation and what interference with management can be partially tested by two questions:

(1) What are the powers contained in the statute creating the commission?

(2) Would these powers, if exercised, interfere with the legal right of a public utility to manage its own property and business without interference?

The courts have generally taken the position that legislation which purports to delegate powers of regulation ought to be strictly construed. Thus, in the case of *Public Service Electric Co. v. Board of Public Utility Comm'rs*,¹⁴ the New Jersey court ruled that the regulatory act of that state was not broad enough to confer upon the board the peculiar equitable power to enforce what the lawyers call "specific performance of a contract." Although this decision was reversed for other reasons,¹⁵ Chancellor Walker of the court of errors and appeals sustained the lower court on this point.¹⁶

It is important to keep in mind that since a public utility commission was entirely unknown in the early common law of England, such a special board derives its authority wholly from specific legis-

the corporation." *Id.* at 11. The court inferred that if the purpose and intent of the statute were to give the commission such authority, the law would be of doubtful validity.

In *Grafton, etc. Co. v. State*, 77 N. H. 539, 540, 94 Atl. 193 (1915), the court held that "it is not for the public good that public utilities be unreasonably restrained of liberty of action, or unreasonably denied the rights as corporations which are given to corporations not engaged in the public service." In *Bacon v. Boston & M. R. R.*, 83 Vt. 421, 443, 76 Atl. 128 (1910) the court ruled that the phrase "affected with a public interest" does not mean ". . . that the commission can do whatever a railway company can do, that the Legislature has undertaken to substitute the board of commissioners for the company's board of directors".

The late Chief Justice White of the United States Supreme Court stated the principle most clearly in *Atlantic Coast Line R. R. v. North Carolina*, 206 U. S. 1, 27 S. Ct. 585, 51 L. Ed. 933 (1907) when he said, "As the public power to regulate railways and the private right of ownership of such property coexist and do not the one destroy the other, it has been settled that the right of ownership of railway property like other property rights finds protection in constitutional guarantees, and, therefore, wherever the power of regulation is exerted in such an arbitrary and unreasonable way as to cause it to be in effect not a regulation but an infringement upon the right of ownership, such an exertion of power is void because repugnant to the due process and equal protection clauses of the Fourteenth Amendment." *Id.* at 20.

¹⁴ 87 N. J. L. 128, 93 Atl. 707 (1915).

¹⁵ 88 N. J. L. 603, 96 Atl. 1013 (1916).

¹⁶ A number of other New Jersey decisions have recognized this principle, the outstanding case being that of *West Jersey & S. E. Co. v. Public Utility Comm'rs*, 8 N. J. Misc. 899, 152 Atl. 378 (1930).

lation, whether constitutional or statutory. Therefore, according to one authority,¹⁷ the commission possesses only such powers as are conferred upon it by its enabling legislation. There is even a difference of opinion as to whether incidental powers which might be necessarily or fairly implied can be included or whether the commission ought to be strictly limited to the powers expressly conferred. In any event, it has been said that "neither convenience, expediency, nor necessity can be considered in determining whether the commission has power to perform a particular act; and jurisdiction to perform an act not authorized by statute can not be conferred upon the commission by consent or agreement, nor can the commission assume jurisdiction over an enterprise or appliance simply because it is in quasi-public service, where such jurisdiction is not given it by statute."¹⁸ From the same source, the common-law rule is stated that "nothing will be presumed in favor of the commission's jurisdiction, but it must affirmatively appear."¹⁹ It would follow that any doubt of the commission's power would ordinarily be resolved against its exercise.

The United States Supreme Court in *Southwestern Bell Telephone Co. v. Public Service Comm.*,²⁰ upheld the so-called license contract fee paid by the local Bell company to the American Telephone & Telegraph Company, and observed that "while the State may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies and is not clothed with the general power of management incident to ownership."²¹

¹⁷ (1930) 51 C. J. 36, 37.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ 262 U. S. 276, 43 S. Ct. 544, 67 L. Ed. 981 (1923).

²¹ *Id.* at 289, citing *State Public Utilities Comm. v. Springfield Gas & Elec. Co.*, 291 Ill. 209, 234, 125 N. E. 891 (1920). In two later decisions, the same court held that because of the relationship between the parent company and its subsidiaries there must be evidence to support the charges made under the licensed contract. See *Smith v. Illinois Bell Telephone Co.*, 282 U. S. 133, 51 S. Ct. 65, 75 L. Ed. 255, P. U. R. 1931A 1 (1930), where the court said: "In view of the findings, both of the state commissions and of the court, we see no reason to doubt that valuable services were rendered by the American Company, but there should be specific findings by the statutory court with regard to the cost of these services to the American Company and the reasonable amount which should be allocated in this respect to the operating expenses of the intrastate business of the Illinois Company in the years covered by the decree." *Id.* at 157. In *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 54 S. Ct. 658, 78 L. Ed. 1182, 3 P. U. R. (n. s.) 337 (1934), the court said: "Considering the fact that ninety-nine per cent. of the stock of appellee is owned by the American Telephone & Telegraph Company, which also owns substantially the same proportion of the stock of the Western Electric Company, we

On the specific subject of regulating salaries and pensions of utility employees, which came before the United States district court in *Consolidated Gas Co. of N. Y. v. Newton*,²² United States District Judge Hand ruled that items of expense incurred by a gas company in furnishing transportation for officers, payment of sick benefits, and employee pensions were *prima facie* a legitimate part of the cost of production and therefore within the discretion of the company officials. Likewise, the Maryland court in *Havre de Grace & Perryville Bridge Co. v. Towers*,²³ ruled that allowances for salaries are to be determined by utility management except where there appears a flagrant abuse of discretion.

A great many state commissions have been gradually encroaching upon managerial functions through the particular avenue of approach known as "proper charge to operating expenses". This can have the indirect effect of interfering with the companies' control of such managerial functions as payment of salaries.²⁴ Another avenue of approach towards the same objective lies in the extravagant interpretation of the phrase, "in the public interest", or similar language frequently used in regulatory statutes after the enumeration of various powers of the commission.

An interesting example of this approach, which, incidentally, illustrates the current attitude taken by zealous regulationists, is to be found in *Electric Public Utilities v. West*.²⁵ This case involved an attempt by a Delaware holding company to buy up controlling stock of four Maryland electric utilities. The public service commission refused to grant permission because it could not see "wherein the public will be benefited in the slightest degree". The Maryland court of appeals reversed the commission and held that it is not within the province of the commission to insist that the public should be *benefited* as a condition to a change of ownership in such circumstances, but that the commission's duty is to see that no change shall be made that would work to the public *detriment*.

directed that there should be further examination of the purchases made by appellee from the Western Electric Company and of the payments made by appellee to the American Company. . . . The District Court made specific findings as to the character of the services rendered by the American Company under its license contracts with appellee and the amounts of the cost of these services which should be allocated to the operating expenses of the latter's intrastate business." *Id.* at 156, 157.

²² 267 Fed. 231 (D. C. N. Y. 1920).

²³ 132 Md. 16, 103 Atl. 319 (1918).

²⁴ *Breen v. Northern N. Y. Utilities*, P. U. R. 1921B 463, 475 (1920); *Re Crystal City Gas Co.*, P. U. R. 1923B 823, 834 (1923).

²⁵ 154 Md. 445, 140 Atl. 840, P. U. R. 1928C 3 (1928).

The court added, “. . . the test in any given case is: Does the order bear any substantial relation to any public interest that the commission is authorized or required to protect?”²⁶

However, as late as December 14, 1937, the Federal Power Commission in *Re Inland Power & Light Co.*,²⁷ denied an application for a transfer of electric utility facilities under the provisions of the Federal Power Act, because the applicant had not sustained its burden of showing that the proposal was consistent with the public interest. The Federal Power Commission thereafter stated its opinion that “it is not sufficient for an applicant . . . merely to show that no serious harm may be apprehended as a result of the proposed merger or that such merger is a matter of indifference in so far as the public interest may be affected.”²⁸

One of the mischievous angles of this doctrine of refusing the utility the right to exercise managerial powers (unless some affirmative benefit to the outside public could be proven) was the fact that until the United States Supreme Court decision in *Rochester Telephone Corp. v. United States*²⁹ administered a knockout blow to the so-called “negative order” doctrine, it was often impossible to get any relief in the courts by way of appellate review.

It is somewhat reassuring to note, however, that since the *Rochester Telephone Corp.* decision, the Federal Power Commission by a four-to-one vote in *Re Ottetail Power Co.*³⁰ authorized the utility company to split its nonpar common stock, notwithstanding a dissenting opinion by Commissioner Scott, to the effect that no affirmative proof had been furnished to show that the proposal would result in benefit to the public.

Recently the supreme court of Pennsylvania wrote an enlightening opinion in a case which overruled the public utility commission of that state in its refusal to approve a merger of two public utilities.³¹ The court pointed out that the proposed merger concerned the financial affairs of the corporation with which the directors had the sole right to deal in the absence of an act contrary to the public interest. The state commission had conceded that the merger would benefit the two corporations, reducing their expenses

²⁶ *Id.* at 453.

²⁷ 23 P. U. R. (N. S.) 425 (1938).

²⁸ *Id.* at 429.

²⁹ 307 U. S. 125, 59 S. Ct. 754, 83 L. Ed. 718, 28 P. U. R. (N. S.) 78 (1930).

³⁰ 29 P. U. R. (N. S.) 129 (1939).

³¹ *Northern Pennsylvania Power Co. v. Pennsylvania Pub. Utility Comm.*, 333 Pa. 265, 5 A. (2d) 133, 27 P. U. R. (N. S.) 233 (1939).

to the advantage of their stockholders. The court's opinion by Judge Schaffer stated on this point:

“... The commission apparently seems to think that stockholders are no concern of its, but they are of concern, because, if their company is financially strengthened, its public service can be better rendered. It would seem that the merger is denied largely on the ground that it will not result in the *immediate* reduction of rates and, therefore, is not in the public interest. This is not a proper ground for the commission's refusal. If it were, no long term plan looking to ultimate reduction of rates could be set in motion. The approach of the commission to the approval or disapproval of the merger is erroneous in principle, because the question of merger is one of internal management, unless evidence heard by the commission discloses that the merger would adversely affect the public. The only question before the commission is whether it does so adversely affect, and where the testimony establishes, as it does here, that the merger would not adversely affect the public interest, the power of the commission over the merger vanishes.”³²

The court concluded that the commission had denied the merger “on a merely arbitrary ground that it preferred to have the companies not merge.”³³ The court observed that the commission's “attitude conveys the impression that it was really acting in the capacity of a board of directors.”³⁴

Still more recently (July 11, 1939), we have further evidence that the courts still recognize some prerogatives of management in the decision of the supreme court of Wisconsin, overruling a telephone rate reduction order of the public service commission of that state against the Wisconsin Telephone Company.³⁵ In the course of his extensive opinion, Chief Justice Rosenberry came upon the question of the excess capacity of the company's plant for the purpose of valuation. The commission's engineering witness, basing his estimate of the usefulness of the company's property during a depression period (1932-33) which marked the lowest point of usage by the public, found the company's plant overbuilt by eight per cent. The commission made a corresponding exclusion in the utility's rate base. The company took the view that the usefulness of its property investment should be considered as of the time when the investment was made. The court stated:

³² *Id.* at 269.

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ Wisconsin Telephone Co. v. Pub. Serv. Comm., 237 N. W. 122, 30 P. U. R. (N. S.) 65 (Wis. 1939).

“ . . . In making its determination in this case the Commission substituted the discretion of the witness for that of the managers of the property without in any way impeaching the discretion of the managers. It is much easier to point out past errors in management than it is to avoid future mistakes. A reasonable rate is one based on reason as applied to the property of the utility. While the Company must bear the burden of an unreasonable extension of its plant and the risk that portions of it prudently acquired may become obsolete or not useful, it should not be penalized for failure exactly to anticipate future demands for service in a period of depression. After careful consideration we are of the view that the amount of excess plant does not at the most exceed 2%.”³⁶

With the courts and regulatory bodies in a somewhat confused state of mind, as has been indicated, what attitude can the public utilities take to prevent too great an encroachment upon functions which they think properly belong to management and which they consider necessary to preserve, if for no other reason than to safeguard the investment? One step might be to impress upon the commission the fact that the rule of strict construction of statutes should be applied. For this purpose, utilities can rely upon cases decided by courts and commissions, some of which have been discussed above. Failing in that, their only recourse seems to be in the courts. One of the best arguments that has come to the attention of this writer is contained in Judge Lehmann's brief, as utility counsel, in the *St. Louis Rate Case*, where the judge said in part:

“And management by the company is more than a right. It is a duty and a duty that cannot be declined. Problems of policy, of greater or lesser importance arise every day and the posts of duty must be constantly occupied by vigilant officials and agents who will deal with these problems as they present themselves. It might be very convenient for this company to absolve itself from responsibility by an appeal to the commission for their determination. Is there a new demand for service which will require an extension of the lines into a new field and the construction of a new exchange? And where shall the exchange be located? An engineering difficulty presents itself. How shall that be surmounted? New methods and new mechanism are suggested. Shall they be adopted? *When may the company try an experiment and when shall it hold fast to that which past experience has approved?* A faithful and efficient officer has passed away. Who shall be appointed to take his place? Refer these and other questions daily arising

³⁶ *Id.* at 158.

to the commission and the commission must and will refer them back at once, for dealing with all the public utilities in the state, numerous as they are and varied as their functions are, and the special knowledge, skill, training, and experience required for each of them, no one body of men could be so superhumanly endowed as to be able to deal with them all.'³⁷

In other words, what a utility does, acting in good faith or within the scope of the powers conferred upon it by law, is entitled to some presumption that it has been properly done. And this should be so, Judge Lehmann tells us, even though in the light of subsequent events the steps then taken, according to the best judgment of the utility's officers and directors, might have been done to a better advantage. And any investment or expense incident to such a reasonable exercise of ordinary discretion might well be held a legitimate investment or expense of the business. Any other or different rule has the effect of penalizing human judgment exercised in good faith because it is not infallible. It results in the substitution of regulatory hindsight for managerial foresight. In the long run, it would inevitably result in the demoralization of the managerial initiative which has brought American public service to the highest point of development in the world today.

³⁷ Brief, *Southwestern Bell Telephone Co. v. Pub. Serv. Comm.*, 262 U. S. 276, 43 S. Ct. 544, 67 L. Ed. 981 (1923).