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RECENT DEVELOPMENTS IN REGARD TO RATE REGULATION

BY THOMAS PORTER HARDMAN**

That the law of today is what the courts would decide today, not merely what the precedents say1, is strikingly illustrated by a series of recent Supreme Court decisions dealing with the basic value or the basic investment upon which a public utility is constitutionally entitled to earn a return, and in particular with the inclusion or exclusion of going-concern value or going-concern investment2. Accordingly the purpose of my paper is to discuss this aspect of the progress of the law of public utilities since this conference last convened3.

Others in this conference and elsewhere have recently discussed the so-called present-value doctrine in rate regulation and have shown, among other things, that basing rates on present value involves "the vicious circle" in that the value of a public utility, strictly speaking, depends upon the rate of return and the rate of return is the very thing that is in issue4. Hence, while I quite agree with this criticism and with the recent concurring opinion

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1 Of Mr. Justice Holmes, "The Path of the Law," 10 HARV. L. REV. 457, 461 (1897): "The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law."
3 For a discussion of the earlier law on this question, under the then "orthodox" present-value doctrine, see Hardman, "Going Value as Value for Purposes of Rate Regulation," 25 W. VA. L. QUAR. 30 (1918). In the present paper a new rate base, with its incidents, is advocated.
of Mr. Justice Brandeis and Mr. Justice Holmes\(^5\) that the present-value doctrine is "legally and economically unsound" and that the prudent-investment doctrine is preferable, I shall not now touch upon that question except incidentally.

As every one knows, the majority of the United States Supreme Court, the final arbiter of the whole question, still purports to hold that in cases of rate regulation a public utility is constitutionally entitled to earn a return upon the so-called present value of its property\(^6\). But in one recent case where this so-called present value, if calculated as of the time of the valuation, would have been abnormally high, and there was, or probably would be, a trend toward a lower level, the majority of the Supreme Court sanctioned a so-called present value based, primarily at least, on prices or values prevailing at a time prior to the valuation, thus eliminating at least a part of the unearned increment and arriving at a rate base perhaps somewhat approximating the prudent investment'. And apparently, if the so-called present value calculated as of the time of the valuation would be abnormally low, at any rate if there was a trend, or probable trend, of prices toward a higher level, the Supreme Court would uphold a value higher than the value at the time of the valuation, thus prima facie sanctioning a prospective unearned increment, but sanctioning it perhaps in order to arrive at a value approximating the prudent investment; for, according to Mr. Justice Brandeis and Mr. Justice Holmes\(^8\),

"What is now termed the prudent investment is, in essence, the same thing as that which the court has always sought to protect in using the term present value."\(^9\)

Moreover, the Supreme Court recently insists that so-called present value must be based partly on the estimated future value of the property, calculated with reference to the probable level

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\(^5\) In State of Mo. ex re Southwestern Bell Telephone Co. v. Public Service Commission of Mo., supra note 2. The minority opinion is by Mr. Justice Brandeis, with whom Mr. Justice Holmes concurs. This opinion dissents from the reasoning but concurs in the conclusions, of the majority. The majority opinion says that the rate regulation in question is confiscatory for the reason that it prevents the utility from earning a fair return on the present value of its property. Mr. Justice Brandeis says: "I concur in the judgment of reversal. But I do so on the ground that the order of the state commission prevents the utility from earning a fair return on the amount prudently invested in it . . . . The so-called rule of Smyth v. Ames is, in my opinion, legally and economically unsound."

\(^6\) Smyth v. Ames, 169 U. S. 466 (1898); and cases cited supra note 2.

\(^7\) Georgia Power Co. v. Railroad Commission of Georgia, supra note 2. See particularly the dissenting opinion of Mr. Justice McKenna.

\(^8\) State of Mo. ex re Southwestern Bell Telephone Co. v. Public Service Commission of Mo., supra note 2, at pp. 308-309.

\(^9\) "Compare Mr. Justice Field in Railroad Commission Cases, 116 U. S. 307, 343, 344; Mr. Justice Harlan, ibid. p. 341; Dow v. Feldelman, 125 U. S. 680, 690, 691; and Reagan v. Farmer's Loan and Trust Co., 154 U. S. 262, 409, 412: where the necessity of limiting the broad power of regulation enunciated in Munn v. Illinois, 94 U. S. 113, was first given expression. See also, "Public Utilities, Their Cost New and Depreciation," by H. V. Hayes, pp. 255, 256."
of future prices\textsuperscript{10}, so that under the doctrine of the majority of the Supreme Court, value for purposes of rate regulation is now not merely a \textit{present} value, whatever the word value may mean in this connection, but a composite present and future value—a value, however, which, according to Mr. Justice Brandeis and Mr. Justice Holmes, the Supreme Court seeks to calculate so as to make it protect the prudent investment. Such future value, however, was sanctioned in cases in which prices or values were abnormally high and there was, or probably would be, a trend toward a lower level. One wonders what the majority of the court would say in regard to cases in which it appeared that the so-called present value calculated as of the time of the valuation was the same as the prudent investment but in which prices, then normal, were trending either toward a higher or toward a lower level. Would the Court then adhere to its recent ruling that:

"An honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances, is essential?"\textsuperscript{11}

If so, present value so calculated would protect less than the prudent investment when the trend was toward a lower level, and would protect more than the prudent investment when the trend was toward a higher level.

However, until Mr. Justice Brandeis and Mr. Justice Holmes can induce the majority of the Court to cease to base rates on so-called value, it is perhaps less objectionable to base rates partly on the probable future value of the property than on a value calculated as of the time of the valuation; for, at any rate under present conditions, not only does it permit the courts and commissions by a fiction to fix a so-called present value approximating the prudent investment, but, since the rate is to operate \textit{in futuro}, the rate base should, so far as practicable, be a base that would exist, with as little change as possible, during the period in which the rate is to operate. Values at the time of the valuation may be abnormal and with a trend, or probable trend, toward a higher or lower level. Therefore value based partly on the probable future value of the plant under the predicted new level of prices might more closely approximate the average value of the property during the period when the rate now fixed will operate. This, whether such average value did or did not approximate the prudent investment, would

\textsuperscript{10} State of Mo. \textit{ex rel.} Southwestern Bell Telephone Co. \textit{v.} Public Service Commission of Mo., \textit{supra} note 2; Bluefield Water Works & Improvement Co. \textit{v.} Public Service Commission of W. Va., \textit{supra} note 2.

\textsuperscript{11} The quotation is from the cases cited \textit{supra} note 10.
reduce the frequency of the need for a new rate investigation;\textsuperscript{12} and, if it approximated the prudent investment, so much the better. Hench, to the extent that the value accepted as the rate base is the predicted value under future conditions, and to the extent that the prediction as to values is fulfilled, there might be an increased amount of stability, a very desirable quality, in the public utility world. But who can predict, with a reasonable degree of certainty, future prices or future values?\textsuperscript{13} Stability cannot be established by unstable standards.

But whether the rate base adopted in a given case is the investment prudently made and properly managed,\textsuperscript{14} or so-called present value, calculated solely on the basis of prices prevailing at or before the time of the valuation, as was commonly done until recently,\textsuperscript{15} or calculated partly on the basis of a predicted new level

\textsuperscript{12} The frequency of the need for a new rate investigation under the present-value doctrine is one of the serious objections to that doctrine. If value is accepted as the rate base every fluctuation in value involves the ascertainment of a new rate base. The present-value doctrine, in its common form, is therefore impractical. And, as "law is a practical matter," Found "Jurisprudence Science and Law," 31 Harv. L. Rev. 1047, 1058 (1918), the doctrine, if applied at all, should be applied in a practical way.

\textsuperscript{13} Cf. Mr. Justice Brandeis in State of Mo. ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Mo., supra note 2 at pp. 308, 304: "Engineers testifying in recent rate cases have assumed that there will be a new plateau of prices. In Galveston Electric Co. v. Galveston, 258 U. S. 388, the company contended that a plateau 70 per cent. above the price level of 1914 should be accepted, and a plateau 25\% above was found probable by the master and assumed to be such by the lower court. In Bluefield Water Works & Improvement Co. v. Public Service Commission, 500, post, one 50 per cent. above the 1914 level was contended for; in the case at bar a plateau 25 per cent. above. But for the assumption that there will be a plateau there is no basis in American experience. The course of prices for the last 112 years indicates, on the contrary, that there may be a practically continuous decline for nearly a generation; that the present price level may fall to that of 1914 within a decade; and that, later, it may fall much lower. Prices rose steadily (with but slight and short recessions for the 20 years before the United States entered the World War. From the low level of 1897 they rose 21 per cent. to 1900; then rose further (with minor fluctuations, representing times of good business or bad) and reached in 1914 a point 50 per cent. above the 1897 level. Then the great rise incident to the war set in. "Wholesale Prices, 1850 to 1921," U. S. Department of Labor, Bureau of Labor Statistics, Bulletin No. 320, pp. 9-26. These are averages of the wholesale prices of all commodities. In the Bureau chart the 1913 prices are taken as the datum line (100). As compared with them the 1897 level was 67, the 1900 level 81. The chart of page 18 of the pamphlet entitled, "Price Changes and Business Prospects" published by the Cleveland Trust Company, gives price fluctuations for the 110 years prior to 1921. It shows three abrupt rises in the price level, by reason of war; and some less abrupt falls, by reason of financial panic. These may be called abnormal. But the normal has never been a plateau. The chart shows that the peak price levels were practically the same during the War of 1812, the Civil War and the World War; and it shows that practically continuous declines, for about 30 years, followed the first two wars. The experience after the third may be similar."\textsuperscript{16}

\textsuperscript{14} The term prudent investment, as Mr. Justice Brandeis expressed it in the last cited case, "is not used in a critical sense. There should not be excluded from the finding of the base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest, or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown."

\textsuperscript{15} See Richberg, op. cit., supra note 4.

\textsuperscript{16} See, e.g., Willcox v Consolidated Gas Co., 212 U. S. 19, 52 (1909): "The value of the property is to be determined as of the time when the inquiry is made regarding the rates."
of prices, as in some recent cases, is there any justification for the Supreme Court's recent ruling that:

"Whether going concern value should be considered and allowed at all in determining the rate base for rate making, and if allowed what the amount of it should be, depends upon the financial history of the company?"\(^{17}\)

The importance of the problem is illustrated in a late decision of a state public service commission, in which it is said:

"Commissions and courts differ widely in their conclusions [as to going value]. In some quarters going value is seldom or never allowed; in others it is calculated upon deficiency in earnings or preliminary costs of financing and securing rights. In \textit{Galveston Electric Company v. Galveston}\(^{18}\), the United States Supreme Court held that the determination of this factor depends upon the history of the company. From a careful consideration of the point the commission believes this item should be represented in the sum of $55,000.00, [which was about 2\(\frac{1}{2}\)% of the total value allowed]."\(^{19}\)

And in a late Federal case the Court said:\(^{20}\)

"In \textit{Galveston Electric Company v. Galveston} it appears to be settled that the going-concern value cannot be considered in ascertaining just rates."\(^{21}\)

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"The Public Utility Reports for 1920, 1921, 1922 and 1923 (to March 1) contain 363 cases in which the rate-base or value was passed upon. Reproduction cost at unit prices prevailing at the date of valuation appears to have been the predominant element in fixing the rate base in only 5. In 63 the commission severely criticised, or expressly repudiated, this measure of value. In nearly all of the 363 cases, except 5, the commission either refused to pay heed to this factor as the measure of value, or indeed as evidence of any great weight. The following summary shows the predominant element in fixing the rate base in the several cases:

In 5 cases: Reproduction cost at unit prices prevailing at the date of the valuation.

In 28 cases: Reproduction cost at unit prices prevailing at some date, or the averages of some period, prior to the date of the valuation.

In 12 cases: Reproduction cost at unit prices prevailing at some date not specifically stated.

In 22 cases: Reproduction cost of an inventory of a prior date at prices prevailing at that date or prior thereto, plus subsequent additions at actual cost (so-called split inventory method).

In 3 cases: Reproduction cost on basis of future predicted prices (so-called trend prices, or new plateaux method).

In 102 cases: A prior valuation by the commission plus the actual cost of subsequent additions.

In 35 cases: The actual original cost (including both initial cost and additions).

In 6 cases: Original cost arbitrarily appreciated.

In 27 cases: The historical cost or prudent investment.

In 25 cases: Book cost or investment.

In 12 cases: Bond and stock capitalization.

In 36 cases: Determination and classification of method impossible."

\(^{17}\) See supra note 10.


\(^{19}\) See supra note 2.


\(^{21}\) This statement, however, is unwarranted as is shown by the fact that in the subsequent case \textit{Jacksonville, Fla. & Power Co. v. Railroad Commission of Georgia}, supra note 2, the United States Supreme Court allowed an item of $41,629 as "going-concern" value.
The court, therefore, totally excluded the estimated going value, viz., $269,000, which the commission had allowed.

Of course, whether going-concern value, or going value, either in whole or in part, constitutes value for purposes of rate regulation depends, in the first place, on what is taken as constituting going value, and, in the second place, on what doctrine is adopted as to the rate base, i.e., for present purposes depends on whether the rate base adopted in the given case is so-called present value or, what we may call for immediate purpose, though rather inaccurately, prudent-investment value, that is, the amount prudently invested and properly managed. First, then, what is going value? In the leading case on the question the Supreme Court defined "going value" as "the value which inheres in a plant where its business is established as distinguished from one which has yet to establish its business,"

And this conception of going value the Supreme Court has never repudiated. Moreover, in that case the Supreme Court held unqualifiedly, and so held until recently, that "going value" . . . [thus defined, i.e., going value not including good-will value] "is a property right and should be considered in determining the value of the property, upon which the owner has a right to make a fair return." Is there, then, any sound reason for the Supreme Court's recent departure from precedent on this point? In Galveston Electric Company v. Galveston, the only case in which the Supreme Court cited in its recent decision to support its proposition that whether going value is to be considered at all in rate cases "depends upon the financial history of the company," the Supreme Court, in a case in which present value was permitted to be calculated primarily on the basis of the cost of reproducing the plant, held, in effect, that "the cost of developing an operating utility into a financially successful concern" is not to be considered in calculating value for rate-making purposes, namely, in calculating going value. In that case, which was decided only last year, the utility, apparently because of insufficient patronage and an underdeveloped operating system, not because of insufficient rates, had for a considerable time been unable to realize a reasonable return on the value of its property. Now, it seems indisputable that, if

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23 Id. Of course, good-will value, while logically a part of going-concern value as above defined, is not value for purposes of rate regulation. See Hardman, op. cit., supra note 3.
26 Supra note 2.
value is taken either in its strict or economic sense, or in the sense of prudent investment, then, in that type of case, *viz.*, where there has been an unremunerative development period, due to insufficient patronage and an unedveloped operating system, "the value which inheres in a plant where its business is established as distinguished from one which has yet to establish its business" is a very important part of the value of such a plant.

To illustrate, suppose that, exclusive of going value, the so-called present value of a plant properly constructed and sufficiently needed, is $1,000,000, and that the amount prudently invested in the plant, exclusive of the cost of establishing the business, is also $1,000,000. Suppose further that for the first five years of operation the utility paid only proper operating expenses, although it charged rates that yielded a maximum return, and for the sixth year the utility, after deducting proper operating expenses for that year, earned a reasonable return upon its value or investment, exclusive of that value or investment which represents the cost of establishing the business. What is the going value of the plant in the sense in which the Supreme Court uses going value? For five years $1,000,000 invested in a public utility has been unremunerative. Yet this $1,000,000 invested in other businesses would normally have earned, say, 6% *per annum*, or a total, for the five years, of $300,000; or, if this money were borrowed the interest on the money for that period at 6% would be $300,000. Hence this one item of "the cost of developing the operating system into a financially successful concern" has been about $300,000. And many other things costing money or money's worth, such as physical and mental effort in securing customers and developing an efficient operating system, have been expended in building up this going-concern part of the plant7). Yet, in just that sort of case and a case in which the Supreme Court approved a so-called present value based primarily on the cost of reproduction, the Supreme Court,

7) Cf. Miller, J., in the leading case of People v. Willcox, 210 N. Y. 479, 486, 104 N. E. 931 (1914): "What then, is 'going value' and how is it to be appraised?

"It takes time to put a new enterprise of any magnitude on its feet, after the construction work has been finished. Mistakes of construction have to be corrected. Substitutions have to be made. Economies have to be studied. Experiments have to be made, which sometimes turn out to be useless. An organization has to be perfected. Business has to be solicited and advertised for. In the case of a gas company, gratuitous work has to be done, such as selling appliances at less than a fair profit, and demonstrating new devices to induce consumption of gas and to educate the public up to the maximum point of consumption. None of these things is reflected in the value of the physical property, unless, of course, exchange value be taken, which is not admissible in a rate case. The company starts out with the 'bare bones' of the plant, to borrow Mr. Justice Lurton's phrase in Omaha Waterworks case, supra. By the expenditure of time, labor and money it coordinates those bones into an efficient working organism and acquires a paying business. The proper and reasonable cost of doing that, whether included in operating expenses or not, is as much a part of the investment of the company as the cost of the physical property."
in effect, refused to allow any going value calculated on the cost of reproducing this going-concern element of the total value of the plant.

The view of the Supreme Court on this point will be clarified by considering briefly what the master in chancery and what the lower court held. The master allowed the sum of $520,000 as going value, and, as the master adopted what we may, for present purposes, call the reproduction-cost method of calculating present value, i.e., a method based primarily on the cost of reproduction, this going value was calculated on the basis of “the cost of developing the operating system into a financially successful concern,” though the evidence of this cost, which was relied upon, was apparently the accrued losses during the unremunerative development period. The lower court, in refusing to allow such going value, said:28

“The allowance of any element for development cost cannot, in a judicial proceeding, be reasonably sustained, for the reason that such a utility is entitled to a reasonable rate of return upon its plant from the day it goes into operation, and the court does not take into consideration at all that there may be lean years before the fat ones.”

The United States Supreme Court, in affirming this holding, said:

“Going concern value and development cost, in the sense in which the master used these terms, are not to be included in the base value for the purpose of determining whether the rate is confiscatory.” “... The fact that a sometime losing business becomes profitable eventually through growth of the community, or more efficient management, tends to prove merely that the venture was not wholly misconceived.”

With deference, it is submitted that the reasoning of both courts is erroneous. In the first place, it seems unsound to say, as the Supreme Court said, that “the fact that a sometime losing business becomes profitable eventually through growth of the community, or more efficient management, tends to prove merely that the venture was not wholly misconceived.” It, of course, tends to prove that; but, if we take value in the strict or economic sense in this connection, then it also tends to prove that the value of the plant with such a successful business established is greater than the value of the very same physical plant before it thus established its business. The whole difficulty, of course, arises out of the failure to adopt some definite conception of the meaning of value for purposes of rate regulation or, more accurately, to adopt some

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definite rate base. Does the Supreme Court by saying that ‘‘the fact that a sometime losing business becomes profitable eventually through growth of the community’’ tends to prove merely that the venture was not wholly misconceived’’ mean to intimate that value represented by unearned increment arising ‘‘through growth of the community’’ is not to be considered value for rate-making purposes? If so, the Supreme Court’s so-called present-value doctrine is not what it used to be. And in this connection, it is interesting to remember that the opinion of the Court in that case—the Galveston case—is by Mr. Justice Brandeis, and that in a somewhat later case Mr. Justice Brandeis, in a concurring opinion, not only vigorously condemns the present-value doctrine as ‘‘legally and economically unsound’’ and strenuously advocates the substitution of the prudent-investment doctrine, but he says that ‘‘what is now termed the prudent investment is, in essence, the same thing as that which the Court has always sought to protect in using the term present value.’’ Of course, if so-called present value means prudent investment, then the increment in value arising ‘‘through growth of the community’’ is not value for rate-making purposes, for the prudent-investment doctrine ex vi termini eliminates the unearned-increment element of value. Indeed, in this connection, it has recently been asserted that ‘‘the item of going-concern value does not arise under the prudent investment theory.’’ But even if the prudent-investment theory is adopted, or, if as Mr. Justice Brandeis says, what the Supreme Court seeks to protect by its present-value doctrine is, in essence, the prudent investment, is it justifiable to eliminate from the rate base that element of effort which produces a more efficient management, or which represents ‘‘the cost of developing the operating system into a financially successful concern’’? Clearly such outlay is an investment costing money or money’s worth, and if prudently made and properly managed should be allowed just as much as an investment in the physical plant. This

29 Galveston Electric Co. v. City of Galveston, supra note 2, at pp. 396, 397, 398. Italics ours.

30 It is not intended to intimate that the United States Supreme Court does not now sanction unearned increment, for in one of its latest decisions, Georgia Ry. & Power Co. v. Railroad Commission of Georgia, supra note 2, at pp. 630, 631, the court said: ‘‘that part of the rule which declares the utility entitled to the benefit of increases in the value of property was, however, specifically applied in the allowance of $125,000 made by the commission to represent the appreciation in the value of the land owned . . . . In Wilcox v. Consolidated Gas Co., 212 U. S. 19, 52, it had been made clear that the value of the property is to be determined as of the time when the inquiry is made concerning 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!’’


32 Note, 32 Yale L. J. 507 (1923).
seems indisputable unless such cost is permitted to be charged to operating expense, and even then the result, as we shall subsequently see, is probably the same. But such cost should not be charged to operating expense, for the reason that it is not an expense incident to ordinary operation, but, like the investment in the physical plant, is an expense which has built up a durable instrument of production and which year after year without further outlay earns, and will continue to earn, its share of the total returns. Hence, this investment, being like the investment in the physical plant, a durable instrument of production, is capital investment and should, just as much as the investment in the physical plant, be allowed during its existence to earn its reasonable return.

Of course, the Supreme Court, in thus departing form precedent, says, by way of dictum, that while such going value is not a part of the rate base, "the fact that a utility may reach financial success only in time . . . is a reason for allowing a liberal return on the money invested in the enterprise." But "the cost of developing the operating system into a financially successful concern" is "money invested in the enterprise." Besides, is that a reasonably certain way to secure to the utility a reasonable return on "the money invested in the enterprise," including the cost of establishing its business? What is a liberal return? Is the liberal return to be allowed with reference to all future rates or only until the cost of establishing the business is amortized from the so-called liberal returns? The Supreme Court does not answer. Nor does it appear that the Court allowed a higher rate of return because of this cost. Such an indefinite method of attempting to compensate for such necessary cost is too uncertain to secure adequately the investors' individual interests of substance and the important social interest in the general security, including stability in the public utility field—interests which, in this respect, clearly outweigh any other conflicting interests. Therefore, since the end of law today is to secure a maximum of interests with a minimum sacrifice of interests, if we balance the interests with a view to the socialization of the law, those interests should be secured and the other interests sacrificed. Besides, this method is, at any rate on the face of it, the result of a failure to appreciate the true nature of this going-

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Galveston Electric Co. v. Galveston, supra note 2, at p. 395.


concern element; for, if the rate base is, as the majority of the
Supreme Court says it is, the present value of the plant, this
element of going value is clearly capital value, being like the value
of the physical part of the plant, a durable instrument of pro-
duction which year after year without further outlay continues
to bring in its share of the returns. Moreover, this going-concern
element or value is a continuous and durable instrument of pro-
duction, which, as we have seen in discussing the prudent-invest-
ment theory, has cost the investors money or money's equivalent.
Why, then, under the present-value theory, is not this going value
to the extent that it is based upon prudent investment, a part of
the value upon which the utility should be allowed to earn a fair
return?

It may be contended that the Supreme Court in the Galveston
Case merely meant that accrued losses, arising through failure to
charge proper rates or through imprudent management, cannot
be capitalized as a part of the rate base; for it seems that the
evidence offered to prove "the cost of developing the operating
system into a financially successful concern" was the accrued losses
during the unremunerative development period. It is quite true
that such accrued losses are not the measure of this part of the rate
base, viz, for present purposes, going value under the present
value doctrine, or prudent investment under the prudent-invest-
ment doctrine, for such losses might arise from failure to charge
proper rates, or from improper management. Therefore, it is
incorrect to calculate going going-concern value or going-concern
investment, by merely capitalizing past losses. But it seems that
the losses in this case were not losses arising from improper man-
agement or improper rates, and there is no allegation or proof that
they were. And in a later case Mr. Justice Brandeis makes it
quite clear what he meant in this case, i.e., the Galveston Case,
for in the subsequent case he says:36

"In Galveston Electric Company v. Galveston, the cost of
developing the business as a financially successful concern was
excluded from the rate base."

And in a still later case he says impliedly that the losses in the
Galveston Case were not "due to insufficiency of previous rates."37
Therefore, if the public or social need justified the establishment of
the utility, as it apparently did, it being a street car case, and if the
accrued losses were, as they apparently were, the ordinary losses

36 State of Mo. ex rel. Southwestern Bell Tel. Co. v. Public Service Commission of
Mo., supra note 2, at p. 311.
37 "Georgia Ry. & Power Co. v. Railroad Commission of Georgia, supra note 2, at
p. 632.
due to lack of patronage and to the fact that the operating system was not yet fully developed, then such losses, while not the measure of going-concern value or going-concern investment, are certain good evidence of that value or investment, and, therefore, where there is such evidence it does not seem justifiable to disregard this element entirely, as the Supreme Court practically did in the Galveston Case. Said the Court:38

"The fact that a utility may reach financial success only in time . . . does not make past losses an element to be considered in deciding what the base value is and whether the rate is confiscatory."

Nor is it justifiable to say, as the lower court said, and as the Supreme Court apparently implied, that the development cost of this going-concern element cannot be considered "for the reason that such a utility is entitled to earn a reasonable rate of return upon its plant from the day it goes into operation." If a utility were "entitled to earn a reasonable rate of return upon its plant from the day it goes into operation," the street car company in the case before the court might, in its pioneer stage when passengers were few, have been obliged to charge a $5.00 fare instead of a five cent fare. And then, too, an increased rate might well have produced a decreased return. It may have been impossible "to earn a reasonable rate of return." But it is quite clear upon principle that such a high fare could not be charged for the reason that the interests of not only the utility but of the patrons and of society, must be considered in determining the reasonableness of rates; and, since the end of law is to secure a maximum of interest with a minimum sacrifice of other interests, upon a balancing of the conflicting interests it seems clear that the interests of the patrons and of society that rates shall not be unreasonably high may so outweigh the conflicting interests of the utility that during the development period or periods, the utility should be legally required to forego reasonable profits to the extent that the securing of a maximum of interests with a minimum sacrifice of other interests demands. Otherwise the end of law is not subserved. And most of the authorities, such as they are, apparently support this conclusion.

Hence, the law does not necessarily permit a public

38 Galveston Electric Co. v. Galveston, supra note 2, at p. 395. Italics ours.
40 Sec. e. g., Chicago etc. Ry. Co. v. Minnesota, 134 U. S. 413, 458, particularly the concurring opinion of Mr. Justice Miller at p. 459 (1890); Covington etc. Road Co. v. Sanford, 154 U. S. 578, 596 (1895); Smith v. Ames, supra note 6, at p. 544; San Diego etc. Co. v. National City, 174 U. S. 739, 756, 757, (1899); Minnesota Rate Cases, 220 U. S. 352, 454 (1911); BEALE & WYMAN, RAILROAD RATE REGULATION, 2 ed., Sec. 212 (1915); Whitten, "Fair Value for Rate Purposes," 27 HARV. L. REV. 419, 421, (1914); cf. Edgerton, "Value of the Service as a Factor in Rate Making," 32 HARV. L. REV. 516.
utility to realize, from its own point of view, "a reasonable rate of return from the day it goes into operation." Moreover, it should be remembered that such necessarily unremunerative development period may be in part, if not in whole, a period after the utility has for some reason been earning a reasonable return. There may be an unavoidable loss of business and consequently a necessity for further expenditure to re-establish the business. Therefore, where, as in the Galveston Case, a utility has had such an unremunerative period, the law should permit the utility, after it is in successful operation, or after it is again in successful operation, to base rates on this going-concern element so as to enable the utility to realize a reasonable return upon this investment or value, at any rate to the extent that such period was not caused by mismanagement or improper rates, and provided, of course, that the establishment of the business is in furtherance of a real public or social need. And in order adequately to secure the present patrons' individual interests of substance, and the social interests in the general security, by not making the patron of only one year bear this burden, the burden should be distributed proportionately over the entire future period of operation by allowing an increment in the rate base. Thus, properly-incurred losses during such unremunerative period or periods should be considered as evidence in determining the rate base,\textsuperscript{41} i.e., under the present-value theory in determining going value, and under the prudent-investment theory in determining the amount prudently invested in the going-concern part of the plant.

This seems clear enough when after such unremunerative period or periods the rates charged are only reasonable. But suppose that the rates thereafter charged are unreasonably high. May the excess of the return over what is a reasonable return be allowed to eliminate form the rate base this element of value or investment? Some cases say, yes.\textsuperscript{42} But, as we have seen, this going-concern element, under the present-value theory, is capital value and, under the prudent-investment theory, is, either in part or in whole, capital investment. In such a case, then, the question reduces itself to this: May the rate base, whether capital value or capital investment, be amortized \textit{pro tanto} by earnings in excess of a reasonable return?

Perhaps it may be contended in this connection that for rate-

\textsuperscript{41} People ex rel. Kings Co. L. & Co. v. Willcox, 210 N. Y. 479, 104 N. E. 911 (1914); Pioneer Telephone & Telegraph Co. v. Westenhaver, 29 Okl. 429, 118 Pac. 354 (1911); \textit{re} Huntington Water Corporation, P. U. R. 1922C, 656 (W. Va., P. S. C., 1922).

\textsuperscript{42} See, e. g., People ex rel. Kings Co. L. & Co. v. Willcox, \textit{supra} note 41. See also Goddard, \textit{op. cit.} \textit{supra} note 3, at p. 219.
making purposes this increment of value or investment should, at least, not be considered in so far, if at all, as it represents effort the cost of which has been, or probably has been charged to operating expense. But the contention seems untenable. In the first place, if the physical part of the utility's plant has been partially paid for out of past excessive earnings, *e.g.*, by charging the costs to operating expense, it has been held, and it would seem correctly, that this does not cut down the rate base, *e.g.*, the present value, for purposes of rate regulation, for among other reasons hereafter mentioned, if the rate base could be thus amortized a public utility in time might have no rate base left, and therefore would have to serve the public gratuitously. Such an amortization of the rate base would not properly secure the important interests involved, particularly the paramount social interests in having adequate public service, for, among other things, it would lead to a deterioration of the service as there would be left no sufficient incentive to continue to render efficient service, and investors in public utility enterprises would withdraw their investments from public utility businesses. The rate base must always be left such that it will be attractive for capital not only to remain in, but to come in, when needed. If on the other hand the cost of any part of the physical plant has been charged to operating expense and not paid for out of excessive earnings there has of course been no amortization of the rate base. And for the same reason that the so-called physical elements of the rate base cannot be amortized by earnings, so this intangible going-concern element cannot. For, as we have seen, this going-concern element of a plant is, in this respect and in part at least, of precisely the same nature as the physical element of the plant, *via*, capital value or capital investment. Therefore, to that extent both the physical element and the intangible element should be treated alike, at any rate if the effort in producing and maintaining each element was prudently spent.

In the second place, under modern systems of rate regulation

43 Garden City v. Garden City Telephone Light & Mfg. Co., 238 Fed. 693 (C. C. A. 1916); Chicago Rys. Co. v. Illinois Commerce Commission, 277 Fed. 979 (D. C. 1922). See also, Bluefield v. Bluefield Waterworks & Imp. Co., P. U. R. 1917D, 22, 32, 33 (W. Va. P. S. C. 1917): "It could not be said in fairness to a utility, that it should be deprived of a fair return on a proper valuation of its property used in the public service at the present time because of excessive earnings it may have realized in the past." And Mr. Justice Brandeis impliedly admits this in the Galveston Case, supra note 2, for he says at p. 396: "If the success had been so great that, besides paying an annual return at the rate of 8 per cent [which was admitted to be a reasonable rate of return], a large surplus had been accumulated, could the city [the regulating authority] insist that the base value be reduced by the amount of the surplus?"

when commissions are so careful to keep rates within the realm of reasonableness, there is little probability of a public utility paying for any appreciable part of its plant out of excessive earnings. And if a public utility attempts to do so, the proper remedy, in addition to an action to recover the excess charges, would seem to be to reduce rates to the point of reasonableness, thus leaving a certain and stable rate base, not to reduce the rate base, thus subjecting the utility to double reparation for the same act, and in addition injecting another element of uncertainty, not only into rate making, but also into public utility businesses, and thereby promoting and perpetuating an already intolerable instability in a field where paramount public and social interests in the general security have long since been incessantly insisting upon stability.

However, this argument must not be understood to mean that the total "cost of developing the operating system into a financially successful concern," or that the total investment in, or total value of, this going-concern element is necessarily a part of the rate base. For, just as in the case of the physical part of the plant, so, in regard to the intangible going-concern part, investment therein to be allowed under the prudent-investment theory must be an investment prudently made and properly managed; and value thereof to be allowed under the present-value theory must be a value based on the plant or the part of the plant as it should have been constructed and maintained. Also, under the present-value theory where as in the Galveston Case, so-called present value is calculated primarily on the cost-of-reproduction basis, just as the physical part of the plant must be depreciated to suit the present condition of the physical property, so the intangible going-concern part of the plant may not be as good and valuable now as it was at the end of the cost-of-development period or periods, and, therefore under that theory, this going-concern element must, if necessary, be likewise subjected to a sort of depreciation process to suit

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47 If, for example, the plant was built unreasonably large, the value for rate-making purposes is not the total present value of the plant as it was constructed but a present value based on the plant as it should have been constructed. San Diego Land & Town Co. v. Jasper, 189 U. S. 439, 446-447 (1903).

48 The Minnesota Rate Cases, 230 U. S. 352 (1913). But, of course, if so-called present value is calculated on some other basis such depreciation is not necessarily proper.
the present condition of this going-concern element; 40 for under that theory the cost of the plant, or the cost of reproducing the plant, is only "evidence" of the present value of the plant 50 and therefore, "the cost of developing the operating system into a financially successful concern," or the cost of the going-concern part of the plant, is only evidence of the present value of the going-concern element. But, of course, if so-called present value is calculated on the prudent-investment basis, i.e., if present value is used essentially in the sense of the amount prudently invested and properly managed, such depreciation would be improper. Hence under either the present-value theory or the prudent-investment theory it may well be that in a given case there is little or no going-concern value or going-concern investment that is properly allowable as a part of the rate base.

[In the discussion of this paper a question was raised as to whether it is justifiable to start with an admittedly unsound premise (for it is herein admitted that present value is an unsound rate base) and to follow the argument out to its logical conclusion. And in order to dispel any similar misapprehension this paragraph is intercalated. Of course, it is better to be right than to be logical. 51 if one cannot be both. But no part of going value is herein included simply because it is logically a part of present value. For example, good-will value, though logically a part of going value is, in the argument, excluded from the rate base. And going value is included only to the extent necessary to secure a maximum of interests with a minimum sacrifice of other interests. To be specific, only such going-concern value as represents the results of prudent investment 52 in building up the going concern or in establishing the business should be included. If there has been no such investment—if the business was established without the expenditure of money or effort, then, under the present-value theory there should be no allowance for going value. In substance the argument in this respect is that reason, in general, and the prudent-investment doctrine, in particular, require the inclusion in the rate base of the amount, if any, prudently invested in the

40 This depreciation, like the ordinary depreciation of the physical part of the plant, should be met annually out of operating expenses, and, if not properly met, such accrued depreciation, like the ordinary accrued depreciation of the physical part of the plant, should not be capitalized as value for purposes of rate regulation. See City of Knoxville v. Knoxville Water Co., 212 U. S. 1, 13-14 (1909).
50 The Minnesota Rate Cases, supra note 49.
51 See HOLMES, THE COMMON LAW, 1 (1881): "The life of the law has not been logical."
52 See 2 WHITTEM, VALUATION OF PUBLIC SERVICE CORPORATION, 1214, 1215 (Supplement, 1914): "When, therefore we speak of going-value as an element of fair value for rate purposes it must be assumed that such value will be based on a necessary cost actually entering into the cost of production."
going-concern part of the plant. The Supreme Court requires the adoption of the present-value doctrine. Therefore, since this investment, if any, in the going concern should be protected, this investment should be reflected in the rate base under the present-value doctrine.\footnote{Accordingly, because of the peculiar difficulty and uncertainty in calculating the value of the intangible going-concern part of the plant, and because a calculation of such value involves perhaps the most vicious part of "the vicious circle," it seems best to calculate so-called going-concern value by merely estimating the amount prudently invested and properly maintained in the going-concern part of the plant, thus avoiding undue difficulty, uncertainty and the vicious circle, and at the same time adequately securing the important property interests of the investors and the interest of society in the general security, without sacrificing any countervailing conflicting interests.}

Of course, any discussion of this question, unless purely theoretical, is necessarily rather unsatisfactory, for the reason that the problem must be discussed largely on the unsatisfactory theory of the majority of the Supreme Court that the rate base is the value of the property. The adoption of the prudent-investment doctrine, as advocated by Mr. Justice Brandeis and Mr. Justice Holmes, would not only clarify this nebulous question, but, among other things, by establishing "a definite stable and readily ascertainable" rate base, would, as compared with the "orthodox" present-value doctrine, more adequately secure the various important interests involved, particularly the paramount social interest in the general security, including stability in the public utility field, would thus promote the socialization of the law,\footnote{By the term "socialization of law" is meant the recent emphasis which the law is putting "upon social interests; upon the demands or claims of desires involved in social life rather than upon the qualities of the abstract man in vacuo or upon the freedom of the will of the individual." \textit{Found, the spirit of the common law}, 195 (1921). In the nineteenth century the law emphasized the wants or interests of the isolated individual. But today the law is tending toward "a more embracing and more effective securing of social interests." See \textit{Found, an introduction to the philosophy of law}, 99 (1922).} and better subserve the true purpose of law. Mr. Justice Brandies and Mr. Justice Holmes ("may their tribe increase!") have dramatically set the stage for the majority of the Court to act out a theory that would bring about, or tend to bring about, "a consummation devoutly to be wished."