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A Just and Scientific Basis for the Establishment of Public Utility Rates, with Particular Attention to Land Values.*

In the Minnesota Rate Case,¹ the original cost of the terminal properties of the Northern Pacific Railway Company in the State of Minnesota was found to be \$4,527,228.76. The Master in the United States Circuit Court allowed a return on \$17,315,869.45. The original cost of the entire system was found to be something over \$312,000,000, but the cost of reproduction new, which the Master took as a basis, was over \$452,000,000. The difference of \$140,000,000 represented principally the unearned increment of land and the value of donated lands. Of the total reproduction value of the Railway Company's property in Minnesota the value of the land, including percentages for engineering, superintendence, legal expenses, contingencies and interest during construction, amounted to more than 37% of the total.

In the Western Advance Rate Case,² decided by the Interstate Commerce Commission on February 22, 1911, the Burlington claimed a return on a present value of \$530,000,000. Commissioner Lane found that the original investment was only

¹ 230 U. S. 352.

² 20 Interstate Commerce Commission Reports, 307.

*A paper read before the Annual Convention of the National Association of Railway Commissioners in October, 1913.

\$258,000,000, and that approximately \$150,000,000 of the Burlington's claim represented the increase in land values.

In *Kern County Merchants' Association vs. Southern Pacific Company, et al*,³ it appeared that the right-of-way of the Sunset Railroad was donated to it and that it was worth at the time between \$3,000 and \$4,000. The Railroad Company claimed a return on the present value of right-of-way estimated at \$473,000, which sum was \$200,000 more than the entire value of all the other property of the company.

These three cases, typical of many others, present the question which I shall discuss in this paper. If the present value or reproduction value theories are carried to their logical conclusion, how long will it be before rates become so high that nobody can pay them? Can it be possible that our courts and commissions are blind to the danger which confronts them and that under the hypnotic spell of the so-called physical valuation theory, they will insist on steering straight on to the rocks toward which they are now heading?

In view of the tremendous importance of this question and the apparent tendency of some of our courts and commissions to follow either the present value or the reproduction value theory without a realization of the result of such action on their part, I believe it opportune to re-examine the entire question of the proper basis on which to establish public utility rates and to consider again, before it is too late, whether it is not possible to find a basis which shall be scientific and at the same time just alike to the public and to the public utilities.

In this paper I shall first consider the decisions of the Supreme Court of the United States, beginning with *Smyth vs. Ames*, to ascertain the extent to which the Supreme Court has committed itself on this question. I shall then analyze what I believe to be the most logical single basis for rate fixing. Finally, I shall make such suggestions as occur to me concerning the manner in which our railroad and public service commissions should act until the question is finally determined.

In the leading case of *Smyth vs. Ames*,⁴ the Supreme Court affirmed a decree of the lower court enjoining certain railway companies from establishing certain rates prescribed by an

³ 1 California Railroad Commission Reports, page 298.

⁴ 169 U. S. 466.

act of the legislature of Nebraska, on the ground that the rates so established were confiscatory. In announcing the decision of the Supreme Court, Mr. Justice Harlan uses the following famous language with reference to the proper basis for public utility rates:

“We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case.”

He then continues as follows:

“What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth.”

This language must be considered in the light of Mr. Justice Harlan's earlier declaration in the same case, to the effect that a statute or order establishing rates for the transportation of persons or property by railroad will violate the provisions of the Federal Constitution only if it “will not admit the carrier earning such compensation as under all the circumstances is just to it and to the public.” It is clear that under “all the circumstances” must be included the fundamental circumstance of the character of the relationship between the public and the railroad, which relationship, as I shall hereafter show, is that of principal and agent.

Mr. Justice Harlan says nothing concerning the unearned increment of land. No question of the appreciation in the value of land or of donated lands was raised in this case. Mr. Justice Harlan was urged by the railroads to accept the outstanding stocks and bonds as the proper basis for rate fixing,

but he refused to do so, and in getting away from that basis established the other bases hereinbefore referred to. It should be noted that the first basis which Mr. Justice Harlan mentions is "the original cost of construction," to which should be added "the amount expended in permanent improvements" thereafter made.

Before leaving this case, I desire to draw attention to Mr. Justice Harlan's declaration⁵ as follows:

"A railroad is a public highway, and none the less so because constructed and maintained through the agency of a corporation deriving its existence and powers from the state. Such a corporation was created for public purposes. It performs a function of the state. Its authority to exercise the right of eminent domain and to charge tolls was given primarily for the benefit of the public."

In these words Mr. Justice Harlan shows a clear appreciation of the fact that the relationship between the railroad and the public is one of agent and principal.

In *San Diego Land and Town Company vs. National City*,⁶ the San Diego Land and Town Company filed a bill in equity in the United States Circuit Court for the Southern District of California, against the city of National City to obtain a decree declaring water rates fixed by the defendant to be void as violating the State and Federal constitutions and to secure an injunction against their enforcement. The decree of the lower court dismissing the bill was affirmed.

Mr. Justice Harlan,⁷ uses the following language with reference to the basis on which a return is to be allowed:

"What the company is entitled to demand, in order that it may have just compensation, is a fair return upon the reasonable value of the property at the time it is being used for the public. The property may have cost more than it ought to have cost, and its outstanding bonds for money borrowed and which went into the plant may be in excess of the real value of the property. So that it cannot be said that the amount of such bonds should in every case control the question of rates, although it may

⁵ Page 544.

⁶ 174 U. S. 739.

⁷ Page 757.

be an element in the inquiry as to what is, all the circumstances considered, just both to the company and to the public."

It is evident that Mr. Justice Harlan had in mind the possibility that the moneys originally expended may have been unwisely or dishonestly expended and that he was trying to get away from the claim that the utility was entitled to a return on the amount of outstanding securities. At page 754, he reaffirms his statement in the *Smyth vs. Ames* case to the effect that the judiciary should not interfere with the collection of rates established under legislative enactment unless they are so plainly and palpably unreasonable as to make their enforcement equivalent to the taking of property for public use without such compensation "as under all the circumstances is just both to the owner and to the public." There is no inference here to the effect that the property of the utility will be confiscated unless a return is allowed on the present value or on the reproduction value of the property, without regard to the relationship existing between the public and the utility. Mr. Justice Harlan says that a fair basis can be determined only by considering all the circumstances. Apparently he did not have in mind the difficulties arising out of the unearned increment of land and was concerned principally with sounding a warning against excessive alleged original cost and excessive bond and stock issues.

In *San Diego Land and Town Company vs. Jasper*,⁸ the Supreme Court affirmed a decree of the Circuit Court of the United States for the Southern District of California, dismissing a bill to have an ordinance of the Board of Supervisors of San Diego county fixing irrigation rates, declared unconstitutional as taking the plaintiff's property without due process of law. After quoting from the *National City* case, *supra*, to the effect that just compensation is to be measured by a fair return upon the reasonable value of the property at the time it is being used for the public, Mr. Justice Holmes points out that the original cost in this case was apparently "inflated by improper charges to that account and by injudicious expenditures." It is evident that Mr. Justice Holmes, like Mr. Justice Harlan, in the preceding cases, was primarily

⁸ 189 U. S. 439.

solicitous to prevent a return on an original cost which was inflated by improper charges and injudicious expenditures. No question of appreciation of land values or of donations of land was before him.

In *City of Knoxville vs. Knoxville Water Company*,⁹ the Supreme Court reversed a decree of the Federal Circuit Court for the Eastern District of Tennessee, enjoining the enforcement of an ordinance of the city of Knoxville establishing maximum rates for water. The Master below apparently reached his conclusion on the basis of the cost to reproduce the property new. Mr. Justice Moody held that this was error, for the reason that material depreciation had taken place in the plant. Mr. Justice Moody says¹⁰

“The cost of reproduction is one way of ascertaining the present value of a plant like that of a water company, but that test would lead to obviously incorrect results if the cost of reproduction is not diminished by the depreciation which has come from age and use.”

It thus appears that Mr. Justice Moody definitely discards the theory of reproduction new in a case in which depreciation has taken place. There is nothing in the case concerning real estate or possible appreciation. Both sides below started with reproduction value and nothing was urged concerning the original investment with betterments and additions. Mr. Justice Moody refused to consider the amount of stocks and bonds outstanding, for the reason that they obviously exceed the value of the property.

In *Willcox vs. Consolidated Gas Company*,¹¹ the Supreme Court reversed a decree of the Circuit Court for the Southern District of New York, enjoining the enforcement of an 80c gas rate in the City of New York. Mr. Justice Peckham says:¹²

“And we concur with the court below in holding that the value of the property is to be determined as of the time when the inquiry is made regarding the rates. If the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such in-

⁹ 212 U. S. 1.

¹⁰ Page 9.

¹¹ 212 U. S. 19.

¹² Page 52.

crease. That is, at any rate, the general rule. We do not say that there may not possibly be an exception to it, where the property may have increased so enormously in value as to render a rate permitting a reasonable return upon such increased value unjust to the public. How such facts should be treated, is not a question now before us, as this case does not present it. We refer to the matter only for the purpose of stating that the decision herein does not prevent an inquiry into the question when, if ever, it should necessarily be presented."

It should be noted that Mr. Justice Peckham uses the general language found in preceding cases to the effect that the utility is entitled to a return on the value of the property as of the time when the inquiry concerning the rates is made. He seems also to see the danger ahead if this theory is carried to its logical conclusion. He expressly states that there may be cases when property values have increased so enormously as to make a rate based thereon unjust, and refuses to decide that question. This is the first case in which the Supreme Court seems to realize the gravity of the ever increasing value of land, as affecting the establishment of public utility rates. While restating the general language of former cases, Mr. Justice Peckham clearly refuses to commit the Supreme Court to a decision as to what shall be done in view of the ever increasing value of land. Furthermore, Mr. Justice Peckham, in fixing a franchise value, refused to follow his own language to the effect that the present value of the property is the determining feature. He gave to the Gas Company a franchise value of \$7,781,000, being a value agreed upon by the State of New York by a statute of 1884, although it was very evident that the value of the franchise had increased tremendously since that time. I refer to this fact as showing that whatever general language courts may use, they nevertheless, when their attention is specifically directed to the injustice of applying that language to the facts before them, frequently reach a conclusion which on the facts is fair and just though contrary to such general language. The important question in such a case is whether the theory underlying the general language is not in itself wrong, and whether it is not time to re-examine the question and to ascertain the correct theory.

In *Cedar Rapids Gas Light Company vs. Cedar Rapids*,¹³ decided on March 11, 1912, the Supreme Court affirmed a decree of the Supreme Court of Iowa dismissing a bill to enjoin the enforcement of an ordinance of the city of Cedar Rapids establishing a maximum rate for gas of 90c per thousand cubic feet. The court below fixed a value on the plant considerably in excess of its cost. Mr. Justice Holmes, in delivering the opinion of the Supreme Court, held that the rates as established were not confiscatory even on the basis of such higher value, and accordingly upheld the action of the state court in dismissing the bill. It was not necessary in this case to ascertain whether the lower basis of return based on the original cost of the property, with additions and betterments, should be used as the basis for fixing rates.

Finally, in *Simpson vs. Shepard*,¹⁴ more commonly referred to as the Minnesota Rate Case, decided on June 9, 1913, the Supreme Court for the first time examined the question of land values as bearing on the proper basis for establishing public utility rates. Mr. Justice Hughes, while again using the general language with reference to present value and reproduction value found in the earlier cases, at the same time gave to the railroads considerably less than the present value of their land, based upon the cost of present acquisition, as I shall hereinafter show.

In the proceedings before the court below, the railroad companies estimated their land values as follows: They first estimated what they called "a market value," which value included an uncertain excess which the railroads estimated they would have to pay for their right-of-way and terminal grounds over the market value of the property as determined from the market value of contiguous and similarly situated property. The "market value" as so determined did not include any allowance for improvements found upon property, or consequential or severance damages or expense of acquisition. These items were taken care of by applying to the "market value" certain multiples. In the case of agricultural land, multiples up to the multiple of three were applied, resulting in a sum which the railroad companies called "value for railway purposes." Thus,

¹³ 223 U. S. 655.

¹⁴ 230 U. S. 352.

while the railway companies estimated a "market value" of \$2,008,491.50, they claimed a value for railway purposes, after applying the multiples of \$4,944,924.60. The Master allowed 75% of the latter sum. With reference to terminal grounds, it was shown that the original cost was \$4,527,228.76. To the "market value" the Master added 5% in St. Paul and Minneapolis and 25% in Duluth for the cost of acquisition and consequential damages, reaching a total of \$17,315,869.45. To the totals thus allowed by the Master were added 4½% for engineering, superintendence and legal expenses, then 5% on that total for contingencies, and then 9% on the preceding totals for interest during construction. The addition of these multiples raised the Master's estimate of "value for railway purposes" from \$21,024,562.90 to a total of \$33,454,526.78, being, as hereinbefore stated, over 37% of the value of the entire property as found by the Master.

Mr. Justice Hughes refused to allow anything in "market value" for an excess over the market value of adjoining lands of similar character, for the reason that he refused to assume that in eminent domain proceedings any price in excess of the fair value of the land would have to be paid. He also refused to allow multiples or any value for over-head expenditures, and concluded,¹⁵ that:

"Assuming that the company is entitled to a reasonable share in the general prosperity of the communities which it serves, and thus to attribute to its property an increase in value, still the increase so allowed, apart from any improvements it may make, cannot properly extend beyond the fair average of the normal market value of the land in the vicinity having a similar character. Otherwise we enter the realm of mere conjecture."

The same conclusion is expressed in greater detail¹⁶ as follows:

"The company would certainly have no ground of complaint if it were allowed a value for these lands equal to the fair average market value of similar land in the vicinity, without additions by the use of multipliers, or otherwise, to cover hypothetical outlays. The allowances made below

¹⁵ Page 762.

¹⁶ Page 763.

for conjectural cost of acquisition and consequential damages must be disapproved; and, in this view, we also think it was error to add to the amount taken as the present value of lands the further sums, calculated on that value, which were embraced in the items of 'engineering, superintendence, legal expenses,' 'contingencies,' and 'interest during construction.'"

It is very clear that Mr. Justice Hughes does not allow reproduction value. It is equally clear that he does not allow even the present value of the land. He allows only the "fair average market value of similar lands in the vicinity," without allowing anything for the damages which we all know are caused by severance of railway right-of-way from the larger tracts of land, and without allowing anything for the expense of acquisition. That a railway right-of-way cutting across parcels of land has a greater present value than other lands in the vicinity which are not strips of right-of-way is an undoubted fact. By reason of severance and other damages, it costs more to acquire it. It seems beyond controversy that Mr. Justice Hughes, while again using general language to the effect that the basis is the "fair present value of the property," clearly fails to allow to the railroad company as much as the fair present value of its right-of-way and terminal grounds. He says that under all the circumstances of the case, including, of course, the tremendous increase in the value of land, the railway companies ought to be satisfied if they are allowed a sum "equal to the fair average market value of similar lands in the vicinity," without any addition whatsoever for consequential or severance damages or the expense of acquisition. Exhaustive investigations conducted by the California Railroad Commission show with reference to the railways so far examined that it has actually cost these railway companies an average of approximately 1.33 times as much in the case of country lands and an average of approximately 1.28 times as much in the case of city lands to acquire its land as the fair average market value at the time of similar land in the vicinity. The significance of the decision on this point consists in the fact that while Mr. Justice Hughes was unwilling to regard the original investment as the basis, he nevertheless, consciously or unconsciously, refused to allow even the present value of the land. Mr. Justice Hughes realized that it would

not be fair to the public to use the entire present value of the land. Here, as in the Willcox case, when the Supreme Court has been squarely confronted with the injustice of applying the present value or reproduction value theories, the court has refused to apply those theories while apparently still voicing them.

It is evident from the foregoing cursory review of all the decisions of the Supreme Court of the United States since *Smyth vs Ames*, bearing on the question, that the Supreme Court has not as yet definitely established the basis on which public utility rates are to be calculated. While the court has said that the "fair value" of the property is to be used as the basis, it has not as yet clearly analyzed what constitutes a "fair value." It is particularly clear that the court has not as yet given final consideration to the tremendously important questions of the appreciation in the value of land and the return on donated land. Hence it seems not too late to reconsider on principle the entire question of the proper basis for fixing public utility rates, and I shall now attempt to do this by going back to fundamental principles and by building my conclusions up therefrom.

The fundamental relationship existing between the public and its public utilities is that of principal and agent. Out of this relationship logically should grow the proper basis for determining the rates which a public utility is entitled to charge. The State has the right to do for the public whatever is demanded for the public welfare, including the establishment and operation of enterprises of a public utility character. What the State can do itself it has the right to delegate to private corporations and persons to do for it. As Mr. Justice Harlan says in *Smyth vs. Ames*,

"A railroad is a public highway, and none the less so because constructed and maintained through the agency of a corporation deriving its existence and powers from the state. Such a corporation was created for public purposes. It performs a function of the state."

In *San Diego Water Company vs. San Diego*,¹⁷ Mr. Justice Van Fleet, now a judge of the United States District Court, expresses the same idea in a case involving water rates, as follows:

¹⁷ 118 Cal. 556, 570.

"As we have said, it is not the water or the distributing works which the company may be said to own, and the value of which is to be ascertained. They were acquired and contributed for the use of the public; the public may be said to be the real owner, and the company only the agent of the public to administer their use."

In carrying out the agency, the public has given to the public utilities the right to use the streets and highways and to take the property of private persons in the exercise of the power of eminent domain. These are tremendous powers which are conferred by the State only upon its agents in the prosecution of enterprises of a public or quasi-public character. In eminent domain proceedings the plaintiff must allege and prove that the use is a public use and that the plaintiff is in charge thereof. He can be in charge thereof only as the agent of the public to carry out powers exercised in behalf of the public as principal.

I shall now consider the bearing of this relationship on the problem of the proper basis for rate fixing. It is a well established principle in agency that an agent acting within the scope of his authority is entitled to be reimbursed for the money which he honestly and judiciously expends for the benefit and account of the principal, together with a proper compensation for his services. As a general rule, it is a breach of good faith and of loyalty to the principal for an agent to deal with the subject matter of the agency so as to make a profit out of it for himself in excess of his lawful compensation. If such profit is made, the agent may be held as a trustee and may be compelled to account to his principal for all profits and advantages acquired by him out of the relationship. If the agent acquires title to property in his own name as part of the agency, he will be deemed to hold this title for his principal. If A is the principal and B the agent, and A, for the purpose of enabling B to carry out the agency, deeds property to B, B cannot later contend that he can hold the property for himself. He holds it for his principal. Likewise, if B, in the course of his agency, acquires title to property from any source, and that property thereafter increases in value, he cannot lay claim to keep the increase for himself. In each of the above cases the agent holds the property for the principal and must account to the principal for it.

Applying these principles to the relationship between the public and the public utilities, it seems clear that the public utilities are entitled to a reasonable return upon such money as they honestly and wisely expend for the public, but that they should not be allowed a return on the increased value of the property used in the agency. If the agent has expended money dishonestly or has expended it injudiciously, he is not entitled to a return thereon. On the other hand, if he has acted honestly and wisely, and it thereafter becomes possible to acquire more cheaply property which he has purchased in the agency or to secure at a lesser expense labor or material used therein, the agent should not be compelled to suffer the loss but should be entitled to a return on the money honestly and wisely spent by him in pursuance of the agency. The justice of this rule, both to the public and to the public utility, is clearly shown by Justice Van Fleet in the San Diego Water Company case, hereinbefore referred to. In that case the question at issue was the basis on which a water company was entitled to a return. Referring first to the unfairness to the water company of applying the present value or the reproduction value rules in case prices have gone down, Justice Van Fleet says:¹⁸

“The construction of a municipal water works is a matter of growth. It is necessary in common prudence, on the one hand to construct the water works of such capacity as to satisfy the needs of the growing city, not only at the moment, but within the near future; and, on the other hand, not to extend them so much as to cast an unnecessary burden on the stockholders, or the present consumers. As such works are a necessity to the city, they must keep pace with, and to some extent anticipate its growth. When constructed they stimulate to that extent the progress of the city, and tend, like all conveniences, to lower the general cost of production of all things. It results that at least the first water system in any city occupies the position of a pioneer. At any expense the works must be constructed, and usually no reward can be realized by the constructors until some time has elapsed. It would, therefore, be highly unjust to permit the con-

¹⁸ Page 568.

sumers to avail themselves of the plea that at the present time similar works could be constructed at a less cost, as a pretext for reducing the rates to be paid for the water. The reduced expense, if it be reduced, is due in part at least to the very fact that the city has been provided at the cost of the water company with increased facilities for doing business."

Referring then to the injustice to the consumer if he is compelled to pay a higher rate on the ground of an advance in prices, Justice Van Fleet continues:¹⁹

"Nor would it, on the other hand, be just to the consumers to require them to pay an enhanced price for the water, on the ground that it would now cost more to construct similar works. Such a contingency may well happen; but to allow an increase of rates for such reason would be to allow the water company to make a profit, not as a reward for its expenditures and services, but for the fortuitous occurrence of a rise in the price of materials or labor. The law does not intend that this business shall be a speculation in which the water company or the consumers shall respectively win or lose upon the casting of a die, and upon the equally unpredictable fluctuations of the markets."

Justice Van Fleet then states his general conclusion as follows:

"For the money which the company has expended for the public benefit it is to receive a reasonable, and no more than a reasonable reward. It is to be paid according to what it has done, and not according to what others might conceivably do. In effect, the bargain between the company and the public was made when the water works were constructed; and this matter is to be determined according to the state of things at that time."

Finally,²⁰ Justice Van Fleet states the necessary qualification to this rule as follows:

"It should, of course, be said that it does not follow that in every case the company will be entitled to credit for all of its current expenditures, or to receive a com-

¹⁹ Page 569.

²⁰ Page 572.

pensation based on the entire cost of its works. Reckless and unnecessary expenditures, not legitimately incurred in the actual collection and distribution of the water furnished, or in the acquisition, construction or preservation of so much of the plant as is necessary for that purpose, cannot be allowed. * * * * It is the money reasonably and properly expended in the acquisition and construction of the works actually and properly in use for that purpose, which constitutes the investment on which the compensation is to be computed."

The foregoing conclusion was worked out by Justice Van Fleet logically and on principle from the fundamental relationship existing between the public and its public utilities. The use of the present value or the reproduction value theories does not spring in any way out of that relationship and has no necessary connection with it. As Justice Van Fleet clearly points out, the use of either the present value or the reproduction value theories may be as clearly unjust to the public utilities on the one hand, in case prices have gone down, as it is to the public on the other hand, in case values have gone up. In logic and justice, the public utility should receive a return on the money reasonably and properly expended in the acquisition and construction of its works actually and properly in use to carry out its agency—no more and no less.

A study of the decisions and of the trend of events shows clearly the cause of the adoption of the present value or the reproduction value theories. In the first cases which came before the courts, the utilities claimed a return on the amount of stocks and bonds outstanding or on the original cost, including large expenditures either dishonestly or unwisely incurred. The courts saw clearly that it would be unfair to allow a return on such basis, and in looking for a way to avoid the unjust results which would follow therefrom, hit upon the present value and the reproduction value theories. But in doing so, the courts did not see that the application of these theories might with increasing values, particularly of land, result in an injustice to the public just as great as the injustice which would ensue in many cases if the amount of outstanding securities were used as the basis or if the original costs, swollen by dishonest or injudicious expenditures, were used. In seek-

ing to avoid Scylla many of our courts have rushed into Charybdis. The time has come for a return to first principles.

Franklin K. Lane, whose ability on the Interstate Commerce Commission marks him as one of the great constructive statesmen of the age, clearly saw the danger which now confronts us.

In the Western Advance Rate Case,²¹ hereinbefore referred to, Mr. Commissioner Lane refers to the decisions of the United States Supreme Court prior to the more recent decisions, and reaches the conclusion that it yet remains for the Supreme Court to decide that

“A public agency such as a railroad created by public authority, vested with governmental authority, may continually increase its rates in proportion to the increase in its value, either because of betterments which it has made out of income or because of the growth of the property in value due to the increase in the value of the land which the company owns.”

Referring to the contention of the Burlington that it was entitled to a return on the \$150,000,000 of unearned increment in land, Mr. Lane says:²²

“If this is a precise expression of what our courts will hold to be the law, then as we are told there is certainly the danger that we may never expect railroad rates to be lower than they are at present. On the contrary, there is the unwelcome promise made in this case that they will continuously advance.”

Mr. Lane then sounds the following warning:

“In the face of such an economic philosophy if stable and equitable rates are to be maintained, the suggestion has been made that it would be wise for the government to protect its people by taking to itself these properties at present value rather than await the day, perhaps thirty or fifty years hence, when they will have multiplied in value ten or twenty fold.”

With this suggestion I heartily concur. If the courts and commissions are going to push us over the brink and to establish definitely the principle that a utility is entitled to a return

²¹ 20 Interstate Commerce Commission Reports, 307.

²² Page 339.

either on present value or on its reproduction value, including the unearned increment of land and including a return on property which was donated to it by the public for the public use, there is only one remedy to save the public from the consequences of such action—the acquisition by the public itself at the earliest possible date of the property of all public utilities in whose property land enters as a material element, before rates have become so high and the property has increased so tremendously in value that the public will look in vain to its representatives for justice as against its agents, the public utilities.

Mr. Lane reaches the following conclusion as to the proper basis of fixing rates, with which conclusion I am heartily in accord:²³

“The trend of the highest judicial opinion would indicate that we should accept neither the cost of reproduction, upon which the Burlington’s estimate of value is made, nor the capitalization which the Santa Fe accepts as approximate value, nor the prices of stocks and bonds in the market, nor yet the original investment alone, as the test of present value for purposes of rate regulation. Perhaps the nearest approximation to the fair standard is that of bona fide investment—the sacrifice made by the owners of the property—considering as part of the investment any shortage of return that there may be in the early years of the enterprise. Upon this, taking the life history of the road through a number of years, its promoters are entitled to a reasonable return. This, however, manifestly is limited; for a return should not be given upon wastefulness, mismanagement or poor judgment, and always there is present the restriction that no more than a reasonable rate shall be charged.”

Mr. Lane’s conclusion is based upon the fundamental relationship between the public and the utilities; it is accurate in theory; and it is just both to the utilities and to the public. In my opinion, it furnishes the best single basis for fixing rates and the basis to which attention should primarily be directed whenever the facts can be ascertained. Of course there will be cases in which modifications of this basis will have to be

²³ Page 347.

made. I am only seeking to ascertain the proper basis to use as a starting point in rate fixing inquiries.

I shall now consider several objections which have been made to the principles herein advocated.

It has been said that original cost, including betterments and additions, should not be used as a basis for utility rates, for the reason that it is often difficult to ascertain original cost. This objection goes not to the correctness of the principle but to the difficulty of applying it in a given case. It is true that in the eastern, and to some extent the middle western sections of this country, it is often impossible to ascertain the original cost of public utilities. In such case the courts and commissions should strive to ascertain as nearly as they can what the original cost reasonably should have been. A number of commissions in applying the reproduction test ascertain as nearly as possible what the work reasonably should have cost under the conditions under which it was actually performed. This test is practically the same as the test herein advocated. If it is impossible to ascertain the unit price and the conditions under which the work was originally performed, it may become necessary to ascertain reproduction value less depreciation as of the time when the rate inquiry is held. In doing so, it should be clearly borne in mind that this is being done not because reproduction less depreciation is the proper ultimate basis, but because it furnishes in the particular case the best available evidence of what the original cost reasonably should have been. If we bear this fact clearly in mind, we shall not rush into the dangers which ensue from the use of the present value or reproduction value test, without clearly understanding its significance. In California, the Railroad Commission has ascertained the original cost of right-of-way and terminal grounds of a considerable number of railroads, including all the land of the Western Pacific Railway. In other western and middle western states it will be possible to a considerable extent to ascertain the original cost, particularly of land.

It has frequently been urged that a public utility is entitled to a return upon the present value of its property or upon the reproduction value thereof, for the reason that it has title to the property, and it has been argued that a failure to give to a public utility a reasonable return upon the property to which it has title would be to confiscate its property in

violation of the 14th Amendment to the Federal Constitution. This conclusion overlooks the relationship between the public and the utility and is based on the erroneous assumption that title is the basis of a fair return in public utility cases.

Referring to the first point, the Supreme Court, as hereinbefore pointed out, beginning with Mr. Justice Harlan, in the case of *Smyth vs. Ames*, has held that a utility is entitled to a return upon the fair value of the property, considering, however, all the circumstances. The most fundamental of these circumstances is the agency relation existing between the public and the utility. The utility takes its property subject to that relationship and can no more urge the plea of confiscation than can any other agent who acquires his property in the course of the agency and who is accountable to his principal for it. It would be just as logical for an agent who has acquired title to a piece of land in the course of his agency to claim confiscation if he is not allowed to keep the unearned increment for himself as it is for a public utility to make the same plea with reference to the property which it holds in its capacity as agent.

Referring now to the argument that title is the determining factor in ascertaining the proper basis for rates, it is evident that this view is erroneous. A public utility may, in the pursuit of its agency, spend large sums of money properly chargeable to capital account and entitled to be considered in rate fixing inquiries, and yet the utility may not secure title to the property represented by that money. For instance, a railway company may be put to considerable expense in paving streets, the title to which is in the public. Again, the company may build expensive structures in the public streets and may incur large expenditures for grade separations in the public streets. That the company is entitled to a return on the money so expended, even though it does not have title to the property acquired thereby, must be admitted by every fair minded person. If it is just that the utility should be allowed a return in certain cases on money expended on property to which the utility does not secure title, it seems equally just that it should not be allowed a return on property to which it does have title, in excess of the amount to which, under its agency relation, it is fairly entitled. This thought is expressed by Whitton in Section 192 of his valuable work on "Valuation of Public Service Corporations," as follows:

“Similarly if the government has given this same company the land for its right-of-way, the actual property in which the company has invested its capital and not that part to which it has title but which has been donated by the government should be considered in determining reasonable rates. Actual title and possession are not always conclusive. The determination of a reasonable rate is an equitable process and equity will demand that certain property to which the public has title should be included and certain other property to which the company has title should be excluded. It is the actual investment or sacrifice on the part of the company that is entitled to consideration regardless of mere title or possession.”

The reason why a private citizen buying land is entitled to the unearned increment while a public utility acquiring land is not so entitled is that the citizen is performing no function of government and is not acting as an agent of the government, while the utility owes its entire existence and right to operate to the action of the state in conferring upon it certain of the powers of government, such as the right to use the streets and to take private property, to be used in the pursuance of its agency. The two cases are entirely different. To reach a conclusion in the one by an analogy to the other is extremely dangerous.

Commissioner Maltbie of the New York Public Service Commission of the First District, has clearly seen the difficulties arising out of appreciation of values and has tried to avert the danger by considering appreciation in value as income and balancing it against depreciation in other kinds of property. However meritorious this theory may be, the Appellate Division of the Supreme Court of New York, in the case of *People ex rel. Kings County Lighting Company vs. Willcox*, decided on May 9, 1913, refuses to adopt this view. While it seems clear that the result which Commissioner Maltbie desires to ascertain is correct, and that his theory, if adopted, would reach that result, I am of the opinion that the same result would be obtained more logically by starting with the basis herein explained than by starting with the cost of reproduction less depreciation basis. It seems to me wiser to return to first principles and to adopt a basis which springs logically and justly out of the fundamental relationship between the

public and public utilities. If the courts fail to adopt this view, Commissioner Maltbie's theory appears to offer the only remaining hope.

In view of the tremendous importance of the problem and the uncertainty as to its ultimate solution, the policy to be pursued in the meantime by the various state railroad and public service commissions becomes a matter of serious consideration. I would suggest that in making physical valuations of utility properties and making their findings thereon, the commissions confine themselves to findings on questions of fact, and refrain wherever possible from finding as to the ultimate question of value. This is the policy pursued by the California Commission.²⁴ The Commission makes its findings on certain questions of fact, including the facts with reference to the organization and operation of the railroad, its stocks and bonds, its revenues and expenses, its original book cost, its reproduction value and its present value, by which latter term is not meant the ultimate fact of present value, but what may be termed the reproduction value less depreciation. The Commission accumulates all these facts and makes its findings on them, but refuses to make a finding on the ultimate question of the value of the property. The value may be one sum for one purpose and another sum for another purpose. The correct value depends fundamentally both on the purpose for which it is to be ascertained and on the correct principles to be adopted in ascertaining it. Until the Supreme Court of the United States has clearly and unequivocally established the principle which it considers correct after its attention has been squarely drawn to the tremendous importance of the question of appreciation in value, I believe it would be far wiser for the commissions to adopt the policy which the California Commission is at the present time pursuing. Whenever the correct principle is definitely established, it will be possible to refer to the findings of the commissions on the various branches of the question and from these findings to determine the ultimate fact of the value which is to be assigned to the property for rate making purposes. By exercising care with reference

²⁴ See Report of Decision of the Railroad Commission of California. In the matter of ascertaining the value of the property of the Tonopah and Tidewater Railroad within the State of California. Case No. 210, decided July 29, 1913.

to these facts, and distinguishing clearly between a fact and a conclusion therefrom, the commissions will avoid the danger of putting themselves in a position from which they cannot withdraw and of adopting theories and making findings which will later come back to plague them.

I accordingly suggest that the various state commissions do all in their power to draw the attention of the courts to the dangers which confront them and to secure, if possible, the establishment of the principle herein contended for, which principle I believe to be correct in logic and in justice, and that in the meantime the commissions so do their work that they do not commit themselves in a way which will work increasing injustice to the public throughout the generations which are to come.

MAX THELEN.

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