Value of the Service as a Ceiling on Public Utility Rates

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*Smyth v. Ames*¹ has long been known as the source of the theory of rate making under which a utility is entitled to a reasonable return on the "fair value" of its property devoted to public use. This theory has been under attack for years until even its ghost is supposed to have been laid in *Federal Power Commission v. Hope Natural Gas Co.*² The five judges constituting the majority went about their work with such enthusiasm, however, that they overlooked the desirability of providing a substitute that would furnish some intelligible standard for judging the lawfulness of rates. This deficiency in the majority opinion is adverted to with some emphasis by Mr. Justice Jackson in his dissent wherein he said:

"... We need not be slaves to a formula but unless we can point out a rational way of reaching our conclusions they can only be accepted as resting on intuition or predilection. I must admit that I possess no instinct by which to know the 'reasonable' from the 'unreasonable' in prices and must seek some conscious design for decision.

"The Court sustains this order as reasonable, but what makes it so or what could possibly make it otherwise, I cannot learn."³

The decision pointed out no path for commissions to follow—on the contrary it turned them loose with the assurance that their conclusions would be upheld if anyone could think of any excuse for them.⁴

The excuse in the *Hope* case seemed to be that the Company owed no money, had "efficient management", a good supply of gas and had built up its property by withholding dividends from its stockholders and so could stand a rate reduction. Another excuse, not used in the *Hope* case but alluded to in the remark that "the rate-making

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¹ (1898) 169 U.S. 466.

² (1944) 320 U.S. 591. See Hale, *Does the Ghost of Smyth v. Ames Still Walk?* (1942) 55 HARV. L. REV. 1116.

³ *Federal Power Commission v. Hope Natural Gas Co.*, *supra* note 2, at 645, 646.

⁴ Mr. Justice Jackson is apparently not sure that any excuse is required. He says in his dissent (*ibid.* at 645): "... If we are to hold that a given rate is reasonable just because the Commission has said it was reasonable, review becomes a costly, time-consuming pageant of no practical value to anyone."

process . . . involves a balancing of the investor and consumer interests", is that rates should not exceed the "value of the service". It is sometimes not realized that this thought was likewise expressed in *Smyth v. Ames* where the Court said by way of dictum that "the public is entitled to demand . . . that no more be exacted from it . . . than the services . . . are reasonably worth."⁵ Along somewhat the same lines, the Court said, also by way of dictum, in *Covington & Lexington Turnpike Co. v. Sandford*:

"It cannot be said that a corporation is entitled, as of right and without reference to the interests of the public, to realize a given per cent upon its capital stock. When the question arises whether the legislature has exceeded its constitutional power in prescribing rates to be charged by a corporation controlling a public highway, stockholders are not the only persons whose rights or interests are to be considered. The rights of the public are not to be ignored. It is alleged here that the rates prescribed are unreasonable and unjust to the company and its stockholders. But that involves an inquiry as to what is reasonable and just for the public. If the establishing of new lines of transportation should cause a diminution in the number of those who need to use a turnpike road, and, consequently, a diminution in the tolls collected, that is not, in itself, a sufficient reason why the corporation, operating the road, should be allowed to maintain rates that would be unjust to those who must or do use its property. The public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."⁶

It has long been considered axiomatic that, in order to avoid confiscation, rates must not be lower than the cost of service, which includes not only operating expenses, but also a reasonable return to the investor.⁷ Is there, in fact, a conflicting principle which permits rates to be fixed below cost where cost exceeds the "value" of the service?

⁵ (1898) 169 U.S. 466, 547.

⁶ (1896) 164 U.S. 578, 596.

⁷ See the often-quoted remarks of Mr. Justice Brandeis in his dissenting opinion in *Southwestern Bell Telephone Co. v. Public Service Commission* (1923) 262 U.S. 276, 291: ". . . The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital." The foregoing definition of cost was quoted with approval in the *Douglas-Black-Murphy* concurring opinion in *Federal Power Commission v. Natural Gas Pipeline Co.* (1942) 315 U.S. 575, 607.

I. MEANING OF "VALUE OF THE SERVICE" THEORY

In order to avoid the confusion which sometimes attends a discussion of this question it is desirable to note that the following points are not in issue:

1. The power to lower rates as a punishment for poor service and an inverse incentive to improve service. The existence and extent of such a power is outside the scope of this article. In order to give the "value of the service" doctrine a clear cut test, it is necessary to assume that the service is satisfactory in the sense that the water is potable, interruptions in service are not unduly frequent, the trains and cars run on schedule, etc.

2. The fact that two glasses of water are more valuable than one. When an attack is made on the value of the service theory one is sometimes met with the statement that it is an extremely important factor and the glasses of water cited as an example. For instance in a recent decision the California Railroad Commission quoted the following excerpt from a memorandum filed by the utility:

"... The attempt to use the value of the service theory in establishing a rate which is below cost (including a reasonable return) and also below what the consumer will pay must fail both because it would result in the illegal confiscation of the utilities' property and because no reasonable standard to measure the value of service is available.'"

and thereupon said:

"We are not in accord with this view. The argument that the value of a utility service should have no bearing on the price paid for such service is contradicted not only in the Public Utilities Act and the decisions of the courts, but also by the every-day realities of rate making and rate paying. A longer ride is worth more than a shorter ride and usually costs more, and rates are made on that basis.'"⁸

We can readily recognize the truth of the Commission's statements but they do not have any bearing on the question of the right to reduce rates below cost of the service.

3. The question of whether or not it is desirable for a Commission to vary rates in a range *above* cost depending on its judgment of the value of the service. It is only the reduction of rates *below* cost with which we are concerned.

4. The power to disallow unreasonable operating expenses such as high salaries. While a Commission cannot prohibit the payment of unreasonably high salaries, it has the undoubted power, entirely apart

⁸ *In re California Street Cable Railroad Company* (1944) 45 C.R.C. 384.

from any value of the service theory, to disregard them to the extent they are excessive.⁹

5. The power to reduce a rate base for excessive plant capacity arising from initial overbuilding or decline of population.

A decision on the propriety of including unused facilities in a utility's rate base is not dependent on the existence of a power to reduce rates below cost but rather on the question as to whether, under the particular circumstances, upkeep and return on the unused facilities are reasonable elements of cost of the service actually being rendered.¹⁰

Thus, by the "value of the service" theory we mean the claimed right, in the absence of such special considerations as poor service, unreasonable operating expenses or excessive plant capacity, to reduce the overall rates of a utility below cost on the ground that cost exceeds the value of the service.

II. ATTITUDE OF THE COURTS AND TEXT WRITERS

The quoted remarks in *Smyth v. Ames* and the *Turnpike*^{10a} case had nothing to do with the decisions, but they sounded well and perhaps for this reason have been frequently quoted or imitated. However, in 1918 R. E. Edgerton, now Justice of the Court of Appeals for the District of Columbia, reviewed the cases and concluded:

"... In other words, all the talk of courts—including the Supreme Court itself—commissions and text-writers to the effect that rates may be fixed so low that they will not produce a reasonable return to the company, if that is necessary in order that they may not exceed the value of the service to the public, is baseless."¹¹

The statement that rates "must not exceed the value of the service" came to be regarded as a sonorous but harmless means of rounding out an opinion and showing the author's regard for the public welfare but practically no attention was paid to it until the depression of the thirties. Thereupon, the general scarcity of income created an

⁹ See *Chicago & G. T. R. Co. v. Wellman* (1892) 143 U.S. 339, 345, and *United Gas Public Service Co. v. Texas* (1937) 303 U.S. 123, 150, which are sometimes erroneously cited in support of the value of the service theory as, for example, in *Federal Power Commission v. Natural Gas Pipeline Co.*, *supra* note 7, at 608.

¹⁰ See discussion in *Wisconsin Telephone Co. v. Public Service Commission* (1939) 232 Wis. 274, 341-348, 287 N.W. 122, 155-158.

^{10a} *Supra* p. 284 at n. 5, 6.

¹¹ Edgerton, *Value of Service as a Factor in Rate Making* (1919) 32 HARV. L. REV. 516, 529.

appeal for even a small reduction in utility rates, as a result of which proponents of lower rates developed a curious by-product of the value of the service doctrine. The thought was advanced that in good times the cost of utility service consumed a given percentage of the consumer's income and was therefore worth this percentage. When the consumer's income declined it was reasoned that the value of utility service declined in like proportion and that rates should be set accordingly.¹²

This conclusion has two obviously false premises:

(1) That in good times the rates and value of the service were synonymous. There is no evidence that this is so—on the contrary it would not be difficult to establish that people would have unhesitatingly paid far more to get the service. Thus it was the cost of utility service not its value that bore the given percentage to the consumer's income in good times.

(2) The second false assumption is that a fire to cook dinner on and other necessities becomes less valuable to us as our income declines. This is contrary to all experience. The fact is that men have been known to speak even more highly of the potability of water when nothing else is available.

This offshoot of the "value of the service" theory had only a limited acceptance although it was taken up by the Wisconsin Commission until disapproved by the Wisconsin Supreme Court which said:

"... Nor do we find that the statute confers upon the Commission any power to relieve the economic condition of consumers by taking property away from the utility and awarding it to its patrons. . . ."¹³

"... The individual rate-payer determines for himself the value of the service rendered to him. If he thinks it is not worth what is charged he does not use it. The question—whether the service rendered by the Company to the public is rendered at a greater charge than is just and reasonable is a different question and is controlled by wholly different considerations."¹⁴

In answer to a similar contention that rates should not exceed

¹² See Fisher, *Value of the Service and Public Utility Rates* (1935) XI JOURNAL OF LAND AND PUBLIC UTILITY ECONOMICS 76, and see also, Lilienthal, *Regulation of Public Utilities during the Depression* (1933) 46 HARV. L. REV. 745, 762.

¹³ Wisconsin Telephone Company v. Public Service Commission, *supra* note 10, at 325, 287 N.W. at 147.

¹⁴ *Ibid.* at 243, 287 N.W. at 156.

what the consumers can reasonably afford, the California Supreme Court said:

"... It is true that in the order under review the commission stated that the testimony of the water users was unanimously to the effect that none of them could afford to pay a rate of more than \$2.25 per acre, even with stock water furnished during the entire year without additional cost. We may assume that this recital in the order of the testimony of the water users states their true condition, but does their inability to pay reasonable rates justify the fixing of rates which would be unjust to the public utility and insufficient to pay the cost of maintaining its operating plant? The authorities are all to the contrary, and neither the courts nor the commission is authorized to fix or approve a rate which would confiscate the property of the utility."¹⁵

Along with this attempt to limit rates by the consumer's income there was some renewed expression of allegiance to the general theory that rates should not exceed the value of the service. This resurgence received a cold welcome from the courts and text writers. While the Supreme Court has reminisced about the early dicta, it has never made the theory the basis of any decision. The Supreme Court cases were reviewed by a three-judge court in *Telluride Power Company v. Public Utilities Commission*¹⁶ where the Commission had said:

"It would seem that the basic principle or rule laid down by the courts is that regardless what the effect may be upon the cost of oper-

¹⁵ *Miller v. Railroad Commission* (1937) 9 Cal. (2d) 190, 202, 70 P. (2d) 164, 171.

¹⁶ (1934) 8 Fed. Supp. 341. See also *State ex rel. Washington Water Power Co. v. Department of Public Works* (1934) 179 Wash. 461, 464, 38 P. (2d) 350, 352, where the court said: "... May the department fix rates based upon the value of service to the consumer, the ability of the consumer to pay, or prevailing economic conditions, or are all three combined sufficient reasons for compelling public service companies to furnish any particular service for anything less than reasonable compensation?"

"These elements are to be considered in connection with all of the other facts and circumstances which bear upon the question of what is reasonable and sufficient compensation and the courts have often so held.

"No authority has been cited, and we know of none, which goes further and holds to the effect that the value to the consumer, or his ability to pay, is the prime factor which alone will warrant the reduction of a rate affording no more than reasonable compensation."

In *Wisconsin-Minnesota Light & Power Co. v. R. R. Commission* (1924) 183 Wis. 96, 103, 197 N.W. 359, 362, the court stated: "... If it be established that the service costs the consumer more than it is worth, the utility cannot be compelled to furnish it at less than cost including return and depreciation."

Maine appears to be the only state in which the value of the service theory has been actually followed by the courts. See *Gay v. Damariscotta-Newcastle Water Co.* (1932) 131 Me. 304, 162 Atl. 264.

ation of the utility or its financial condition, the cost to the consumers should in no event exceed what the services are reasonably worth to them."¹⁷

It was stipulated that the single issue before the court was whether the Commission "may legally make an order reducing rates for the reasons stated". The court held:

"We cannot agree that any opinion of the United States Supreme Court sustains the proposition that in fixing fair and reasonable rates the customer's ability to pay and the value of the service to him are paramount and controlling. If rates are so low as to be confiscatory of the utility's property, they are condemned by the Fourteenth Amendment."¹⁸

Bonbright, who was quoted with approval on other points by various justices in both the *Natural Gas Pipeline*¹⁹ case and the *Hope*²⁰ case, put the matter succinctly when he stated:

"... But from the standpoint of value theory, the important point is that the determination of a fair price for utility service can never depend on an answer to the question, What is the service worth? The mere fact that people are willing to pay the price demanded by the companies indicates that the service is worth to them the full amount of the charge. This charge may be so extortionate as to be termed a 'holdup' and yet may be well within the limits of the value of the service."²¹

¹⁷ Telluride Power Co. v. Public Utilities Commission, *supra* note 16, at 342.

¹⁸ *Ibid.* at 343.

¹⁹ Federal Power Commission v. Natural Gas Pipeline Co., *supra* note 7.

²⁰ Federal Power Commission v. Hope Natural Gas Co., *supra* note 2.

²¹ BONBRIGHT, (1937) 2 VALUATION OF PROPERTY 1109. In PUBLIC UTILITY ECONOMICS (1941) 260, 262, THOMPSON AND SMITH say: "... value of the service is no help at all as a primary standard of reasonableness for pricing of utility services ... is distinctly subordinate and supplementary to cost of service as a theory of particular rates and is never acceptable as a general theory of reasonableness of rates."

See also BARNES, ECONOMICS OF PUBLIC UTILITY REGULATION (1942) 292.

The majority of the Commissions pay lip service to the theory but some have the forthrightness to express their contrary views in no uncertain terms, e.g. the Oregon Commission which said *In re Pacific Tel. & Tel. Co.*, P.U.R. 1922 C, 248, 258:

"In the case of a service like that of the telephone, practically indispensable to the great majority of its users, the cost of giving service, under prudent management, with proper recompense to the investor for the use of his capital, furnishes the only practicable measure by which to establish reasonable rates. Some will doubtless find that the value of the service to them is less than the rate thus fixed, as would be the case no matter how low the rates were made. Is it the proposition of petitioners that the company shall be required to serve such customers at less than cost? *The Commission rejects the proposal without hesitation, as contrary to justice and common sense.*" (Italics added.)

Thus by 1942 in the light of the criticism of the theory and absence of cases supporting it, one would have been justified in concluding that rates could not be reduced below cost because they allegedly exceeded the value of the service. However, in that year the Supreme Court decided the case of *Federal Power Commission v. Natural Gas Pipeline Co.*²² in which Justices Douglas, Black and Murphy said in their concurring opinion:

"The consumer interests cannot be disregarded in determining what is a 'just and reasonable rate'. Conceivably a return to the company for the cost of service might not be 'just and reasonable' to the public. . . . The investor and consumer interests may so collide as to warrant the rate making body in concluding that a return on historical cost or prudent investment though fair to investors would be grossly unfair to the consumers."²³

and quoted with approval the passage from the *Turnpike* case which is quoted above.²⁴ While these comments were dicta and not part of the majority opinion, nevertheless since these three judges were included in the five man majority in the *Hope* case decided two years later, we are on notice that the value of the service theory may be due for a revival.

III. SITUATION IN CALIFORNIA

The situation in California is of interest because this is the only state in which the highest court has discussed the theory subsequent to the decision in the *Hope* case. The California Railroad Commission in the thirty years of its existence prior to 1943, had never decided a case on the value of the service theory despite frequent reference to this factor in its decisions. However, the *California Street Cable* case,²⁵ decided in 1944, and the *Market Street Railway case*²⁶ decided in 1943, appear to rest partly on this theory although the issue was obscured due to criticisms of the service rendered by both companies.²⁷

²² *Supra* note 7.

²³ *Ibid.* at 607, 608.

²⁴ *Supra* p. xxx, at note 6.

²⁵ *In re California Street Railroad Co.*, *supra* note 8.

²⁶ 45 C.R.C. 53.

²⁷ Two of the five commissioners dissented in both cases and expressly repudiated the value of the service theory. No authorities were cited in the opinion in the California Street Cable case and the five authorities cited in the Market Street opinion do not support the Commission's decision, viz.:

(1) In *W. F. Rogers, et al. v. Sacramento Valley West Side Canal Company* (1915) 7 C.R.C. 113, 145, the commission did not allow a full return on the plant

The *Market Street* case was appealed to the California Supreme Court which had the following to say:

"... The problem of the value of the service, and the correctness of the commission's decision on the consumer interest, do not involve constitutional questions, so long as otherwise the investor or company interest has received adequate consideration by the commission. When the company interest has received constitutional protection, the findings of the commission on the consumer interest become final in the proceeding. The question involving that interest then has been answered by the commission correctly pursuant to the statute and the authorities to the effect that the reasonableness of rates should not be considered apart from the adequacy of the service, and that the public should not be charged more than the service is reasonably worth. The statute is a legislative recognition of the public's right to demand that consideration be given to the value of the service."²⁸

The court appears to hold that the Commission was correct in giving "consideration" to the value of the service but that the rates were not reduced below cost so that no constitutional question was involved. The case was appealed to the United States Supreme Court which held that since the rate was not confiscatory, the court did "not need to pronounce upon the abstract doctrine as to the validity of the 'value of the service' theory as justifying rates which do not yield a fair return."²⁹

IV. THEORETICAL JUSTIFICATION?

Aside from the law on the subject, is there any theoretical justification for limiting rates to the "value of the service"? The value

because it was *eight times* too large for the public it was serving.

- (2) In *Lake Hemet Water Co.* (1916) 11 C.R.C. 617 the company had collected sums from the consumers for "water rights" in addition to charging for water served. The rates allowed provided a return of over 7% on undepreciated cost after deducting the capital sums which the commission held were unlawfully collected.
- (3) In *Coast Valleys Gas & Electric Company* (1923) 24 C.R.C. 53 the commission purposely allowed rates in excess of cost with the expectation that the company would continue the improvements of its system and initiate a more liberal policy in the construction of line extensions.
- (4) *BRYANT & HERRMANN* in *ELEMENTS OF UTILITY RATE DETERMINATION* (1940) at 224 criticize the value of the service as a standard on the ground that it "is very difficult to measure".

(5) *THOMPSON AND SMITH* in *PUBLIC UTILITY ECONOMICS* (1941) say value of the service is "no help at all as a primary standard".

²⁸ (1944) 24 Cal. (2d) 378, 404, 150 P. (2d) 196, 210.

²⁹ *Market Street Ry. Co. v. Railroad Commission* (1945) 65 Sup. Ct. (Adv. Op.) 770, 778.

of any article is the amount of money for which it can be exchanged.³⁰ This value is simple enough to ascertain in case of an article like a share of telephone stock because there is only one price at which it can be sold at any given time. No one will pay any more than any one else for it. An entirely different situation prevails, however, with such an item as a long distance telephone call. To some such a call would be worth hardly more than postage while others would gladly pay many dollars for it. With such a wide range of prices, is there any way of ascertaining the value of telephone service? As said above, the value of anything is the amount of money the owner can get for it. Consequently, the value of a telephone service is the greatest amount of money which can be obtained for the service. If the owner had an unlimited supply and the service cost him nothing it would then be possible to determine the value of the service by experimenting to find the rate which produced the largest gross revenue. However, obtaining cash for a service is a meaningless performance if the cash must all be paid out in expenses—in such a case the owner obtains nothing for the service. Thus when we speak of “the greatest amount of money which can be obtained for the service” we mean the greatest net amount. In this way we arrive at the definition of value of a service as the greatest amount of net income which can be obtained for it. Consequently, when we say that rates must not exceed the value of the service we mean—if we are using value in the ordinary sense of the word—that rates must not exceed the level which will produce the highest net income.³¹

With such a result, the utilities could not have a legitimate quarrel. No one can claim his property is being taken for public use without just compensation if more compensation is forced on him by lowering his rates. If a seven cent rate is theoretically necessary to produce a fair return to a street car company, but if due to competition of other forms of transportation the company will make more and more money as rates are reduced to five cents at which point further reductions begin to produce less net income, the value of the service is

³⁰ Webster's definition is “The value of a thing is what it would bring on the market. . . . In political economy, worth as estimated by the power of purchasing or being exchanged for other commodities.”

³¹ The converse of this proposition was expressed in *Northern States Power Co. v. Public Service Commission* (1944) 13 N.W. (2d) 779, 787, N.D., where the court said: “. . . We do not see how a department of the company can have a higher value than the amount upon which it can earn a fair return at rates nicely adjusted to what the traffic will bear.”

five cents and the company should not be permitted to charge more even if the five cent rate does not produce a fair return.

If this is all that judges and commissioners mean—and it is all that many of them mean—when they remark that rates must not exceed the value of the service, utilities should have no concern over these statements which are more statements of economic rather than statutory law. However, it is clear that many judges and commissioners, including, for example, Justices Douglas, Black and Murphy of the Supreme Court and two of the present California Railroad Commissioners, have a very different idea. They do not use value in the ordinary sense of market value found in the dictionary—they mean something like inherent value or appraised value or, to use an expression that would receive a higher rating from a semanticist, “fair value” of the service. In other words, they would permit a commission to reduce rates below market value and below cost if the commission was of the opinion that the rates exceeded “fair value”. How is the commission to arrive at such an opinion? If a jury of five art critics declared that one painting was better than another, most of us would accept the verdict without any announcement of the standards for judgment. Are we to repose the same confidence in utility commissioners? Most commissioners would not want us to do so. Most would agree with the remarks of Mr. Justice Jackson quoted in the opening paragraph above³² to the effect that some objective standard is necessary.³³

V. IMPOSSIBILITY OF MEASURING VALUE OF THE SERVICE

Is there any suitable standard for judging the fair value of the service? A search of the cases and literature on the subject has re-

³² *Supra* p. xxx, at note 3.

³³ However, even though most commissioners would be reluctant to claim the power or ability to value a service without some standard, it is not at all clear that the Supreme Court will not bestow these qualities on all rate making authorities. In the Hope case the court said that the “expert administrators” may work out “various routes” to fixing a rate, that their conclusion is “the product of expert judgment which carries a presumption of validity” and that it is unimportant if the “method employed . . . may contain infirmities” so long as the utility is unable to carry “the heavy burden of making a convincing showing” that the order is unjust and unreasonable in its consequences.

In *Utah Power & Light Co. v. Public Service Commission* (1944) 152 P. (2d) 542, 572, *Utah*, Judge Hoyt in his concurring opinion quotes from the Hope case and then says: “From the language contained in a decision of the highest court in the land, other courts and public service commissioners may argue that a rate order should be upheld unless it can be shown to be confiscatory, regardless of whether the Commission based it upon relevant facts or upon a throw of dice or instinct or intuition.”

And see the quotation in *supra* note 4 from the Jackson dissent.

vealed only three suggestions in addition to the proposal discussed above that value be determined by the ability of the consumer to pay, viz.:

1. The effect on the gross income or patronage of the utility of a change in rates. If an increase in rates results in a decline in gross revenue or a "material" decline in patronage the new rate is said to be beyond the value of the service.³⁴ Any increase in rates will probably result in some decline in patronage but how much of a decline is "material"? If we must first decide what "material" means we can hardly be said to have a standard. And the trouble with using gross revenue as an indicator is that it would seldom indicate anything since it is not often that a rate increase actually decreases gross revenues.

2. The cost of furnishing a similar service by another method.³⁵ If a utility must serve its customers at a rate equal to the cost of producing the service under the latest methods, the utility is forced to bear the entire loss of obsolescence and the public permitted to gather all the benefit arising from new inventions. Such a result has been disapproved in principle by the Supreme Court³⁶ and does not follow the general practice of commissions.³⁷ Moreover, it is theoretically unsound and actually self-defeating. If the risk of obsolescence is added to the other risks of doing business it would have to be considered in fixing the reasonable rate of return or investment funds would not be attracted to the industry. Merely reducing the rate base will not lower rates if there is a corresponding upward adjustment in the rate of return. Obsolescence is a part of the cost of doing business and will therefore have to be taken into consideration if rates are to cover cost. This issue of furnishing service at the cost of a similar service was squarely presented in *Oklahoma Gas & Electric Co. v. Corporation Commission* where a three-judge court stated that the validity of the order of the Commission depended upon a single question, viz.:

"Does the Corporation Commission have the power to order plaintiffs to furnish electricity for the same amount as the ginner would

³⁴ See Tingley, *Value of Utility Service as a Limit on Rates* (1935) 10 PUBLIC UTILITIES FORTNIGHTLY 749.

³⁵ Fleming, *Public Utility Rates on a Reproduction-cost-of-Service Principle* (1941) 17 JOURNAL OF LAND AND PUBLIC UTILITY ECONOMICS 138.

³⁶ *P. G. & E. Co. v. City and County of San Francisco* (1923) 265 U.S. 403.

³⁷ See for example, *L. A. Gas & Electric Co. v. R. R. Commission* (1932) 289 U.S. 287 (gas manufacturing plant still included in rate base after introduction of natural gas).

be compelled to pay for coal, without regard to the return afforded by such rates on the properties used and useful in such service?"³⁸

The court unanimously decided that a rate for one type of service could not be limited to the cost of the cheaper service. The court said:

"The power to compel a citizen to furnish one commodity for the same price that others can furnish substitutes is an extraordinary power. Most of us would use electricity for heating and cooking in our homes if the cost was no more than for coal. Railroads have voluntarily put in rates to compete with water competition, as gas companies have put in industrial rates to compete with coal. It is a different thing to compel, by force of law, a utility to furnish services at less than cost in order to meet such competition. We do not believe such power exists."³⁹

3. The rates charged by other utilities. Such a comparison manifestly does not furnish a fair standard unless conditions are the same for the two utilities and it is difficult to find another utility operating under like conditions. If a commission does point to a utility which it believes can fairly be used as a measuring rod, the company under investigation would clearly be entitled to question the justice of the comparison. Are we then to devote part of every rate case to evidence and argument on the question of whether some other utility is operating under comparable conditions? Even if operating conditions are the same, we cannot use the other rates as a standard unless they are themselves proper and how are we to ascertain this fact? Surely we cannot also spend part of every rate case in ascertaining whether the rates of some other utility are reasonable.⁴⁰ Moreover, there is a fun-

³⁸ (1932) 1 Fed. Supp. 966, 969.

³⁹ *Ibid.*

⁴⁰ See Tingley, *supra* note 34, at 750: "The existence of a rate elsewhere does not prove its fairness. If it did, the lowest rate extant might tend to draw all others to its level."

See also Heyman, *Value of the Service: Its Various Meanings and Uses* (1939) 9 JOURNAL OF LAND AND PUBLIC UTILITY ECONOMICS 252, 258: "The shortcomings of comparisons as criteria of the reasonableness of rates have been recognized by commissions. The New York Commission stated: 'Comparisons of rates to ascertain the reasonableness thereof, are competent evidence, but their probative force depends on circumstances, and in no case ought to be controlling.' In a similar vein is the California Commission's statement: 'A comparison of rates has little, if any, value when no evidence is submitted to show that the rates used, in a measure are themselves just and reasonable.' Another requisite condition, if the comparison is to be of any value, is that there must be a similarity of operating conditions. This principal was expressed in a number of cases; it seems obvious enough, but at times absurd comparisons have been introduced, as in the Arkansas Valley case. The Commission correctly refused to admit the relevancy of a

damental fallacy involved in endeavoring to judge the fair value of the service of one company by the rates offered by another. The rates of practically all utilities are based on cost, so if we try to determine the fair value of Company A's service by looking at the rates of Company B, we are adopting a principle, for which there is no logical foundation, that the *fair value* of Company A's service is equal to the *cost* of Company B's service.

This question came before a three-judge court in *Georgia Power & Light Co. v. Georgia Public Service Commission* which said:

"... Reliance is placed mainly on the fact that the new rates are about the same as those acquiesced in by the Savannah Electric Power Company which serves the city of Savannah, and the Georgia Power Company which serves the remainder of the state, and the consideration that the old rates of complainant would make an unfair discrimination against its territory and are higher than the service is worth to the consumer. These general considerations, while weighty, cannot control, because complainant's property and the use of it cannot constitutionally be taken in order to equalize South Georgia with other sections, nor does the willingness or the ability of the two other power companies to furnish electricity at a certain price prove that complainant could do so with a fair profit."⁴¹

VI. CONCLUSION

Many text writers have called attention to the impossibility of measuring value of the service. Barnes says:

"The weaknesses of value of service as an independent measure of the reasonableness of utility rates becomes apparent when the question is asked as to how it may be measured. 'Value of service' is not a definite and objective pecuniary sum; it is highly subjective; and it varies from individual to individual and for the same individual from time to time. In particular instances an attempt has been made to give objectiveness to the concept by references to the retention of patronage, the price of substitute service, the charges made by other companies similarly situated, and the ability of consumers to pay as affected by changing price levels and changes in business activity. Incapable of objective measurement, value of service has become less and less significant as methods of cost determination have improved, until at present it is treated chiefly as an exception to the general rule

comparison between the rates, that were being attacked, and the value and the cost of the service, of a proposed municipal plant. As is apparent, great care must be taken in introducing comparisons in rate cases."

⁴¹ (1934) 8 Fed. Supp. 603, 604.

that rates should be sufficient to cover cost of service. In this use, it is primarily a rationalization in the face of adverse circumstances, where no rate, however high, will enable the utility to earn a fair return."⁴²

These so-called standards for applying the fair-value-of-service theory are thus so unsatisfactory that their use would amount to little more than giving free play to the subjective reactions of the rate-making authorities. Accordingly, we can conclude that the law not only does not now permit but that it should not permit rates to be reduced below cost and below actual value of the service merely because the authorities are of the opinion, however reached, that the rates exceed the "fair value" of the service. Such a doctrine would be unfair to the utility, impractical of application because of the absence of a workable objective standard, and undesirable from the public's point of view as it might well have a tendency to inhibit investment in and consequent expansion of the smaller utilities outside of well-settled metropolitan areas.

It may be observed that wherever the companies have attempted to have their rates established on a value of the service theory instead of on cost, the proposal has been flatly rejected by the courts.⁴³ And to quote again the dissenting opinion of Mr. Justice Jackson in the *Hope* case, "I have doubts about resting public regulation upon any rule that is to be used or not depending on which side it favors."⁴⁴

⁴² BARNES, *loc. cit. supra* note 21. See also BRYANT & HERRMANN, *loc. cit. supra* note 27; Nash, *Utility Rates at the Cross Roads* (1933) 11 PUBLIC UTILITIES FORTNIGHTLY 79, 87; Spurr, *Value of Service as a Basis for Rate Making* (1932) 10 PUBLIC UTILITIES FORTNIGHTLY 363, 369.

⁴³ *Denver Union Stock Yard Co. v. United States* (1932) 57 F. (2d) 735, 740-741; *Mississippi River Fuel Corp. v. Federal Power Commission* (1941) 121 F. (2d) 159, 164-165; *Natural Gas Pipeline Co. of America v. Federal Power Commission* (1941) 120 F. (2d) 625, 633.

⁴⁴ *Supra* note 2, at 644.