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HISTORY OF RATE-DETERMINATION UNDER DUE PROCESS CLAUSES*

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INTRODUCTION

SOME two years ago the Supreme Court in *Federal Power Commission v. Natural Gas Pipeline Co. of America*,¹ moved one step farther from the traditional method of rate-determination developed under *Smyth v. Ames*.² Various writers have indicated that the decision was the forerunner of the adoption of the prudent-investment theory as the proper method of rate-determination.³ Although the present writer has no fault to find with prudent investment as a theory of rate-determination, he believes that more emphasis should and can be given to the reasonable rate or price approach as developed in the price-fixing cases under the due process clauses for the regulation of minimum and maximum prices in competitive industry. There is little difference between determining a rate-schedule for a utility and fixing prices for competitive industry. In seeking to show that such transition from present

* This paper raises the question: Can the reasoning of the price-fixing cases be applied to the rate-determination utility cases in place of the "fair value" approach? It was prepared prior to the decision of the United States Supreme Court in *Federal Power Com'n, City of Akron and Pennsylvania Public Utility Com'n v. Hope Natural Gas Co.* rendered on January 3, 1944 Nos. 34 and 35, October Term, in which Justice Jackson in his dissent argues that gas is a commodity and not a service. Therefore, the rules governing the determination of a fair and reasonable price of the price-fixing cases should be applied, and not the "fair value" rule of the utility cases, where a service is sold. The writer does not draw this distinction between the sale of a commodity and a service.

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¹ 315 U.S. 575 at 602 (1942).

² 169 U.S. 466 (1898).

³ Hale, *Does the Ghost of Smyth v. Ames Still Walk?*, 55 Harv. L. Rev. 1116 (1942). Bauer, *Supreme Court Hints New Utility Rate Base*, National Municipal Review, May, 1942, p. 254.

"fair return on the fair value of the used and useful property" approach to some other test⁴ is possible under the present legal precedents, this paper in Part I discusses *Smyth v. Ames*, the cases prior to *Smyth v. Ames*, and the decisions subsequent thereto. Part II summarizes the price-fixing cases and attempts to correlate the line of reasoning in this group of decisions to the public utility field.

PART I

The rule of *Smyth v. Ames*⁵ is the basic principle of modern public utility valuation. It is not important because it says that there must be no confiscation of property, but because it sets forth the *method* to be employed in valuing public utility property so that there will be no confiscation in establishing the rate of return. The rule lists many factors that must be considered by the rate-fixing body and given some weight in its decision. This rule was amplified by later decisions until it virtually meant spot-reproduction cost of the utility with emphasis upon a forecast of future wages and prices.⁶ The test of confiscation followed by Mr. Justice Harlan in *Smyth v. Ames* was very simple and practical, or so it seemed upon casual observation. It was the business man's maxim that an investor is entitled to a return upon his investment. But Justice Harlan stated it in the following fashion: that the return for a public utility should be based upon a certain percentage of its fair value. The original statement of the principle has been modified and adapted to meet the problems arising when the rule is applied under varying and complex circumstances. The rule has now come to mean that the utility, after deducting legitimate expenses from income, excluding interest to bondholders, is entitled as a minimum to between four and eight per cent upon its used and useful property minus proper depreciation reserves. There has been little litigation over the rate of return. A peculiar twist, however, has unconsciously developed in the application of the rule. Mr. Justice Brandeis has said that originally the *Smyth* rule was intended as the minimum limit of the

⁴ Cook, Eight Methods of Rate Determination, Bulletin No. 3, 1942, Bureau of Business Research, Pennsylvania State College. Herein as applicable to public utilities the author enumerates the following suggestions: "Other methods of rate-determination include (1) What may be called the competitive bases; (2) One seeking a reasonable charge to the consumer; (3) One having regard for compensatory factors; (3) One employing a certain percentage of gross sales; (5) One attempting to find a just price; (6) A recommendation for no regulation."

⁵ 169 U.S. 466 (1898).

⁶ Mr. Justice Butler and many "experts" in the field seemed to believe, until the Los Angeles decision, 1933, that spot reproduction was the only method of valuation sanctioned by the court.

return to be allowed the utility, the test of a compensatory rate.⁷ It is still used to ascertain the minimum return, but now it is referred to as the test of a reasonable rate,⁸ the upper limit under the *Smyth* rule.⁹

But the greatest amount of fantasm grew up upon the term *fair valuation*. True, Harlan listed items that must be considered in finding a fair valuation, but the federal and state courts have assumed that they could determine the weight to be given the various factors in determining fair valuation. There are states that emphasize the original cost of the utility; others, the prudent-investment theory. Until 1933 the United States Supreme Court seemed to have stressed the economist's point of view that the exchange value of a thing is what it will fetch today in the market. Since the utility will not be sold in the market, the Court built up the fiction of reproduction cost *now*. There are at present volumes of cases in legal reports and thousands of words in economic and engineering treatises as to what constitutes reproduction cost. Today there is a trend toward a return to the fundamental principle of confiscation of property—emphasis upon no particular method of valuation. New methods of establishing the net return of a utility are being used and approved by the courts. Part I of this paper comprises an analysis of *Smyth v. Ames*, the legal decisions which preceded it and the cases subsequent to the enunciation of the rule.

A. *Smyth v. Ames*

Smyth v. Ames is the outstanding case in public utility law. Students of the field are inclined to begin all discussion of public utility regulation and valuation with this case. This emphasis upon Harlan's decision is not to be criticized. It was a definite statement by the Court as to the method to be employed by the courts in establishing the net return to be allowed a utility.¹⁰ Since this case apparently summarized all previous law, preceding cases have been overlooked. Inasmuch as all utility cases sub-

⁷ Note the terminology in Hale, *Commissions, Rates, and Policies*, 53 Harv. L. Rev. 1103 at 1114-1115, wherein Professor Hale speaks of an upper and a lower limit to reasonableness; costs are important in determining either rate, but are not the sole criterion. He also indicates that a rate may be reasonable to the carrier, but prejudicial to the shipper. In the instant paper the lower limit is described as a compensatory return; the upper limit as a reasonable return.

⁸ Brandeis's dissent in *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276 (1923).

⁹ See latter part of *Smyth* rule as quoted in footnote 14 of this paper.

¹⁰ Brandeis and Holmes in the dissent of *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276 (1923) contended that the rule was established for the courts in review and not for the commission. But since the courts ultimately pass upon the valuations of the commission, the commissions try to meet the test that the courts will apply.

sequent to the case have either quoted from it or impliedly done obeisance to it, *Smyth v. Ames* has become almost a truism to lawyers, accountants, economists, and engineers interested in the public utility field. Therefore, in tracing the development of the present rule of public utility valuation it is only proper that this case should be first considered.

The case of *Smyth v. Ames* concerned the fixing of rates for certain railroads operating within the state of Nebraska. The railroads argued that the rates established by the legislature of the state were confiscatory. The state contended that they were not. The net return that a railroad should have is difficult to determine when one views the railroad as a compact unit functioning solely within a state and without any competition. Should it be allowed a return based upon the value of its assets? May such charges not be unreasonable? But should not the bondholders and stockholders be protected, and receive a return upon their investment? However, suppose that the money was invested unwisely, asset accounts padded, fictitious salaries and other expense items of a similar nature allowed to swallow much of the capital? Not only did Mr. Justice Harlan have to find the answer to these questions, but his problem was complicated by the fact that he had to establish the rates of return for several railroads, all built under different circumstances and operating under varying degrees of competition. Further, some of the railway lines were interstate in character, so that the burden of establishing a rate applicable to the portion of the line within the boundaries of the regulating state had to be considered.

In reaching his decision Harlan had the following data with which to work. First, the early cases enunciating the principle that a carrier is entitled to compensation for the use of its property. In summarizing these cases he stated the rule to be that:

A state enactment, or regulations made under the authority of a state enactment, establishing rates for the transportation of persons or property by railroad that will not admit of the carrier earning such compensation as under all the circumstances is just to it and to the public, would deprive such carrier of its property without due process of law and deny to it the equal protection of the laws, and would therefore be repugnant to the Fourteenth Amendment of the Constitution of the United States.¹¹

The judge in the lower court more concretely expressed his conception of the law when he stated that a person was deprived of his property without due process of law when he was not permitted to earn a just return upon the property.¹² Thus the principle of confiscation of property was

¹¹ *Smyth v. Ames*, 169 U.S. 466 at 526 (1898).

¹² *Ames v. Union Pacific Ry.*, 64 F. 165, 176 (1894).

definitely extended in words rather than implications, that the income from property was protected as well as the principal itself. Secondly, Harlan had the financial statements of the railroads, with their operating expenses and income for the past three years. Thirdly, he had a report, prepared by the Board of Secretaries of Nebraska, which included all pertinent data in respect to the railroads seeking to avoid the stipulated rates. In this report was a valuation of the utilities at reproduction cost.

The results of the judge's deliberations indicated to him that the rates as established by the state commission and applied to the contestants were confiscatory. However, in reaching that conclusion the judge had to dispose of the arguments of the attorneys on both sides. In ascertaining whether the rates were confiscatory the judge considered the *operating expenses and income* of the railroads.¹³ Herein, we find a definite reliance in the decision, not upon the factors under the so-called *Smyth* rule, but upon expenses and income. The attorneys for the railroads, however, wanted more than a compensatory rate: they asked that they be given a rate sufficient to cover operating expenses, interest on bonds, and a dividend on all of their stock. The spectre of padded asset accounts, fictitious expense items, and unwise expenditure of money invested was perceived by Harlan in this contention of the railroads. To combat that danger he enunciated the famous rule of *Smyth v. Ames*.¹⁴ Although the elements of the rule were not specifically weighed and discussed in this decision, there is evidence that they were contained in the report of the

¹³ Pp. 528-43.

¹⁴ "If a railroad corporation has bonded its property for an amount that exceeds its fair value, or if its capitalization is largely fictitious, it may not impose upon the public the burden of such increased rates as may be required for the purpose of realizing profits upon such excessive valuation or fictitious capitalization; and the apparent value of the property and franchises used by the corporation, as represented by its stocks, bonds and obligations, is not alone to be considered when determining the rates that may be reasonably charged.

"... The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it.

"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. We do not say that there may not be other matters to be regarded in estimating the value of the property. 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." 169 U.S. 466, 544-547 (1898).

Board of Secretaries of Nebraska which was referred to by Harlan on page 549 of his decision.

The rule itself appears to contain an upper and a lower limit, a reasonable and a compensatory rate.

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.

Prior to *Smyth v. Ames* the cases had developed the rule that a utility must have a just compensation for the use of its property or it would be deprived of its property without due process of law. This rule was rather nebulous; there was no definite test to apply. *Smyth v. Ames* supplied a test, comprising many diverse elements, and brought utility regulation out of the sphere of the law and into the classrooms of the economist and the engineer.

B. CASES PRIOR TO *Smyth v. Ames*

The cases dealing with rate-making prior to *Smyth v. Ames* fall into two categories: those developing the principle of public utility regulation by the state, and those enunciating the rule that a utility is entitled to a fair return on its property. *Munn v. Illinois*¹⁵ is the outstanding case in the first group, whereas the second group has no prominent case, but there is a groping toward an unseen but desired end, a measure of a fair return. This end was apparently reached in *Smyth v. Ames*. But this paper by the use of hindsight will endeavor to raise a doubt as to whether or not *Smyth v. Ames* was merely a stopping point and as to whether we are not in fact still seeking a definite method of ascertaining a fair return to a utility enterprise.

For purposes of discussing the cases in the clearest manner possible they will be presented in chronological order; and at the end of this section a summary of their principles will be inserted.

The earliest form of rate-regulation acknowledged by the United States Supreme Court in respect to utilities was competition, plus the possible threat of government intervention. But the subsequent development of the utility after *Baltimore & Ohio Railroad Co. v. Maryland*,¹⁶ indicated that communities received the most efficient service in the absence of competition among utilities. This factor made rate-regulation in some form imperative. However, in the above case we find this statement in the headnotes:

¹⁵ 94 U.S. 113 (1876) .

¹⁶ 21 Wall. (U.S.) 456 (1874).

Relief from onerous and burdensome rates of transportation imposed under State authority must be sought in the competition of different lines, and, perhaps, in the power of Congress to establish post roads and facilitate military and commercial intercourse between the different parts of the country.¹⁷

A reading of the case will indicate that herein the state is seeking one-fifth of the income of the railroad, reserved to the state by the charter granted to the utility. The court, unperturbed by the problem of state regulation of utilities, naïvely states that competition will cure the tendency of the utility to charge a burdensome rate, but that in the event that no competition develops, there is the threat of government intervention by means of government competition under the military power to establish post roads and promote commerce between the different parts of the country.

Two years later, when Illinois attempted to fix the maximum rate that warehouses might charge, the United States Supreme Court in *Munn v. Illinois* could not dodge the issue of state regulation. Three problems confronted the judges in this case: Could the state regulate utilities? If so, was a grain elevator a utility? What was a fair return? The case is famous because the decision answered the first two questions. It did not answer the last question. In expounding its theme the Court went back to English law and discovered that in England inns, ferries, common carriers, hackmen, bakers, millers, wharfingers, auctioneers, and chimney sweeps were permitted to make a reasonable charge established by the state. They were classified as public utilities. Note that the idea of the reasonable charge being based upon the investment in the inn, ferry, or broom of the chimney sweep did not trouble the English courts. The Court in stating its argument says that prior to the Fourteenth Amendment it was not thought that statutes regulating the use of property deprived a person of his property without due process of law.¹⁸ In the Fourteenth Amendment we have the crux of the peculiar slant that utility rate-regulation has taken in the United States. In the gradual expansion of the interpretation of the due process clause as applied to utility rate-determination we find fiction built upon fiction; in the absence of this clause the value of the property of the utility would play no major part in determining the net return that a utility should have.¹⁹

¹⁷ Ibid. at 457.

¹⁸ The English common law has always recognized the principle that a person could not be deprived of his property without due process of law.

¹⁹ In rate-making abroad there is no problem of valuation. Costs are emphasized as well as techniques for getting the most income from a piece of equipment. This is particularly true in England and Germany. Batson, *The Price Policies of German Public Utility Undertakings*, ch. IV, pp. 60-74 (1933).

Munn v. Illinois established the rule that a state could regulate the maximum rates to be charged by a utility; secondly, it placed grain elevators in the public utility class along with inns, ferries, and chimney sweeps. But the case did not answer the last question, what is a fair return, although a significant rule was stated by the Court. After asserting that grain warehouses may charge reasonable maximum rates fixed by the legislature under its police power, the remark was made that only in private contracts does a court pass on the question of the reasonableness of the rates, or where the public interest is affected only when the legislature has made no statutory enactments as to what is reasonable. Here is an assertion which would place the test of reasonableness solely within the power of the legislatures. Subsequently, we shall note the discard of this idea and the resultant increase in the power of the court in rate-determination cases.

In line with *Munn v. Illinois*, cases which followed for a seven-year span upheld the fixing of maximum rates by the state. The Court in the three decisions of *Chicago, Burlington & Quincy R.R. Co. v. Iowa*,²⁰ *Peik v. Chicago & Northwestern Ry. Co.*,²¹ and *Ruggles v. Illinois*²² did not mention the capital invested by the railroads or the rate of return that they should have. But in the *Railroad Commission Cases*²³ the decisions take a different turn. In these decisions the Court for the first time approached the problem of determining what was a reasonable return. The judge in his decision did not stipulate that the utility should have a reasonable return on the value of its property, but such a principle was part of the state regulations upheld by the decision. The cases arose when the railroads in the state of Mississippi sought to prohibit the state from enforcing certain regulations against them. These regulations included the regulation of rates. In discussing the problem of confiscation and what constitutes a reasonable return the Court said:

From what has thus been said, it is not to be inferred that this power of limitation or regulation is itself without limit. This power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation. Under pretence of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property without reward; neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law. What would have this effect we need not now say, because no tariff has yet been fixed by the commission. . . .²⁴

²⁰ 94 U.S. 145 (1876).

²¹ 94 U.S. 164 (1876).

²² 108 U.S. 526, 531 (1883).

²³ 116 U.S. 307 (1886).

²⁴ *Ibid.* at 331.

Thus we find the principle settled that a railroad company is entitled to a reward for carrying persons, and the added dictum that the rate may not be so low as to deprive the utility of its property without due process of law. The case did not establish a method of determining what is a reasonable rate, but the Court still followed the rule in *Munn v. Illinois* that it is within the sphere of the legislature to determine what is a reasonable rate.

However, in *Dow v. Beidelman*,²⁵ the Court directly tussled with the problem of whether a specific rate of return would deprive a railroad of its property without due process of law. A perusal of the decision shows that the Court again side-stepped the responsibility of setting forth what constituted a reasonable rate by holding that no proof was presented to it of the cost of the bonded debt, the amount of capital stock, or the price paid by the corporation for the road. Note that the proof requested implied that the Court felt that the due process clause protected the original investment and not reproduction cost of the property. As a test of the original investment the bonded indebtedness and the outstanding stock would be acceptable evidence.

The doctrine that the legislature and not the courts fixed a reasonable charge is still vigorously asserted by the *Dow* case:

Where property has been clothed with a public interest, the Legislature may fix a limit to that which in law shall be reasonable for its use. This limits the courts, as well as the people. If it has been improperly fixed, the Legislature, not the courts, must be appealed to for the change [citing cases].²⁶

No further addition of importance to the existing law was made by *Georgia R.R. and Banking Co. v. Smith*²⁷ wherein the right of the state to regulate the railroads by fixing a maximum rate per mile was upheld. Stress was laid upon the interest of the public; but the rule was enunciated that the *state* could not take the property of the utility for public use without just compensation, thus anticipating *Chicago, Milwaukee and St. Paul Ry. Co. v. Minnesota*,²⁸ the case following, which overruled the above quotation from the *Dow* case. *Chicago, Milwaukee and St. Paul Ry. Co. v. Minnesota* hinged upon procedural rights of due process of law. The decision held the rates established by Minnesota to be unconstitutional because there was no appeal from the rates fixed by the commission. In going further the Court apparently overruled the previous cases making

²⁵ 125 U.S. 680 (1888).

²⁷ 128 U.S. 174, 180 (1888).

²⁶ *Ibid.* at 688.

²⁸ 134 U.S. 418, 458 (1890).

the legislature the sole judge of reasonableness of rates and put such power in the hands of the judiciary.²⁹

The question of the reasonableness of a rate of charge for transportation by a railroad company, involving as it does the element of reasonableness both as regards the company and as regards the public, is eminently a question for judicial investigation, requiring due process of law for its determination. If the company is deprived of the power of charging reasonable rates for the use of its property, and such deprivation takes place in the absence of an investigation by judicial machinery, it is deprived of the lawful use of its property, and thus, in substance and effect, of the property itself, without due process of law and in violation of the Constitution of the United States; and in so far as it is thus deprived, while other persons are permitted to receive reasonable profits upon their invested capital, the company is deprived of the equal protection of the laws.³⁰

Mr. Justice Brewer in *Reagan v. Farmers' Loan & Trust Co.*³¹ applied the test of operating expenses and income, with consideration of the capital structure of the utility. Inasmuch as he found no inefficiency or mismanagement on the part of the utility in investing its capital, a return which did not permit the utility to earn one-half the interest on the bonded debt above operating expenses was held to be unjust and unreasonable.

It is unnecessary to decide, and we do not wish to be understood as laying down as an absolute rule, that in every case a failure to produce some profit to those who have invested their money in the building of a road is conclusive that the tariff is unjust and unreasonable. And yet justice demands that every one should receive some compensation for the use of his money or property, if it be possible without prejudice to the rights of others. There may be circumstances which would justify such a tariff; there may have been extravagance and a needless expenditure of money; there may be waste in the management of the road; enormous salaries, unjust discrimination as between individual shippers, resulting in general loss. The construction may have been at a time when material and labor were at the highest price, so that the actual cost far exceeds the present value; the road may have been unwisely built, in localities where there is not sufficient business to sustain a road. Doubtless, too, there are many other matters affecting the rights of the community in which the road is built as well as the rights of those who have built the road.

But we do hold that a general averment in a bill that a tariff as established is unjust and unreasonable, is supported by the admitted facts that the road cost far more than the amount of the stock and bonds outstanding; that such stock and bonds represent money invested in its construction; that there has been no waste or mismanagement in the construction or operation; that supplies and labor have been purchased at the

²⁹ Certain authorities feel that the Court made a mistake in asserting that the statute at issue did not give the railway a right to a hearing before the commission. See discussion in Freund, *The Police Power* (1904).

³⁰ *Ibid.* at 458.

³¹ 154 U.S. 362 (1894).

lowest possible price consistent with the successful operation of the road; that the rates voluntarily fixed by the company have been for ten years steadily decreasing until the aggregate decrease has been more than fifty per cent; that under the rates thus voluntarily established, the stock, which represents two-fifths of the value, has never received anything in the way of dividends, and that for the last three years the earnings above operating expenses have been insufficient to pay the interest on the bonded debt, and that the proposed tariff, as enforced, will so diminish the earnings that they will not be able to pay one-half the interest on the bonded debt above the operating expenses; and that such an averment so supported will, in the absence of any satisfactory showing to the contrary, sustain a finding that the proposed tariff is unjust and unreasonable, and a decree reversing it being put in force.³²

In the above rule many of the elements of *Smyth v. Ames* are found. However, Mr. Justice Brewer did not name all of the possible factors that might be considered in making a valuation when he expounded his method of testing a reasonable return. In the *Reagan* case emphasis was placed upon operating expenses and income, permitting a return above operating expenses sufficient to attract capital to the industry. This test will appear again in subsequent decisions. Of course, there was always the limitation that if the utility were overcapitalized it would not be entitled to earnings sufficient to pay interest and dividends on such overcapitalization. Thus Brewer took notice of the same problem of overcapitalization that troubled Harlan in *Smyth v. Ames*. However, Brewer found no overcapitalization or inefficiency, whereas Harlan felt that he could not avoid the problem as easily as his predecessor. Harlan enunciated his famous rule to cover the situation in which there was padding of asset accounts, unwise expenditures, and inefficient management.

After the *Reagan* case in chronological order comes *Smyth v. Ames*. In summarizing the decisions prior to *Smyth v. Ames* there are but a few of them that have contributed to the modern rule of public utility valuation for rate-making purposes. The case of *Baltimore & Ohio v. Maryland* indicated that the principle of state regulation of rates to be charged by a utility was not yet formed. Competition, either from other privately owned lines or from federal agencies, was relied upon to keep reasonable the rates charged by the utility. But in *Munn v. Illinois* the issue again was before the Court: what about rate regulation of certain industries? In this case the Court said that rate regulation of public utilities was permissible by the government bodies, and cited English precedents to prove the point. It further classified a grain elevator as a public utility, but made no attempt to ascertain a reasonable rate or to set forth a method for such ascertainment. Nine years later the nebulous form of our present method

³² Ibid. at 412.

of rate determination entered the legal archives in the Mississippi statute stipulating that in determining the rates to be charged by the utility the state regulating body should consider the capital value of the utility. This method was not discussed by the Court, but it was in the statute upheld as constitutional in the *Railroad Commission* cases. *Dow v. Beidelman* is important merely because the Court in its decision had an inclination to lean toward the original investment theory, stating that it would uphold the state regulation in the absence of any proof of the bonded indebtedness of the road, the amount of its capital stock outstanding, or the price paid for the road. *Chicago, Milwaukee and St. Paul Railway Co. v. Minnesota* cleared the path for the great powers subsequently exercised by the courts in determining what was a reasonable rate. Heretofore, beginning with *Munn v. Illinois* and developed in the cases following, the principle was enunciated that the legislature should determine what was reasonable. If rates were unreasonable the remedy of the people was to act upon the legislature, not upon the courts. But the *Chicago, Milwaukee and St. Paul* decision took this power from the legislature and placed it in the control of the court. The exercise of this power was now in line with the Court's previous assertions that there could be no confiscation of property; for in the cases previous to the *Chicago, Milwaukee and St. Paul* case the Court had apparently tied its own hands by stating that rates established by the legislature were reasonable. In the opinion of the writer the most practicable of all tests of reasonable return to be included up to this point chronologically is found in *Reagan v. Farmers' Loan & Trust Co.* Mr. Justice Brewer states that a rate of return should be based upon operating expenses and income, with a return above such operating expenses sufficient to pay the prevailing interest rate upon capital prudently invested. The top limit of the return was to be reasonableness—the right of the public was not to be prejudiced. Harlan in his decision relied upon Brewer's rule, but he attempted to amplify it further by asserting a test to be applied in eliminating capital imprudently invested. However, by some interpreters his words have been twisted into the late rule that the net return to a utility is based upon a certain percentage of its reproduction value. In the subsequent section of this paper we shall trace the development of the modern interpretation.

C. CASES SUBSEQUENT TO *Smyth v. Ames*

Surprisingly few of the cases following *Smyth v. Ames* actually cite that case, although the decision appears to have its influence. It seems to be in the background—like the Constitution of the United States. In the main

the decisions emphasize reproduction cost of the utility, ultimately arriving at the apex of the theory in *Southwestern Bell Telephone Co. v. Public Service Commission*,³³ wherein the theory of "spot" reproduction cost was enunciated. Under this theory present prices of material and labor are considered and an attempt is made to forecast the future and incorporate such prediction in the final valuation. In this case appears Mr. Justice Brandeis' strong dissent, attacking the *Smyth* rule. Thereafter, we find dissents and even the majority of the Court retreating from the position of the *Southwestern Bell Telephone Co.* case. In *Los Angeles Gas & Electric Corp. v. Railroad Commission*³⁴ the Court indicated that a valuation would not be thrown out because it was not based upon reproduction cost, but all that the Court would consider would be the primary problem under the Constitution as to whether or not there was deprivation of property without due process of law. Following this brief summary of the subsequent cases, we shall consider them in chronological order.

San Diego Land and Town Co. v. National City,³⁵ directly following *Smyth v. Ames*, is important because Mr. Justice Harlan herein explains his decision in *Smyth v. Ames*. In the *San Diego Land and Town Co.* case the judge was faced with the problem of determining the reasonableness of water rates, not the reasonableness of railway rates. The case is important for three contributions to the subject of valuation and rate-making: First, Harlan reaffirmed the right of the judiciary to interfere with a rate when it is unreasonable.

But it should also be remembered that the judiciary ought not to interfere with the collection of rates established under legislative sanction 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; that is, judicial interference should never occur unless the case presents, clearly and beyond all doubt, such a flagrant attack upon the rights of property under the guise of regulations as to compel the court to say that the rates prescribed will necessarily have the effect to deny just compensation for private property taken for the public use [citing cases].³⁶

Secondly, in explaining the part of his decision that has become known as the *Smyth* rule Harlan stated that it was a refutation of the plaintiff's contention that the plaintiff was entitled to operating expenses, interest on outstanding obligations, and dividends to stockholders. The judge said that they were not so entitled, but only to a reasonable return on the fair value of the property. He then reiterated his reason for stating the rule

³³ 262 U.S. 276 (1923).

³⁵ 174 U.S. 739 (1899).

³⁴ 289 U.S. 287 (1933).

³⁶ *Ibid.* at 754.

as he did, by asserting that under the plaintiff's contention the public might be compelled to pay interest on overcapitalization, inefficient management returns, and the like. However, with modern regulation of utility-accounting and capital structure, have not the objections which Harlan sought to remove been eliminated? The *Smyth* rule now stands as the inception of the present method of public utility valuation.

Thirdly, the *San Diego* case enunciated that

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.³⁷

Later cases ignore *Smyth v. Ames*, and quote the above portion of *San Diego Land Co. v. National City*.

Note that Mr. Justice Brewer three years subsequent to *Smyth v. Ames* summarized the decisions from *Munn v. Illinois* to the previous *San Diego* case, including *Smyth v. Ames*, and failed to discover that they included any test of reasonableness.

In the light of these quotations, this may be affirmed to be the present scope of the decisions of this court in respect to the power of the legislature in regulating rates: As to those individuals and corporations who have devoted their property to a use in which the public has an interest, although not engaged in a work of a confessedly public character, *there has been no further ruling than that the State may prescribe and enforce reasonable charges. What shall be the test of reasonableness in those charges is absolutely undisclosed.* (Italics added.)

The above words were written in *Cotting v. Kansas City Stock Yards Co.*,³⁸ wherein regulations fixing rates and affecting other matters pertaining to a particular stockyard company were held unconstitutional under the equal protection clause because of their limited application to one company.³⁹

In 1902 Mr. Justice Holmes was confronted with the reasonableness of a rate structure for a company which had made injudicious expenditures and had built its plant large for an anticipated future demand. The water company in *San Diego Land and Town Co. v. Jasper*,⁴⁰ did not obtain rates sufficiently high to enable them to maintain the larger plant. Holmes herein relied on the previous *San Diego* case, definitely discarded the theory of original cost, denied a return on the excess plant, and struggled with the concept of value. In quoting from the decision we find that Holmes said:

³⁷ Ibid. at 757.

³⁸ 183 U.S. 79, 91 (1901).

³⁹ The "value of service" rule was laid down in the *Cotting* case. Hale, op. cit. supra at 1129.

⁴⁰ 189 U.S. 439 (1903).

The main object of attack is the valuation of the plant. It no longer is open to dispute that under the Constitution "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."⁴¹

Thus we see the emphasis upon the *then* value of the plant.

In his dissertation upon value Holmes tries to reconcile the exchange concept of value in its application to a utility which will never be sold in the market. He says,

Of course it is hard to answer the proposition that value expressed in money depends on what people think at the time. That determines what they will give for the thing, and whether they think rightly or wrongly, if they or some of them will give a certain price for it, that is its value then. Nevertheless, it has been held, under some circumstances, even in ordinary suits, that when events have corrected the prophecy of the public, the facts may be shown and a more correct valuation adopted.⁴²

Inasmuch as subsequent cases will show that Holmes is out of sympathy with emphasis upon reproduction cost, he insists in the above case that the method of rate determination followed by the commission is none of the court's concern.

The two *San Diego* cases were followed in *Stanislaus County v. San Joaquin and King's River Canal and Irrigation Co.*⁴³ Mr. Justice Peckham in writing the opinion of the Court held that the company was not entitled to a return on the original value, for there had been original losses, caused by inefficiency and injudicious courses of action. The company sought a return of eighteen and one-half per cent on its original cost.

In *San Diego Land Company v. National City*, 174 U.S. 739, it was held, (following *Smyth v. Ames*, 169 U.S. 466, 543, 544,) that what the company was entitled to demand in order that it might have just compensation was a fair return upon the reasonable value of the property at the time it was being used for the public. The appellants in that case contended that in fixing what were just rates the court should take into consideration the cost of the plant and of its annual operation, the depreciation of the plant, and a fair profit to the company above its charges for its services. It was observed by the court that undoubtedly all these matters ought to be taken into consideration and such weight be given them, when rates are being fixed, as under all the circumstances would be just to the company and to the public. The same principle is reaffirmed in *San Diego Land etc. Company v. Jasper*, 189 U.S. 439, 442.

After taking such facts into consideration, the company might still be directed to receive rates that would be nothing more than a fair and just compensation or return upon the reasonable value of the property at the time it was being used for the supplying of the water to the public.

Much of the capital was invested between twenty and thirty years ago, and to be able still to realize six per cent upon the money originally invested is more than most

⁴¹ Ibid. at 442.

⁴² Ibid. at 444.

⁴³ 192 U.S. 201 (1904).

people are able to accomplish in any ordinary investment, and more than is necessary in order to give just compensation for property at the time it is used for the public purpose originally intended.⁴⁴

Thus, we observe that a return of six per cent upon an established industry is sufficient under the Constitution of the United States.

*City of Knoxville v. Knoxville Water Co.*⁴⁵ is important because it held that cost of reproduction in the valuation of property was acceptable, if depreciation was considered. This is the first case specifically endorsing cost of reproduction as a method of determining fair value. Further, the problem of including going-concern value was faced, but no decision made upon it. Stocks and bonds of the company were ignored in reaching the valuation figure, because the company was overcapitalized. The rule of *Smyth v. Ames* was not cited. The Court's emphasis upon expenses and income is noted in the fact that the rates of the commission were upheld on the ground that the company failed to introduce evidence in subsequent years of earnings, gross and net income, under the alleged confiscatory rates. There was indication that the company's earnings had increased although the property devoted to the use of the public had also increased.

*Willcox v. Consolidated Gas Co.*⁴⁶ reveals the judge's dissatisfaction with the "fair-value method" of rate-determination and his desire to rely upon an actual test operation under the proposed rates. He enunciates the possibility that lower rates would probably give greater returns.

The value of real estate and plant is to a considerable extent matter of opinion, and the same may be said of personal estate when not based upon the actual cost of material and construction. Deterioration of the value of the plant, mains, and pipes is also to some extent based upon opinion. All these matters make questions of value somewhat uncertain; while added to this is an alleged prospective loss of income from a reduced rate, a matter also of much uncertainty, depending upon the extent of the reduction and the probable increased consumption, and we have a problem as to the character of a rate which is difficult to answer without a practical test from actual operation of the rate. Of course, there may be cases where the rate is so low, upon any reasonable basis of valuation, that there can be no just doubt as to its confiscatory nature, and in that event there should be no hesitation in so deciding and in enjoining its enforcement without waiting for the damage which must inevitably accompany the operation of the business under the objectionable rate. But where the rate complained of shows in any event a very narrow line of division between possible confiscation and proper regulation, as based upon the value of the property found by the court below, and the division depends upon opinions as to value, which differ considerably among the witnesses, and also upon the results in the future of operating under the rate ob-

⁴⁴ *Ibid.* at 215, 216.

⁴⁵ 212 U.S. 1 (1909).

⁴⁶ 212 U.S. 19, 22 (1909).

jected to, so that the material fact of value is left in much doubt, a court of equity ought not to interfere by injunction before a fair trial has been made of continuing the business under that rate, and thus eliminating, as far as is possible, the doubt arising from opinions as opposed to facts.

There is no particular rate of compensation which must in all cases and in all parts of the country be regarded as sufficient for capital invested in business enterprises. Such compensation must depend greatly upon circumstances and locality; among other things, the amount of risk in the business is a most important factor, as well as the locality where the business is conducted and the rate expected and usually realized there upon investments of a somewhat similar nature with regard to the risk attending them. There may be other matters which in some cases might also be properly taken into account in determining the rate which an investor might properly expect or hope to receive and which he would be entitled to without legislative interference. The less risk, the less right to any unusual returns upon the investments. One who invests his money in a business of a somewhat hazardous character is very properly held to have the right to a larger return without legislative interference, than can be obtained from an investment in Government bonds or other perfectly safe security. . . .

In an investment in a gas company, such as complainant's, the risk is reduced almost to a minimum. . . . And, so far as it is given us to look into the future, it seems as certain as anything of such a nature can be, that the demand for gas will increase, and, at the reduced price, increase to a considerable extent. An interest in such a business is as near a safe and secure investment as can be imagined with regard to any private manufacturing business, although it is recognized at the same time that there is a possible element of risk, even in such a business.

The elevated railroads in New York when first built charged ten cents for each passenger, but when the rate was reduced to five cents it is common knowledge that the receipts were not cut in two, but that from increased patronage the earnings increased from year to year, and soon surpassed the highest sum ever received upon the ten cent rate.⁴⁷

Nowhere in the decision was the *Smyth* rule cited by the Court. No goodwill was allowed to the gas company, for a monopoly has no goodwill. However, the Court permitted the franchise to be included in the valuation figure where states allow the franchise to be capitalized. It must be placed in the valuation computation at such capitalization, not at an increased value.

*Lincoln Gas Co. v. Lincoln*⁴⁸ was practically a repetition of the *Knoxville Water Co.* case, for the Court upheld reconstruction value, then depreciation to date. The entire decision hinged upon the proper amount of depreciation. The *Smyth* rule was not cited; however, the rule of the *San Diego* case, that a company is entitled to a fair return upon the value of the property at the time of the inquiry, was quoted.

The Court assumed that cost of reconstruction equaled the then value.

⁴⁷ Ibid. at 42, 48, 49, 51.

⁴⁸ 223 U.S. 349 (1912).

Heretofore the cases had held that utilities were entitled to a fair return on their fair value. The *Smyth* case enumerated certain factors that were to be weighed in finding fair value. Reproduction cost was one of these factors. The *Knoxville* decision was an endorsement of reproduction cost as representing the fair value in that particular case. But in the *Lincoln Gas Co.* case the Court tends to treat fair value and cost of reconstruction as interchangeable.

Cost of reproduction and fair value are not identical. Cost is only one element in determining value. The cost of reproduction, less depreciation, of the leading hotel in a one-industry town after the industry has quit the town may be ten times the exchange value of the hotel property. Nevertheless, until the *Los Angeles Gas & Electric Co.* case the Court gives more and more weight to reproduction cost in determining fair value.

In the *Minnesota Rate Cases*⁴⁹ the Court for the first time applied the fair-value rule of the *San Diego* cases to a railway rate case. Under this decision land and railway rights of way should be valued at market value for normal purposes, not for railway uses. Operating property only was to be included in the fair value of the property, not stocks and bonds. Although the Court talked about fair value, the figures used by the Court in ascertaining fair value were computed upon the basis of reproduction cost. The Court indicated that to arrive at fair value this computation should be depreciated, for the property was not new. The two *San Diego* cases, the *Willcox* case, and *Smyth v. Ames* were cited. Since the decision explains the constitutional basis for the fair-value approach, that explanation will be included at this point.

It is clear that in ascertaining the present value we are not limited to the consideration of the amount of the actual investment. If that has been reckless or improvident, losses may be sustained which the community does not underwrite. As the company may not be protected in its actual investment, if the value of its property be plainly less, so the making of a just return for the use of the property involves the recognition of its fair value if it be more than its cost. The property is held in private ownership and it is that property, and not the original cost of it, of which the owner may not be deprived without due process of law. But still it is property employed in a public calling, subject to governmental regulation and while under the guise of such regulation it may not be confiscated, it is equally true that there is attached to its use the condition that charges to the public shall not be unreasonable. And where the inquiry is as to the fair value of the property, in order to determine the reasonableness of the return allowed by the rate-making power, it is not admissible to attribute to the property owned by the carriers a speculative increment of value, over the amount invested in it and beyond the value of similar property owned by others, solely by reason of the

⁴⁹ 230 U.S. 352 (1913).

fact that it is used in the public service. That would be to disregard the essential conditions of the public use, and to make the public use destructive of the public right.⁵⁰

Mr. Justice Hughes in the *Missouri Rate Cases*⁵¹ followed the decision in the *Minnesota Rate Cases*; however, he clarified the law upon one point, that the assessment figures were not acceptable as representing the utility's value without showing the method of appraisalment.

*San Joaquin Co. v. Stanislaus County*⁵² held that water rights of an irrigation company could be included in the valuation for rate-making purposes.

The *Knoxville Water Co.* case did not decide the issue as to whether or not going-concern value should be included in the rate base, although the problem was commented upon by the Court in its decision. This problem was resolved in favor of the utility in *Des Moines Gas Co. v. Des Moines*,⁵³ wherein the inclusion of going-concern value in the rate base was approved. In this latter decision the Court also halted the trend of the reproduction theory in its headlong dash towards absurdity, by stating that in the application of the reproduction theory the expense of taking up and putting down the pavement over the gas mains was not to be included in the rate base.

Denver v. Denver Union Water Co.,⁵⁴ followed the *Des Moines* case by holding that under the reproduction theory a utility should be valued as a business in use; in short, going-concern value should be included. Water rights were excluded in this particular case. The rule of the *San Joaquin Co.* case was limited by the refusal of the Court to pass on the question of whether or not water rights should be included in the rate base. Under the state law of Colorado they were excluded.

The inclusion of going-concern value in the rate base led to the decision in *Galveston Electric Co. v. Galveston*,⁵⁵ wherein a street railway company was not permitted to capitalize previous losses as a measure of going-concern and development cost value which would be included in the rate base.

The high-water mark of reproduction cost as a theory of valuation was reached in *Southwestern Bell Telephone Co. v. Public Service Commission*⁵⁶ wherein the theory of spot-reproduction cost was advocated.⁵⁷ Under this

⁵⁰ Ibid. at 454.

⁵¹ 230 U.S. 352, 474 (1913).

⁵² 233 U.S. 454 (1914).

⁵³ 238 U.S. 153 (1915).

⁵⁴ 246 U.S. 178 (1918).

⁵⁵ 258 U.S. 388 (1922).

⁵⁶ 262 U.S. 276 (1923).

⁵⁷ When the Court became reconciled to the proposition that reproduction cost should be considered in making its valuations, the further problem presented itself: reproduction cost

method not only are present prices considered but an attempt is made to forecast the future trend of prices, for the rate will be in effect in the future. Mr. Justice McReynolds writing the majority opinion says:

It is impossible to ascertain what will amount to a fair return upon properties devoted to public service without giving consideration to the cost of labor, supplies, etc., at the time the investigation is made. An honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances, is essential. If the highly important element of present costs is wholly disregarded such a forecast becomes impossible. Estimates for tomorrow cannot ignore prices of today.⁵⁸

In speaking of operating expenses the Court said that the commission must accept the operating expenses charged by the company, unless an abuse of discretion is shown.

Perhaps this case is more important for the dissent of Brandeis and Holmes. Unable to follow the Court to the extreme position of spot-reproduction cost, we find the first strong expression against *Smyth v. Ames* in these words:

The so-called rule of *Smyth v. Ames* is, in my opinion, legally and economically unsound. The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return. Thus, it sets the limit to the power of the State to regulate rates. The Constitution does not guarantee to the utility the opportunity to earn a return on the value of all items of property used by the utility, or of any of them. The several items of property constituting the utility, taken singly, and freed from the public use, may conceivably have an aggregate value greater than if the items are used in combination. The owner is at liberty, in the absence of controlling statutory provision, to withdraw his property from the public service; and, if he does so, may obtain for it exchange value. [Citing cases.] But so long as the specific items of property are employed by the utility, their exchange value is not of legal significance.

The investor agrees, by embarking capital in a utility, that its charges to the public shall be reasonable. His company is the substitute for the State in the performance of the public service; thus becoming a public servant. *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 therefore; the allowance for risk incurred; and enough more to attract capital.* The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more. But a rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined. [Italics added.]

at what price level? Should there be reproduction cost at the price level when the plant was originally constructed, at the price level of an arbitrary year, such as 1913, or spot reproduction cost at present prices, or should an attempt be made to forecast future prices and reproduce the plant at such forecasted prices?

⁵⁸ Ibid. at 287.

To decide whether a proposed rate is confiscatory, the tribunal must determine both what sum would be earned under it, and whether that sum would be a fair return. The decision involves ordinarily the making of four subsidiary ones:

1. What the gross earnings from operating the utility under the rate in controversy would be. (A prediction.)
2. What the operating expenses and charges, while so operating, would be. (A prediction.)
3. The rate-base, that is, what the amount is on which a return should be earned. (Under *Smyth v. Ames*, an opinion, largely.)
4. What rate of return should be deemed fair. (An opinion, largely.)

A decision that a rate is confiscatory (or compensatory) is thus the resultant of four subsidiary determinations. Each of the four involves forming a judgment, as distinguished from ascertaining facts. And as to each factor, there is usually room for difference in judgment. But the first two factors do not ordinarily present serious difficulties. The doubts and uncertainties incident to prophecy, which affect them, can, often, be resolved by a test period; and meanwhile protection may be afforded by giving a bond. [Citing cases.] The doubts and uncertainties incident to the last two factors can be eliminated, or lessened, only by redefining the rate base, called value, and the measure of fairness in return, now applied under the rule of *Smyth v. Ames*.⁵⁹

In the further expounding of his dissent Brandeis asserted that the rule of *Smyth v. Ames* was laid down for the use of the court in review and not for the commissions to use in determining the rate of return. Further, the rule was established before the issuance of securities was regulated as to-day,⁶⁰ and also before there were uniform depreciation and accounting systems.⁶¹ He finally pointed out that cases have come to hold that a reasonable rate was the minimum rate, not that a compensatory rate was the minimum.

Observe that Brandeis in the italicized excerpt of the dissent quoted asserts a rule similar to that introduced in the *Reagan* case; that is, the return should be sufficient to cover operating expenses⁶² plus interest on capital.⁶³ This is a compensatory rate. The top limit upon the rate charged

⁵⁹ Ibid. at 290-92.

⁶⁰ The regulation of operating companies under the Public Utility Holding Company Act is discussed by Meck and Cary in "Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935," 52 Harv. L. Rev. 216 (1938).

⁶¹ A Uniform System of Accounts for Telephone Companies was adopted in 1935 by the Federal Communications Commission. See *American Tel. & Tel. Co. v. United States*, 1929 U.S. 232 (1936); also *Wheat, The Regulation of Interstate Telephone Rates*, 51 Harv. L. Rev. 846 (1938); and *Cook, Abandoned Property and the Rate Base*, 17 The Accounting Review 243 (1942).

⁶² Approximately eighty cents out of every dollar paid by consumers for telephone service goes to pay operating expenses. *Wheat*, op. cit., p. 857.

⁶³ "... What we need are rates just high enough to insure that the public is continuously furnished with the utility services it needs at the minimum cost to itself. The 'prudent investment' theory, or the 'cost of reproduction' theory, or a rate-making theory that ignored valua-

by the utility would be a reasonable charge to the public. In elaborating upon his rule Brandeis shows that income and expense are the only factors in present-day rate determination that may be ascertained with any exactness. Subsequent discussion will further consider this position.

As if to bolster the reproduction theory of valuation, following the onslaught upon it by Brandeis and Holmes, Mr. Justice Butler in *Bluefield Water Works & Improvement Co. v. Public Service Commission*,⁶⁴ reaffirmed *Smyth v. Ames*, and stated that the reproduction theory must be considered in obtaining fair value. It is erroneous for the commission to fail to consider it. This decision was in the same volume as the *Southwestern Bell Telephone* case and held a return of six per cent on the fair value to be inadequate for a water company.

The ingenuity of the court was taxed to the utmost to uphold the "recapture clause" under the fair-value fiction of rate regulation established by *Smyth v. Ames*. Mr. Justice Taft in *Dayton-Goose Creek Ry. v. United States*⁶⁵ followed the letter of the rule and established a rate based upon the aggregate value of the railroads in the United States. Inasmuch as the *Minnesota Rate Cases* permitted the classification of railways, a rate being confiscatory as to one and not confiscatory as to another, the Court finally arrived at the conclusion that excess profits could be taken from the roads making great profits, thus reducing them to a reasonable rate for the particular road, and paying this excess to the weak roads. Although this plan strengthened the railways of the nation, it might have foundered on the proposition that any road which had such an excessive profit that it could contribute the surplus above a fair profit to a fund must certainly have customer rates too high, and thus be earning an unreasonable return—thus breaking the upper limit of the *Smyth* rule.⁶⁶

Mr. Justice Sutherland in *Ohio Utilities Co. v. Commission*,⁶⁷ merely added to the developing rule the norm that in reproduction cost organization expenses should be included. Proof of original expenditures, made in organizing the utility, would be helpful, but not indispensable. The repro-

tion altogether, must be judged not by its moral grandeur, nor by the elegance of its legal logic, but by the degree to which it promises to accomplish that end.

"The 'fairness' of utility rates depends entirely upon how they function. And from a functional viewpoint, what is needed is rates that will yield a return just sufficient to keep attracting the necessary new capital into utilities, but no higher." New York Times, editorial, Nov. 3, 1937.

⁶⁴ 262 U.S. 679 (1923).

⁶⁵ 263 U.S. 456 (1924).

⁶⁶ No shipper contested this case. However, Mr. Justice Taft pointed out on pp. 483-85 that the rates were reasonable as to the shippers, but unreasonable as to the particular roads.

⁶⁷ 267 U.S. 359 (1925).

duction-cost theory was assumed by the Court to be proper in determining fair value.

The position of the customer was clarified in *Board of Commissioners v. New York Telephone Co.*⁶⁸ In this case the argument was made that the customers had an interest in the profits made by the utility. However, the Court said:

Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses, or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company, just as does that purchased out of proceeds of its bonds and stock.⁶⁹

An injunction was sustained against the service commission prohibiting them from enforcing confiscatory rates. The test of a reasonable return on the value of the property used was applied. No mention was made of reproduction cost.

Spot-reproduction cost was again clarified by the Court in *McCardle v. Indianapolis Water Co.*⁷⁰ wherein Brandeis again dissented, but Butler reaffirmed the predominant theory of the Court in these words:

But in determining present value, consideration must be given to prices and wages prevailing at the time of the investigation; and, in the light of all the circumstances, there must be an honest and intelligent forecast as to probable prices and wage levels during a reasonable period in the immediate future. In every confiscation case, the future as well as the present must be regarded. It must be determined whether the rates complained of are yielding and will yield, over and above the amounts required to pay taxes and proper operating charges, a sum sufficient to constitute just compensation for the use of the property employed to furnish the service; that is, a reasonable rate of return on the value of the property at the time of the investigation and for a reasonable time in the immediate future.⁷¹

Note that Butler uses language similar to the phrases of the Brandeis and Holmes dissent of the *Southwestern Bell Telephone* case: rates should yield operating expenses, plus a sum sufficient to constitute just compensation for the use of the property employed in furnishing the service. This rule he then designates as a reasonable rate of return on the value of the property at the time of the investigation and for a reasonable time in the immediate future. However, query whether his two descriptions of the rule are the same? The latter explanation may not include the former, for if the

⁶⁸ 271 U.S. 23 (1926).

⁷⁰ 272 U.S. 400 (1926).

⁶⁹ Ibid. at 32.

⁷¹ Ibid. at 408.

plant represented an injudicious expenditure, a reasonable return on the property may not cover operating expenses.

The following quotation from the *McCardle* case is an excellent description of the manner in which the Court has turned from the rule of *Smyth v. Ames*, in which all factors were to be considered in placing a fair value upon a utility, to an endorsement of the reproduction-cost theory. The Court simply states that it is more in accord with good economics to value land at its present value, and therefore the utility should also be valued at its present cost of construction or reproduction cost, less reserves for depreciation.

It is well established that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the increase. The decision of this court in *Smyth v. Ames* . . . declares that to ascertain value "the present as compared with the original cost of construction" are, among other things, matters for consideration. But this does not mean that the original cost or the present cost or some figure arbitrarily chosen between these two is to be taken as the measure. The weight to be given to such cost figures and other items or classes of evidence is to be determined in the light of the facts of the case in hand. . . . Undoubtedly, the reasonable cost of a system of waterworks, well-planned and efficient for the public service, is good evidence of its value at the time of construction. And such actual cost will continue fairly well to measure the amount to be attributed to the physical elements of the property so long as there is no change in the level of applicable prices. And, as indicated by the report of the commission, it is true that, if the tendency or trend of prices is not definitely upward or downward and it does not appear probable that there will be a substantial change of prices, then the present value of lands plus the present cost of constructing the plant, less depreciation, if any, is a fair measure of the value of the physical elements of the property.⁷²

The theory of spot-reproduction cost has been again endorsed by the United States Supreme Court as a measure of fair value. Although water rights and going-concern value were included in the rate-base, the Court refused to take the next logical step on the path of reproduction cost. That is, it refused to sanction the theory of reproduction of service, which was advocated in this case, rather than reproduction of the physical plant in use.

The theory of reproduction cost as applied to the expense of depreciation was forced to its logical conclusion in *United Railways v. West*⁷³ wherein Sutherland held that in determining adequate rates for a public utility, the allowances for annual depreciation must be based upon present value, not upon original cost.⁷⁴ Although, this extension of the fiction of

⁷² *Ibid.* at 410-11.

⁷³ 280 U.S. 234 (1930).

⁷⁴ Original cost was approved by the Supreme Court in *United States v. Ludey*, 274 U.S. 295 (1927). Justice Brandeis in writing the opinion used the illustration of a gradual sale of the

reproduction cost is the reasonable development of the theory, it is out of line with the established practice of accountants who depreciate for the purpose of recovering their original investment. Under this ruling of the Court, all capital asset and reserve accounts would be continually fluctuating.

Sutherland, in speaking for the majority of the Court in the *West* case, while discussing the rate of return to be allowed the utility, said:

It is manifest that just compensation for a utility, requiring for efficient public service skillful and prudent management as well as use of the plant, and whose rates are subject to public regulation, is more than current interest on mere investment. Sound business management requires that after paying all expenses of operation, setting aside the necessary sums for depreciation, payment of interest and reasonable dividends, there should still remain something to be passed to the surplus account; and a rate of return which does not admit of that being done is not sufficient to assure confidence in the financial soundness of the utility to maintain its credit and enable it to raise money necessary for the proper discharge of its public duties.⁷⁵

Sutherland in this case introduces the idea of guaranteed stock, when discussing the rate of return. Note that he appears to have the same idea as the attorneys for the railroads in the *Smyth* case. There is no upper limit of reasonableness to the rule, such as was applied in the *Smyth* case.

The high-water mark has been reached for the reproduction-cost theory of utility valuation. Henceforth, the cases stress confiscation under the due process clause, and do not throw out the regulations because they did not give enough weight to a particular theory of valuation. In the first of these cases there appears to be a return to the broad language of *Smyth v. Ames*, a statement that the method of valuation to be given most weight depends upon the facts of the particular case.⁷⁶ Chief Justice

plant being made. Note that when he also wrote the dissent discussing depreciation in *United Railways & Electric Co. v. West*, 280 U.S. 234 (1930) he did not mention this approach.

The *West* case endorsed reproduction cost as the proper basis for depreciation. This doctrine was partially repudiated by *Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151 (1934). It has been argued that the *Lindheimer* case by implication reversed the *West* case and made original cost the only acceptable basis for the depreciation calculation. See Mason, *Recent Trends in Depreciation Decisions*, 14 *The Accounting Review* 1, 4 (1939).

It is a well-known fact that many public service commissions sanction one amount of depreciation to be written off through expenses and accumulated to the reserve, and another amount when computing the depreciated value of a utility for rate-base purposes. Krebs, *Public-Utility Depreciation in its Relation to the Rate Base*, 14 *The Accounting Review* 95 (1939); Braunstein and Johnson, *Public Utility Depreciation and the Income Tax*, 52 *Harv. L. Rev.* 1077, 1085 (1939).

⁷⁵ 280 U.S. at 251.

⁷⁶ This position has been repeatedly asserted by the courts throughout the previous cases, but no reliance had been placed upon these words until the *Los Angeles* case. Inserted in every case, they constitute a convenient means for the court to back away from any untenable position.

Hughes in *Los Angeles Gas & Electric Corp. v. Railroad Commission*⁷⁷ states that

Judicial ascertainment of value for the purpose of deciding whether rates are confiscatory "is not a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts." [Citing cases.]

The actual cost of the property—the investment the owners have made—is a relevant fact. . . . But while cost must be considered, the Court has held that it is not an exclusive or final test. . . . The weight to be given to actual cost, . . . and to cost of reproduction new is to be determined in the light of the facts of the particular case.⁷⁸

The history of this *Los Angeles* case reveals that the valuation of the California commission based upon prudent investment was upheld in this decision. The Court did not undertake to approve or disapprove a method of valuation so long as there was no confiscation of property.

Butler in his dissent indicated that the Court should have given weight to the theory of reproduction cost.

In *West Ohio Gas Co. v. Public Utilities Commission*,⁷⁹ the Court was concerned with the inclusion of certain items among the operating expenses of the utility. The Court indicated that the books of the company were presumptively correct for purposes of computing operating expenses. The facts of the case showed that the utility commission in fixing the rates used the company's financial statements and books as a basis. These reports of the company were not put into evidence, and the company was allowed no opportunity to secure a rate adjustment or reallocatur. The Court said that, "In computing the operating expenses of a gas-distributing company, in the process of fixing its rates, the company's books are presumptively correct."⁸⁰

Our inquiry in rate cases coming here from the state courts is whether the action of the state officials in the totality of its consequences is consistent with the enjoyment by the regulated utility of a revenue something higher than the line of confiscation. If this level is attained, and attained with suitable opportunity through evidence and argument . . . to challenge the result, there is no denial of due process, though the proceeding is shot through with irregularity or error. But the weakness of the case for the appellee is that the fundamentals of a fair hearing were not conceded to the company. Opportunity did not exist to supplement or explain the annual reports as to the distribution of the expenses in the neighboring communities, nor did opportunity exist to bring the rates outside of Lima into harmony with the exigencies of a new method of allocation adopted without warning.⁸¹

⁷⁷ 289 U.S. 287 (1933).

⁷⁸ *Ibid.* at 306, 308.

⁸⁰ *Ibid.*, headnotes, para. 1, referring to opinion, p. 67.

⁷⁹ 294 U.S. 63 (1935).

⁸¹ *Ibid.*

The above position was reaffirmed in *West v. Chesapeake & Potomac Telephone Co. of Baltimore*⁸² wherein the Court said that the function of the federal court was confined to the prevention of confiscation; legislative findings were not to be set aside for errors of procedure. The *Los Angeles* case is endorsed,⁸³ but then delimited by the statement that although the commission erred in failing to consider certain elements, nevertheless other allowances neutralized the possible errors. But Mr. Justice Stone in his dissent denies that the Court passed upon the question of confiscation in its opinion, and contends that the majority of the Court held the price-index theory unconstitutional because it was not the proper method, not because it confiscated property without due process of law. The decision blasted the price-index theory of valuation advocated by certain economists. Mr. Justice Roberts, writing for the majority, indicated that the price indices used by the commission were improper. The commission used the low indices of 1932, and then projected them into a future of rising prices. The appraisal by a lower court, using book values less depreciation reserves, was also deemed to be arbitrary and erroneous. Note that in this pronouncement of the Court price-indices were not condemned; the method used in applying price-indices to this particular case was not sanctioned by the Court. There appears to be a definite swing back towards the language of the cases preceding *Smyth v. Ames*, when there was no definite test or method of ascertaining whether or not a rate was reasonable, but there was merely reliance upon the mind of the court to decide whether a particular set of regulations constituted confiscation on the facts considered by the judge in his own approach to the problem.

A California case again came before the Court in *Railroad Commission v. Pacific Gas & Electric Co.*,⁸⁴ where, in referring to procedural due process, it is said:

When the rate-making agency of the state gives a fair hearing, receives and considers the competent evidence that is offered, affords opportunity through evidence and argument to challenge the result, and makes its determination upon evidence and not arbitrarily, the requirements of procedural due process are met, and the question that remains for this Court, or a lower federal court, is not as to the mere correctness of the method and reasoning adopted by the regulating agency but whether the rates it fixes will result in confiscation.⁸⁵

The Court restates its present position:

There is no principle of due process which requires the rate-making body to base its decision as to value, or anything else, upon conjectural and unsatisfactory estimates. We have had frequent occasion to reject such estimates. . . .

⁸² 295 U.S. 662 (1935).

⁸³ At 674.

⁸⁴ 302 U.S. 388 (1938).

⁸⁵ *Ibid.* at 393-94.

While the Court has frequently declared that "in order to determine present value, the cost of reproducing the property is a relevant fact which should have appropriate consideration," we have been careful to point out that "the court has not decided that the cost of reproduction furnishes an exclusive test" and in that relation we have "emphasized the danger in resting conclusions upon estimates of a conjectural character."⁸⁶

The Texas commission in *United Gas Public Service Co. v. State of Texas*⁸⁷ used expenses and income for the past four years in setting a rate. This method was approved by the Court. In line with the *Los Angeles* case the Court said that it merely checks for confiscation. Although the commission relied chiefly upon operating expenses and income over a four-year period in the past, it indicated in its report that it also found the fair value of the property, thus doing homage to *Smyth v. Ames*.

At this point *Smyth v. Ames* is still the law of the Court, but reproduction cost as a dominant element in determining the rate base has been superseded by other methods, where it can be shown that such other methods do not deprive the utility of its property without due process of law. To eliminate the ineffectiveness of fixing rates upon the valuation principle, New York has introduced the system of temporary rates, which will be in force until rates can be properly fixed under the present requirements of the law. These rates are not based upon any valuation method. Pennsylvania copied the New York law, and provided that such temporary rates should be based upon the original cost of the property, less depreciation as shown on the company's books, but, if these records were not available, then upon the income for 1935 or such subsequent year as the commission should deem proper. When the rates were finally established, any loss that the utility incurred under the temporary rates should be recouped under the regularly established rates. This method of rate-making was held in accord with *Smyth v. Ames* by Mr. Justice Reed in *Driscoll v. Edison Light & Power Co.*⁸⁸ He found that the commission had considered all of the elements of *Smyth v. Ames*, although their report did not expressly so state. The rate of six per cent was ample, and there was no confiscation. Justices Frankfurter and Black soundly criticized the rule of *Smyth v. Ames* in their concurrence:

Smyth v. Ames should certainly not be invoked when it is not necessary to do so. The statute under which the present case arose represents an effort to escape *Smyth v. Ames* at least as to temporary rates. It is the result of conscientious and informed endeavor to meet difficulties engendered by legal doctrines which have been widely re-

⁸⁶ *Ibid.* at 397-98.

⁸⁷ 303 U.S. 123 (1938).

⁸⁸ 307 U.S. 104 (1939).

jected by the great weight of economic opinion, by authoritative legislative investigations, by utility commissions throughout the country, and by impressive judicial dissents. As a result of this long process of experience and reflection, the two states in which utilities play the biggest financial part—New York and Pennsylvania—have evolved the so-called recoupment scheme for temporary rate-fixing (thereby avoiding some of the most wasteful aspects of rate litigation) as a fair means of accommodating public and private interests. It is a carefully guarded device for securing "a judgment from experience as against a judgment from speculation," *Tanner v. Little*, 240 U.S. 369, 386, in dealing with a problem of such elusive economic complexity as the determination of what return will be sufficient to attract capital in the special setting of a particular industry and at the same time be fair to the public dependent on such enterprise.⁸⁹

The most recent case, *Federal Power Commission v. Natural Gas Pipeline Co.*,⁹⁰ decided in March, 1942, follows the trend enunciated in the *Los Angeles* case. Mr. Chief Justice Stone, writing the opinion for the majority of the Court, amplifies the holding of the *Los Angeles* case in the following words:

The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end.⁹¹

Stress here is also placed upon the procedural aspect of due process, and there would appear to be an implication of a return to the cases prior to *Chicago, Milwaukee and St. Paul Ry. Co. v. Minnesota*,⁹² in which case the courts assumed the responsibility of determining what constituted a reasonable charge under the due process clause. Prior to 1890 the reasonableness of the charge and the determination of a fair return were left in the hands of the legislature.

However, the broad effect of the words of the majority of the Court is limited by the facts of the case. The *Los Angeles* decision and *Railroad Commission v. Pacific Gas & Electric Co.* involved methods of rate-determination other than reproduction cost and such methods were sustained. In the instant *Pipeline* case the commission and the company used reproduction cost, but the chief point of contention was the inclusion of going-concern value. The Court denied the right to include going-concern

⁸⁹ Ibid. at 123.

⁹¹ Ibid. at 743.

⁹² 315 U.S. 575.

⁹³ 134 U.S. 418 (1890).

value in that the reproduction-value allowance by the commission was particularly generous and was sufficient to include a sum for going-concern value within the reproduction-cost figure. Further, the company had already written off through operating expenses, the losses originally incurred, which losses would be used as a basis for determining going-concern value. The Court in writing its decision showed a grasp of accounting principles and fundamentals. Inasmuch as a natural-gas company was involved, and its supply of gas would be exhausted at the expiration of a certain number of years, charges for depletion had to be made. Therefore, this case is noteworthy because it exemplifies the treatment of a fair return to a wasting-asset concern in the public utility field.

Another peculiar aspect of the case which should be pointed out is that the Natural Gas Pipeline Company was formed and controlled by retail gas companies in the Chicago area. The Natural Gas Pipeline Company sold the gas at wholesale to the retail companies. In the main, the owners and consumers were identical, and therefore the company raised the issue that its charges could not be unreasonable to the consumers, because the ultimate public consumer did not deal with the company. This argument was brushed aside by the Court by simply indicating that the return was too high above its reproduction value even after depletion charges had been made.

Just as the *Driscoll* case is outstanding among critics of the *Smyth* rule because of Justices Frankfurter's and Black's concurring opinion, so the *Natural Gas Pipeline Co.* case is important for the concurring opinion of Justices Black, Douglas, and Murphy. To the writer of this paper the opinion is noteworthy because it attempts to tie up the price-fixing cases with the field of public utility rate-determination. In the concurrence the argument is made that rate-determination is merely a form of price-fixing. This paper seeks to show that such transition from the public utility cases decided under *Smyth v. Ames* to the position of a reasonable price or return under the price-fixing cases is feasible and reasonable. But this broad approach is not strongly advocated by the concurring Justices. In the latter half of their decision they return to an analysis of the majority opinion, stating that in their reading of the majority opinion the Federal Power Commission may now adopt the prudent-investment theory if it so desires. This statement has caused certain writers to feel that the next step in the trend away from *Smyth v. Ames* will be the adoption of prudent investment.⁹³ The present writer feels that although prudent investment may be sanctioned under certain conditions, the trend of the Court makes

⁹³ Hale, op. cit. supra note 3; Bauer, op. cit. supra note 3.

it practicable to make a cleaner break with the principles of *Smyth v. Ames* than is possible under the prudent-investment theory. Prudent investment is similar to original cost and reproduction cost in that the fair return is based upon a rate base. The differences among the three methods lies in the method of determining the rate base. Since the rate-base approach is not followed in price-fixing for nonutility cases, the query is raised as to why the methods used in those decisions would not be applicable to utility cases.

The foregoing pages have indicated that in its treatment of rate-determination by utility commissions the Court has moved from the case of *Chicago, Milwaukee and St. Paul Ry. Co. v. Minnesota*, in 1890, wherein it first assumed the power to pass upon whether or not a rate established by the legislature violated the due process clause of the Fourteenth Amendment, back to a position similar to the declarations of that case. Intervening cases sought to find a definite test for a reasonable rate. *Smyth v. Ames* laid down a rule of multiple factors to determine present value, but did not indicate the weight that was to be given to them. Subsequently, the Court held that more weight should be given to reproduction cost than to the other elements. A series of cases developed the theory of reproduction cost, stating that depreciation should be deducted,⁹⁴ goodwill excluded,⁹⁵ franchises included at original capitalized value, if the state permitted,⁹⁶ going-concern value included,⁹⁷ water rights included,⁹⁸ land included at present value,⁹⁹ cost of tearing up and putting down pavement excluded¹⁰⁰—comprising a very formidable structure, becoming more and more divorced from actual conditions. The *Los Angeles* case in 1933 represented a turning point. Perhaps other writers may point out that the Court turned from stressing the theory of reproduction cost because the price level had declined and the reproduction cost would now be low;¹⁰¹ and that, therefore, the Court merely spoke vaguely about a

⁹⁴ *City of Knoxville v. Knoxville Water Co.*, 212 U.S. 1 (1909).

⁹⁵ *Willcox v. Consolidated Gas Co.*, 212 U.S. 19, 42 (1909).

⁹⁶ *Ibid.*

⁹⁷ *Des Moines Gas Co. v. Des Moines*, 238 U.S. 153, 165 (1915).

⁹⁸ *San Joaquin Co. v. Stanislaus County*, 233 U.S. 454 (1914).

⁹⁹ *Minnesota Rate Cases*, 230 U.S. 352 (1913).

¹⁰⁰ *Des Moines Gas Co. v. Des Moines*, 238 U.S. 153 (1915).

¹⁰¹ The writer of the note in 51 Harv. L. Rev. 885 (1938) discussed *Railroad Commission v. Pacific Gas & Electric Co.* and seems to feel that the lack of emphasis upon reproduction cost in this case is a reflection of the change in price level. In a period of high prices, reproduction cost was stressed; in a period of low prices, prudent investment.

deprivation of property under the due process clause and did not sanction any particular method of valuation. This position sounded back beyond *Smyth v. Ames*. The words of the *Los Angeles* case have been reiterated in subsequent cases which have thrown out price-indices as a method of ascertaining the value of a utility, and sanctioned a method of rate determination not based upon valuation, but upon operating expenses and income. The failure to uphold a method based upon a certain percentage of the value of the property used in the utility, whether such valuation be made on the basis of reproduction cost, original cost, or prudent investment, indicates that the Court has gone back in its history to the time of the *Railroad Commission Cases*, where it spoke in simple terms of the taking of private property without due process of law. The concurring opinion in the *Natural Gas Pipeline Co.* case now directs the attention of the courts to a new course of legal thought; that is, the application of the reasonable charge approach of the price-fixing cases to rate-determination for utilities.

PART II

The words of the Court are now on a parallel with another group of cases under the due process clause of the Fourteenth Amendment—the price-fixing decisions. The Court sanctions no method of price-fixing for the cases that come before it; likewise, it now sanctions no method of rate-determination for the utility cases that pass over its bench. Undoubtedly, the line of reasoning in the non-utility group could be applied to the facts of the utility group. The growth of price-fixing in competitive industry is illustrated by the chronological consideration of the important cases in that field.

During the World War I years of 1917-18 there were several attempts to fix prices, which were upheld under the emergency existing at that time. They were sanctioned because they were obviously temporary. *Highland v. Russell Car Co.*¹⁰² belonged to that group, and it is important because of the matters considered by the President in fixing the price of coal. Under the Lever Act, Section 25, the President fixed the price of coal as follows:

The basis prescribed for the determination of prices to be charged by producers of coal was the cost of production, including the expense of operation, maintenance, depreciation and depletion, plus a just and reasonable profit. And prices to be charged by dealers were to be made by adding to their cost a just and reasonable sum for profit.¹⁰³

Note that this is similar to the operating expenses and income rule advocated at various times through the utility cases.

¹⁰² 279 U.S. 253 (1929).

¹⁰³ *Ibid.* at 259.

The "milk cases" of *Nebbia v. New York*¹⁰⁴ and *Hegeman Farms Corp. v. Baldwin*¹⁰⁵ sanctioned the establishment of a minimum price for milk by the local milk control boards. This minimum price was based upon data secured by the milk control board's investigation of the milk market throughout the state and what the producer and milk dealer required for a reasonable return. A fair price was then established.

The Supreme Court in the *Nebbia* case upheld such price regulation, so long as it was not "arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty."¹⁰⁶ The state statute gave the milk control board the power to fix both the minimum and the maximum prices, although the issue of litigation centered around the minimum price aspect of the act. But this case is equally important because the Court recognizes that there is no closed class of businesses affected with a public interest. Therefore, it would be logical to apply the reasoning of the utility decisions and the non-utility decisions interchangeably.

However, in the *Hegeman Farms* case the Court seemed to feel that there was a difference between the utility and the non-utility cases, for it implied that it could only fix a minimum price for milk, not a maximum price, indicating that only for public utilities might it fix a maximum return.

If the designation of a minimum price is within the scope of the police power, expenses or losses made necessary thereby must be borne as an incident, unless the order goes so far beyond the needs of the occasion as to be turned into an act of tyranny. Nothing of the kind is charged. The Fourteenth Amendment does not protect a business against the hazards of competition. . . . It is from hazards of that order, and not from restraints of law capriciously imposed, that the appellant seeks relief. The refuge from its ills is not in constitutional immunities.

Much is made of a supposed analogy between the plight in which the appellant finds itself and that of public utilities subjected to maximum rates that do not yield a fair return. But the analogy, when scrutinized, is seen to be unreal. A public utility in such circumstances has no outlet of escape. If it is running its business with reasonable economy, it must break the law or bleed to death. But that is not the alternative offered where the law prescribes a minimum. An outlet is then available to the regulated business, an outlet that presumably will be utilized whenever use becomes expedient.¹⁰⁷

The Court here indicates that a business operating under a minimum price is not similar to a public utility, for it can raise its price. However, practical economists might not agree with this proposition; the individual business may be in as much of a strait-jacket as the public utility.

¹⁰⁴ 291 U.S. 502 (1934).

¹⁰⁶ 291 U.S. at 539 (1934).

¹⁰⁵ 293 U.S. 163 (1934).

¹⁰⁷ 293 U.S. at 170-71 (1934).

Mr. Justice Cardozo was compelled to make the above contrast with the utility cases when the plaintiff, in line with the *Nebbia* case, attempted to apply the reasoning of the utility cases to his factual situation. He argued that he was entitled to a fair return on the value of his property, less depreciation, and that the minimum prices established did not give him such a return. Cardozo pointed out that there was no indication that the plaintiff ran his business efficiently.

Mr. Justice Cardozo's reasoning would appear to delimit the *Nebbia* decision in two respects: (1) The distinction between utility and non-utility cases is reaffirmed in the face of the denial in the *Nebbia* case that such a distinction any longer exists. (2) Cardozo implies that his reasoning would have been different if the fixing of maximum prices had been at issue. Note that the statute in the *Nebbia* case also provided for the fixing of maximum prices. How seriously the Court regarded Cardozo's above limitations of the *Nebbia* case is exemplified in the subsequent *Highland Farms* and *Townsend* decisions wherein the fixing of maximum prices by the state in non-utility cases was again approved.

In the next "milk case" the control board fixed both the minimum and maximum prices for milk. This was approved in *Highland Farms Dairy v. Agnew*.¹⁰⁸ Thus we see the milk industry treated much like a utility. Although the case hinged upon the license requirements of the act the Court in stating the considerations that the control board should weigh in fixing the prices said:

The commission shall be guided by the cost of production and distribution, including compliance with all sanitary regulations in force in such market or markets, necessary operation, processing, storage and delivery charges, the price of other foods, and the welfare of the general public.¹⁰⁹

Costs appear to be the fundamental consideration here in determining price, limited by the general welfare of the public.

Maximum price-fixing for tobacco warehouses was upheld in *Townsend v. Yeomans*.¹¹⁰ Such price-fixing by the Georgia statute was not deprivation of property without due process of law.

One of the more recent price-fixing cases that was declared to be constitutional was *Publix Cleaners v. Florida Dry Cleaning & Laundry Board*,¹¹¹ wherein minimum price-fixing was sanctioned by the Court. The plaintiff contended that the statute deprived him of his "liberty" to charge less. In writing this opinion the *Nebbia* case was cited.

¹⁰⁸ 300 U.S. 608 (1937).

¹¹⁰ 301 U.S. 441 (1937).

¹⁰⁹ *Ibid.* at 615.

¹¹¹ 32 F. Supp. 31 (S.D. Fla. 1940).

Price-fixing by the federal government was sanctioned under the emergency existing at the time of World War I. Price-fixing during peacetime as applied to non-utilities is exercised under the commerce power.¹¹² As early as 1923 the Court in *Board of Trade of Chicago v. Olsen*¹¹³ introduced the correlation between the price of goods moving in interstate commerce and federal power thereover. In the *Olsen* case the federal government regulated the sale of grain futures on the theory that the manipulation of grain futures affected the price of grain moving in interstate commerce, and thus constituted a burden on such commerce.

However, the federal government first entered the field of peacetime price-fixing in *United States v. Rock Royal Co-operative, Inc.*¹¹⁴ in which a federal statute authorized the Secretary of Agriculture to fix minimum prices to be paid producers for milk sold to dealers. The Court might have used the reasoning of the *Currin* and *Olsen* cases asserting that price-fixing was essential in order to eliminate restrictions on interstate commerce, but excerpts from the decision written by Mr. Justice Reed do not indicate such reasoning, although the act itself is based upon the burden theory:

The Act authorizes and the Order undertakes the fixing of minimum prices for the purchase of milk "in the current of interstate or foreign commerce, or which directly burdens, obstructs, or affects, interstate or foreign commerce" in milk.¹¹⁵

After stating that "where commodities are bought for use beyond state lines, the sale is a part of interstate commerce."¹¹⁶ Reed includes local milk under the federal regulation in the following sentence:

Where local and foreign milk alike are drawn into a general plan for protecting the interstate commerce in the commodity from the interferences, burdens and obstructions, arising from excessive surplus and the social and sanitary evils of low values, the power of the Congress extends also to the local sales.¹¹⁷

Then on the argument of analogy the opinion justifies federal control over price-fixing in the milk field by stating that its control should be equal to that of the states within the field.

The authority of the Federal Government over interstate commerce does not differ in extent or character from that retained by the states over intrastate commerce. Since *Munn v. Illinois*, this Court has had occasion repeatedly to give consideration to the

¹¹² In *Currin v. Wallace*, 306 U.S. 1 (1939), the establishment of inspection standards for tobacco moving in intrastate and interstate commerce when sold at designated "federal" markets, was upheld as a constitutional exercise of the commerce power, for lack of uniform standards in the tobacco market deflated the *price* of tobacco in interstate commerce.

¹¹³ 262 U.S. 1.

¹¹⁴ 307 U.S. 533 (1939).

¹¹⁵ *Ibid.* at 568.

¹¹⁶ *Ibid.* at 568-69.

¹¹⁷ *Ibid.* at 569.

action of states in regulating prices. Recently, upon a re-examination of the grounds of state power over prices, that power was phrased by this Court to mean that "upon proper occasion and by appropriate measures the state may regulate a business in any of its aspects, including the prices to be charged for the products or commodities it sells."¹¹⁸

Observe that the price-fixing power of the states is based upon the police power as limited by the due process clause of the Fourteenth Amendment, while the similar power of the federal government is derived from the commerce power. There is no hint of its limitation by the due process clause of the Fifth Amendment in the above quotation from the decision, but simply the statement that inasmuch as the states exercise the power, the federal government should also possess it. At this point in the historical analysis of the cases the due process clause of the Fifth Amendment has not yet become a formidable limitation upon the commerce power, for its existence as a limitation is not specifically admitted in the above decision.

*Sunshine Anthracite Coal Co. v. Adkins*¹¹⁹ is the latest case in the field of federal price-fixing. It further clarifies the position assumed by the Court in the *Rock Royal Co-operative* case, in that it specifically mentions the Fifth Amendment as a possible limitation upon the exercise of the price-fixing power under the commerce clause. The case involved a federal statute authorizing the bituminous coal commission to fix *maximum* and *minimum* prices for bituminous coal.

Mr. Justice Douglas in writing the opinion of the Court does not refer to the *Curran* and *Olsen* cases to show that the regulation of price is the regulation of commerce itself, but refers to Cardozo's dissent in *Carter v. Carter Coal Co.*¹²⁰ "To regulate the price for such transactions is to regulate commerce itself, and not alone its antecedent conditions or its ultimate consequences."¹²¹

Although the due process clause of the Fifth Amendment was not mentioned in the *Rock Royal Co-operative* case, the *Sunshine Coal Co.* case cites the former decision as authority for federal price-fixing under the Fifth Amendment.

Nor does the Act violate the Fifth Amendment. Price control is one of the means available to the states . . . and to the Congress . . . in their respective domains . . . for the protection and promotion of the welfare of the economy.¹²²

¹¹⁸ Ibid. at 569-70.

¹¹⁹ 310 U.S. 381 (1940).

¹²¹ Op. cit. 394.

¹²⁰ 298 U.S. 238, 326.

¹²² Op. cit. 394.

To a Court which appears to be moving away from the rate-base approach in the fixing of utility rates,¹²³ and in the direction of the method or methods used in the price-fixing cases, the method of fixing prices for bituminous coal outlined in the *Sunshine Coal Co.* decision might prove to be disconcerting, for the utility terminology of "a fair return on the fair value of the property" is used. However, this opinion preceded the decision in the *Natural Gas Pipeline Co.* case, in which the trend towards the price-fixing cases was noted, and, therefore, the fair-value approach as advocated in this price-fixing case is limited by the later decision. Nevertheless, this writer, who is advocating the application of the reasonable-charge approach of the price-fixing cases to public utility rate-determination in place of the present rate-base theories, may be considerably embarrassed if the price-fixing cases should adopt the rate-base methods of the utility cases! The method of price-fixing outlined by the Court in the *Sunshine Coal Co.* case follows:

Nor does the Act contain an invalid delegation of legislative power. Under § 4, II (c) the Commission may fix maximum prices when in the public interest it deems it necessary in order to protect the consumer against unreasonably high prices. These maximum prices must be fixed at a uniform increase above minimum prices so that in the aggregate they will yield a reasonable return above the weighted average total cost of the district. *And no maximum price shall be established for any mine which will not yield a fair return on the fair value of the property.* The minimum prices to be fixed must conform to the following standards: the weighted average cost for each minimum price area must be computed, the elements of cost being defined; a classification of the various sizes and grades of coal shall be made which reflects as nearly as possible the relative market value of the various kinds, qualities, and sizes of coal, which is just and equitable as between producers within the district and which has due regard to the interests of the consuming public; and coordinated minimum prices shall be established for such coal (a) which reflect as nearly as possible the relative market values at points of delivery taking into account specifically enumerated factors, (b) which preserve as nearly as may be existing fair competitive opportunities, (c) which are just and equitable as between the districts, and (d) which, consistently with the process of coordination, yield a return to each area approximating its weighted average cost per ton. (Italics added.)¹²⁴

In each of the previous price-fixing cases, either in the domain of the state or the federal powers, the *method* of price-fixing has been upheld. At this date in the development of principles applicable to price-fixing by governmental bodies, the method of determining a fair maximum or minimum price has not been questioned by the courts under either of the due

¹²³ Note previous discussion of Los Angeles case and decisions subsequent thereto in first part of this paper.

¹²⁴ Op. cit. 397.

process clauses, but in utility cases the primary point at issue has been the method of determining a fair return on the fair value of the used and useful property. The future may find more litigation over the methods of price-fixing laid down by legislative bodies. An attack against the state methods of fixing prices may come under either the due process clause of the Fourteenth Amendment or the equal protection clause of the same amendment. On the other hand, since there is no equal protection clause applicable to the federal government, the due process clause of the Fifth Amendment would seem to be the only recourse at present in an assault upon federal price-fixing methods.

A summary of the price-fixing cases within the domain of the states indicates that under their police power the states may fix both maximum and minimum prices, limited only by the due process clause of the Fourteenth Amendment. The above principle is now firmly established; and likewise all methods of price-fixing have been upheld as constitutional. In the main these methods are based upon costs, competitive factors, and all pertinent economic data.

Price-fixing by the federal government is possible either under the emergency powers available to the government during periods of war, or under the commerce clause. The latter may be limited by the due process clause of the Fifth Amendment, but at this date no such limitation has been applied either to the principle or to the method of price-fixing. Both minimum and maximum prices have been regulated. The extent of federal price-determining power is stated in *Sunshine Coal Co. v. Adkins*¹²⁵ as follows:

Congress under the commerce clause is not impotent to deal with what it may consider to be dire consequences of laissez-faire. It is not powerless to take steps in mitigation of what in its judgment are abuses of cut-throat competition. And it is not limited in its choice between unrestrained self-regulation on the one hand and rigid prohibitions on the other. The commerce clause empowers it to undertake stabilization of an interstate industry through a process of price-fixing which safeguards the public interest by placing price control in the hands of its administrative representative.

CONCLUSION

Prior to July 28, 1868, on which date Secretary of State Seward certified that the Fourteenth Amendment became a part of the Constitution of the United States, it was not thought that statutes regulating the use of property deprived a person of his property without due process of law. *Munn v. Illinois* in 1876, eight years after the enactment of the Four-

¹²⁵ Op. cit. 396.

teenth Amendment, assumed that government regulation of business would be a deprivation of property without due process of law. The social good and economic welfare made the regulation of certain business enterprises necessary. Mr. Chief Justice Waite, in an effort to circumvent the belief that the due process clause forbade the government regulation of business, created a group of business enterprises which were without the prohibition of non-governmental regulation; this group consisted of those enterprises affected with the public interest. Rate-determination¹²⁶ and price-fixing¹²⁷ were allowed only where the business had become affected with the public interest.

Because of the monopoly characteristics of the public utility, some form of rate-regulation was more urgently required than in the competitive enterprises, where the forces of competition tended to keep the prices at reasonable levels. Therefore, from the time of *Munn v. Illinois*, the power of the state to fix rates for enterprises affected with the public interest has never been seriously doubted. Over this span of sixty-odd years the Court has found it necessary to acknowledge that rate-regulation was constitutional, so long as the rates were not confiscatory. A method of determining when a rate is confiscatory was outlined in *Smyth v. Ames*, and is based upon a fair return upon the fair value of the property. This guarantee of a fair return on a rate base is not a direct approach to the rate that the residential consumer will pay for the use of electric current. It is an indirect approach, stating that a utility is entitled to a certain over-all net income, the individual rates for residential, commercial, and industrial users are then fixed to yield actual net income before interest to bondholders and dividends to stockholders are deducted, equal to the fair return allowed under the *Smyth* rule.

Between *Munn v. Illinois* and *Nebbia v. New York* the charges of no enterprise, competitive or noncompetitive, could be fixed by the government unless it was affected with the public interest. In 1934 under the *Nebbia* case a new interpretation was placed upon the due process clause in respect to government regulation of business. It was no longer interpreted as forbidding all price-regulation of business *except* those affected with the public interest, but as prohibiting only those price-fixing statutes which are arbitrary, discriminatory, or irrelevant to the policy which the legislature is free to adopt. This interpretation abolished the public utility concept in the eyes of the Court.

¹²⁶ *Mississippi Railroad Commission v. Mobile & Ohio R.R. Co.*, 244 U.S. 388, 391 (1917).

¹²⁷ *Tyson & Brother—United Theatre Ticket Offices v. Banton*, 273 U.S. 418, 430 (1927).

Principles of price-fixing for competitive industries have been developing for less than ten years. The Court has not attempted to set forth any method of price-determination such as it sought to do in the public utility field under the *Smyth* rule. The methods of price-fixing used in the individual cases were approved by the courts, and only in the *Sunshine Coal Co.* decision is there any indication of any groping by the Court for a method of determining a fair price. However, twenty years passed between 1878 when the *Munn* case was decided and 1898 when *Smyth v. Ames* laid down the present rule to be followed in determining a fair return, so there is yet time for the Court to devise a method of determining a fair price, if it believes such a step necessary.

Observe the following difference in the status of the rate-determination and the price-fixing cases at the moment. The rate-determination cases use the indirect approach of ascertaining a fair return on the rate base, whereas, in the price-fixing cases the value of the used and useful property is ignored, and the fairness of the price itself is directly considered. Undoubtedly, if Mr. Justice Waite had made no distinction between enterprises affected with a public interest and allowed either no regulation of any price or charge, or subjected *all* enterprises, competitive and non-competitive, to government regulation, the Court would not find itself in the incongruous position that it occupies today. For today, principles of determining a fair charge to the consumer have developed under the utility cases, that are difficult of application to a competitive enterprise. On the other hand, in the price-fixing cases of the competitive field principles *have been enunciated that could be applied equally well to the utility enterprise.* The direct approach to fixing the rates for the residential, commercial, and industrial user could be more easily employed at the present time than in the competitive enterprises, because of the extensive data compiled in the public utility field through past regulation.

Although the writer is in favor of a more direct approach to rate determination, with less emphasis upon a fair return on the rate base, he looks with interest upon the Court's assertion in the *Sunshine Coal Co.* decision that the maximum prices fixed for any mine shall yield a "fair return on the fair value of the property."¹²⁸ Here, while groping for a method of ascertaining a fair price, the indirect approach of the utility cases is suggested. The guarantee of a fair return on a marginal plant in a non-competitive enterprise penalizes the consumer; but in a competitive enterprise the owner would be the loser, for his prices would be above those of more favorably situated producers. Further, a guarantee to an entire

¹²⁸ Op. cit. 397.

industry of a certain price would give the low-cost producers greater than a fair return. The introduction of the *Smyth* rule to the competitive field would bring us face to face with defects which heretofore have been seen through a glass darkly.

Although the price-fixing cases seem to have momentarily veered toward the present position of the utility cases, the concurring opinion in the *Natural Gas Pipeline Co.* case¹²⁹ is a step away from the approach of the *Smyth* rule towards the present position of the price-fixing cases, with emphasis upon determining a reasonable charge or price in the light of all pertinent factors. Since this method has been applied in case after case to competitive enterprise, and since the public utility concept is of doubtful validity, it is reasonable to foresee that in the future there will be less stress upon the indirect approach of the *Smyth* rule and more weight upon the direct method of the price-fixing cases.¹³⁰

¹²⁹ 315 U.S. 575 at 603 (1942).

¹³⁰ A comparative study of twenty-five electric power companies for purposes of profit-limitation and rate-determination is found in "A Quantitative Study of Twenty-five Electric Power Companies," Franklin H. Cook, Bulletin No. 6, Bureau of Business Research, Pennsylvania State College.