

## THE UNITED STATES SUPREME COURT AND RATE REGULATION.\*

### INTANGIBLE VALUES.

Difficult as it is to value the physical property of a utility, more difficult is it to value the non-physical or intangible property. This intangible property constitutes the "trimmings" of the plant. The value allowed to each species is separate and distinct from the value of the structure. It is more a question of engineering and finance than of law. Yet as each is termed a property right, it is essential to see what they are and whether they are protected by the constitutional provisions.

The species of the intangible property are going value, going concern value, good will value, water right value, and franchise value.

#### *Going Value.*

Going value has been defined by one writer "as the cost to the owner to bring the plant to a self-supporting basis; hence, it is based on the losses of the earlier years of operation, and is the uncompensated cost incurred in the building up of the business." He adds that "the term is unfortunate in that 'development cost' would have expressed the idea more definitely." And for this reason going value and going concern value are so frequently confused.<sup>1</sup>

As thus defined, going value has never been considered by the Supreme Court.<sup>2</sup> However, the state commissions and

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<sup>1</sup> Wyer: Regulation Valuation and Depreciation of Public Utilities (1913), § 536. In the same paragraph he also states that it "is simply a logical and inevitable sequel to 'interest during construction', and can be readily calculated for any utility. It is not a permanent deficit, but a temporary one only, because the investment has not had time to bring an adequate return." See *Des Moines Gas Co. v. Des Moines*, U. S. Adv. Ops. 1914, page 811, where the terms "going value" and "going concern value" are treated as synonymous.

<sup>2</sup> The going value considered in *Omaha v. Omaha Water Co.*, 218 U. S. 180, 202 (1910), was really going concern value which will be explained later. This is another instance where there was a failure to keep these two values separate.

lower courts have considered it and generally allowed it.<sup>3</sup> One of the best expositions of the right of a utility to have this included as a valuing factor is found in Mr. Justice Miller's opinion in *The People ex rel. King's County Lighting Company v. Willcox*.<sup>4</sup>

"The investors in a new enterprise have to be satisfied as a rule with meagre or no returns, while the business is being built up. In a business subject only to the natural laws of trade, they expect to make up for the early lean years by large profits later. In a business, classified among public callings, the rate-making power must allow for the losses during the lean years or their rate will be confiscatory and, of course, will drive investors from the field. In the former class, the value of the established business is part of the 'good will' and may be determined by taking a given number of years' purchase of profits, or exchange value may be considered. In the latter case, a different rule must be adopted.

"Referring again to the Ames case (*supra*) the public is entitled to be served at reasonable rates, and the corporation is entitled to a fair return on the property used by it in the public service; no more, no less, always assuming, of course, that the return is computed on a proper valuation. . . . If a deficiency in the fair return in the earlier years was due to losses or expenditures which were reasonably necessary and proper to developing efficiency and economy of operation and establishing a business, it should be made up by the return in later years. If there was a fair return from the start the corporation has received all that it was entitled to, irrespective of how much of the earnings may have been diverted to the building of the business."

The weakness of this is that the keystone of the theory is assumed, rather than proved. The point assumed is that a public service corporation is entitled as a matter of right to earn a fair return from the very moment the wheels begin to turn. And if it does not, then the return in the prosperous years must not only be a fair return, but also a fair return plus a return which compensates the investors for the lean years. It is submitted that the Supreme Court have never laid down any rule which would hold a valuation confiscatory which did not allow for this going value.<sup>4a</sup>

<sup>3</sup> For collection of decisions and commissions' rulings, see Whitten, *supra*; Wyer, *supra*.

<sup>4</sup> 210 N. Y. 479, 487; 104 N. E. 11 (1914).

<sup>4a</sup> Since this article was written the Supreme Court in June, 1915, have

No utility has a right to demand a non-confiscatory return at all times and under all circumstances. The public, too, have rights and they "cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."<sup>5</sup> This was recognized as early as *Reagan v. Farmer's Loan and Trust Company*,<sup>6</sup> and in *Smyth v. Ames*<sup>7</sup> it was ruled that no public service corporation "may fix its rates with a view solely to its own interests and ignore the rights of the public." And if the rates were not reasonable, the rights of the public would be ignored. No matter what was the valuation of a plant, unreasonable rates could not be exacted, simply in order to earn a return. The investors are taken to have known that a reasonable rate was all that could be charged, and merely because there were not enough patrons to earn a reasonable return in the beginning is no reason to saddle their loss on the future patrons. It is one of the hazards of any business.

Or take the case where a utility after a short period is in the position slowly to recoup the losses of the earlier years by charging a higher although reasonable rate. If it does so, well and good. But if in order to entice more patrons it does not

cast a doubt on the conclusion as marked by the decision in *Des Moines Gas Co. v. Des Moines*, U. S. Adv. Ops. 1914, page 811 at page 815. In this case it appears that the utility had claimed that an amount must be added to the valuation which represented the investment necessary to organize and establish the business, *i. e.*, to bring the business up to the point where it represented a going concern. This was treated by Mr. Justice Day as follows: "The present company and its predecessors had long carried on business in the city of Des Moines, under other ordinances, and at higher rates than the ordinance in question established. For aught that appears in this record, *these expenses may have been already compensated in rates charged and collected under former ordinances.* As we have said, every presumption is in favor of the legitimate exercise of the rate-making power, and it is not presumed, without proof, that a company is under the necessity of making up losses and expenditures incidental to the experimental stage of its business." What would the Court have done if proof had been offered that the utility was "under the necessity of making up losses and expenditures incidental to the experimental stage of its business", and that it was not already compensated for this expenditure by the rates charged under former ordinances? If there be only a *presumption* against such an expenditure, it certainly can be argued that if the expenditure can be proved to have been made, then it must be treated as a value.

<sup>5</sup> 164 U. S. 578, 596 (1896).

<sup>6</sup> 154 U. S. 362, 412 (1894).

<sup>7</sup> 169 U. S. 466, 544 (1897).

charge a rate, which must also be reasonable, sufficient to enable it to recoup, then the loss falls on the investors and not on the public.

This seems to be borne out by the reasoning in *Knoxville v. Water Company*.<sup>8</sup> The Court ruled that a utility owes the duty, not only to its bondholders and stockholders, but also to the public to charge such rates as will allow it not only to pay the dividend, but also to create a depreciation fund, so that the capital will always be intact. But if it does not, the fault is its own. "When, therefore, a public regulation of its prices comes under question the true value of the property then employed for the purpose of earning a return cannot be enhanced by a consideration of the errors in management which have been committed in the past." The Court did not intend to hold that a utility could have charged an unreasonable rate to provide for the depreciation fund. But rather, that if it could have charged a reasonable rate, although higher than the one it did actually charge, which would have provided for this fund, and it did not, then the sum which could have been collected must be charged up to experience and cannot be saddled on the public. The same is true of going value.

Although the regulating body may allow this going value, nevertheless, the body would not be acting in an unconstitutional and confiscatory manner if it did not. No investor in a public utility has a vested right to look to future generations for recoupment of earlier losses. He is aware that the charges can only be reasonable and that the rates can be changed at will, provided they are not confiscatory.<sup>9</sup>

It is said that going value represents an investment as truly as any capital charge, and if it is not allowed there will be no investor. The answer to the first part is that it is not a capital charge for the very reason that the investor was not entitled as a matter of right to a return unless the rates themselves were reasonable, and hence when he denied himself a return in the

<sup>8</sup> 212 U. S. 1, 14 (1909).

<sup>9</sup> *Galveston v. R. R. Commission*, 137 S. W. 737 (Tex. 1911).

earlier years, he added nothing to the capital of the business to which he was legally entitled to receive. He is in the same position as the plaintiff who, suing in contract, alleged as the consideration his forbearance to sue on a claim which he knew could never have been enforced. The answer to the second part, is that this argument must be addressed to the regulating body, and not to the courts; it is purely a question of business policy and not of law.

*Going Concern Value.*

Going concern value was defined by Mr. Justice Moody to be "an expression of the added value of the plant as a whole over the sum of the values of its component parts, which is attached to it because it is in active and successful operation and earning a return."<sup>10</sup> In the valuation of the gas plant in New York City this question arose, counsel for the utility contending that a value must be included which will cover it. Judge Hough confused this item of value with the good will value and the franchise value, for he said:<sup>11</sup>

"From the testimony I think it is apparent that what is here meant by good will is the organization of complainant, long established, and doubtless well manned and equipped. Such organization is clearly of value, because without it neither its tangible nor intangible property can be profitably managed. Yet the organization itself is but a method of utilizing that which is invested. It is really dependent for its existence and continuance upon the franchise, without which there can be no useful organization. Tangible property has a certain value entirely apart from franchise, or right to continue business, or method of transacting business; but good will in the sense of organization for the business of furnishing gas can have no existence whatever apart or detached from the franchise conferring the necessary privilege."

This discussion of the good will value not only fits the Supreme Court's definition of going concern value but also the one accepted by Mr. Wyer, "the value which is added to the physical value of the plant by virtue of the successful and harmonious operation of the whole and the co-ordination of the

<sup>10</sup> *Supra*, note 8, at page 9.

<sup>11</sup> 157 Fed. 849, 872 (1907).

various parts.”<sup>12</sup> But it does not constitute a part of the franchise value. Each one is independent of the other. When the case was reversed by the Supreme Court this point was not touched.<sup>13</sup> The good will spoken of by Mr. Justice Peckham in his opinion was not the good will value Judge Hough had reference to in this particular part of his decision, but the good will value which is explained later in this section.

A going concern value was recognized in *Omaha v. Omaha Water Works*,<sup>14</sup> which, however, dealt with a valuation under a contract of sale and not for rate regulation. This contract was incorporated in an ordinance authorizing the construction of the water works. It provided that no value should be allowed for the unexpired franchise granted to the utility. The appraisers in making their estimate of valuation included a certain sum for the *going value*. This is a misnomer, because the reason given by the Court for its allowance, shows that it was for the *going concern value*. “The option to purchase excluded any value on account of unexpired franchise; but it did not limit the value to the bare bones of the plant, its physical property, such as its lands, its machinery, its water pipes or settling reservoirs, nor what it would take to reproduce each of its physical features. The value in equity and justice must include whatever is contributed by the fact of the connection of the items making a complete and operating plant. . . . That there is a difference between even the cost of duplication, less depreciation, of the elements making up the water company plant, and the commercial value of the business as a going concern, is evident.”

And it was also pointed out that this going concern value was independent of good will value, or franchise value. “The difference between a dead plant and a live one is a *real value*, and is independent of any franchise to go on, or any mere good will as between such a plant and its customers.”

<sup>12</sup> *Supra*, note 1, § 455, quoting from *Payne v. Wisconsin Tel. Co.*, 4 Wis. R. C. Rep. 1 (1909).

<sup>13</sup> *Willcox v. Consolidated Gas Co.*, 212 U. S. 19 (1909).

<sup>14</sup> 218 U. S. 180, 202 (1910).

<sup>15</sup> *Supra*, note 8.

The weakness of this case is, as pointed out before, that it was not a rate case, but the value was ascertained under a contract of sale. The Court clearly recognized this for they cited as their only authorities cases of the same nature.<sup>16</sup> And the Court apparently thought that there were precedents against the existence of this value, for they wound up by stating: "No such question was considered in either *Knoxville v. Knoxville Water Co.*, 212 U. S. 1, or in *Willcox v. Consolidated Gas Co.*, 212 U. S. 19. Both cases were rate cases, and did not concern the ascertainment of value under contracts of sale." If this were the last word upon this question, it might be well to argue that it was doubtful whether the Supreme Court would allow it in rate cases. But a few years later its status was definitely established.

The council of Cedar Rapids, Iowa, regulated the rates of a gas company. The utility claimed that the rates were confiscatory and resorted to the courts. An injunction against council was refused. In commenting upon the sum estimated to provide for the plant being a going concern, the state court said, *inter alia*.<sup>17</sup>

"And, aside from the intangible element of good will, the fact that the plant is in successful operation constitutes an element of value. . . . Save as above indicated, the element of value designated a 'going concern' is but another name for 'good will' which is not to be taken into account in a case like this, where the company is granted a monopoly."

When the case was appealed to the United States Supreme Court, counsel for the utility "argued that the court excluded *going value*".<sup>18</sup> Mr. Justice Holmes said, however, that "the court expressly took into account the fact that the plant was in successful operation. What it excluded was the good will or

<sup>16</sup> *National Water Works v. Kansas City*, 62 Fed. 853 (1894); *Gloucester Water Co. v. Gloucester*, 179 Mass. 365 (1901); *Norwich Gas Co. v. Norwich*, 76 Conn. 565 (1904).

<sup>17</sup> 144 Iowa 426, 434 (1909).

<sup>18</sup> This is quoted from the opinion, 223 U. S. 665, 669 (1912), and it shows how *going value* and *going concern value* have been used as synonymous terms. What the state court did allow was the *going concern value* as is seen by the Court's answer.

advantage incident to the possession of a monopoly, so far as that might be supposed to give the plaintiff the power to charge more than a reasonable price."

It is safe to assert that the Supreme Court will recognize the claim of a utility that it is entitled to an item of value because it is a going concern.<sup>18a</sup> The disposition of the question in this case proves that the Willcox case can only be regarded as an authority that a good will value is never present when there is the monopolistic feature, and is not an authority against a going concern value.

### *Good Will Value.*

Good will value has been dealt with in the treatment of the going concern value, but it will be well to restate briefly the rules as to the inclusion of this value. The definition of this species of property was adopted by Judge Hough<sup>19</sup> from *Washburn v. National Wall Paper Company*,<sup>20</sup> where it was said to be "all that good disposition which customers entertain towards a house of business identified by the particular name or firm, and which may induce them to continue giving their custom to it." From the very definition, it cannot exist where the utility has a monopoly, either legal, natural, or virtual for "a consumer must take gas from it or go without. He will resort to the old stand because he cannot get gas anywhere else," and all the cases so hold.<sup>21</sup>

<sup>18a</sup> It was also recognized in the very recent case of *Des Moines Gas Co. v. Des Moines*, *supra*, note 4<sup>a</sup>. But it is to be noticed that if this value is treated under another head it cannot be given a separate and distinct value. The Master in this case reproduced the physical property with the idea that the plant was in actual and successful operation, "for he said that otherwise its value would be much less". This led the Master to refuse a value of \$300,000 for what he improperly called the "going value", because he thought that under the Cedar Rapids case he had already considered this value and could not again allow it. The Court held that as the reproduction value had been estimated on the basis of a plant in actual and successful operation, and certain overhead expenses had been allowed, it could not be said that "the element of *going value* [going concern value] has not been given the consideration it deserves".

<sup>19</sup> *Supra*, note 11, p. 871.

<sup>20</sup> 81 Fed. 17, 20 (1897), where it was held that good will was a species of property, independent of the tangible property and corporation stock.

<sup>21</sup> *Willcox v. Consolidated Gas Co.*, *supra*, note 13; *Omaha v. Water Works*, *supra*, note 14; *Cedar Rapids v. Gas Co.*, *supra*, note 18.



In the cases where this value was denied emphasis was placed upon the fact that the utility had a monopoly. The inference from this seems to be that had there been competition the reason for the rule would not exist, and therefore a good will value would be allowed a rate regulation value. But does this necessarily follow? Good will is considered as a valuable property right where the business is to be *sold*. The purchaser pays for that good disposition which will induce customers to continue giving their custom to the old stand. In the regulation of rates there is no sale, the same proprietor is at the same old stand, and surely that proprietor can claim no property value in the mere fact that old customers still remain with him. In fact when the state regulates the rates this will insure not only the retention of the old customers, but also the acquisition of many new ones.<sup>22</sup>

#### *Water Right Value.*

An intangible value which has been the source of much litigation to the municipalities and irrigation concerns of the West is the so-called "water right." The term, properly and customarily speaking, is the right of the owner of the soil to appropriate as much water from a stream as he can beneficially use to irrigate his land. The right cannot exist unconnected with the land, that is, title to the land cannot be vested in one, and the water right in another, but both must be owned by the same one. This is clearly brought out by Judge Morrow of the Circuit Court in an excellent opinion where all the pertinent cases are reviewed and discussed.<sup>23</sup> But in the valuation of these irrigation systems for rate fixation the term is used to denote the right of the utility to appropriate water from the stream for the beneficial use of its customers and not for the beneficial use on its own lands.

<sup>22</sup> Weyer, *supra*, note 1, § 523, states, "Even under competitive conditions, good will cannot be considered in the valuation of rate regulations." For this he cites *Omaha v. Omaha Water Works*, *supra*, note 14; *Payne v. Wisconsin Tel. Co.*, 4 Wis. R. Com. 1, 60 (1909). There is nothing in the first of these two authorities to warrant this rule.

<sup>23</sup> *San Joaquin & King's River Canal Co. v. Stanislaus County*, 191 Fed. 875 (1911).

The utilities claim that this right is of great value and must be included in any constitutional valuation of its property. The claim has been presented in various ways. At first the utility insisted that the regulating body must permit it to charge the customer a fee as a condition precedent to the right to receive this irrigation service. This was repudiated by the Supreme Court on the ground that by the laws of California the regulating body was only authorized to regulate the *annual rentals* for the service.<sup>24</sup> However, the Court expressly left open the point whether the utility could demand this "initiation fee" from the prospective customer. The better view today on this question seems to be that the utility cannot exact this "initiation fee" because all persons are entitled to be served with water upon the payment of the rates prescribed by law.<sup>25</sup>

This charge had been the source of a large income to the utilities and was used to defray initial expenses of constructing the system. When they saw that they were losing this large income, they promptly turned around and demanded that the regulating body value their rights of appropriation along with the other intangible and physical values; and called this right, a "water right." Their request was presented in the recent case from Stanislaus County, California, which may properly be called the hot bed of public service valuation. After a thorough discussion of the question, Judge Morrow refused the request on the ground that the right did not constitute a property right in such a proceeding. He said:<sup>26</sup>

"In these cases [referring to cases he had reviewed] the theory that the irrigation company is an intermediate agency in the execution of a public trust is necessarily based upon the doctrine that the right to appropriate water is attached to the land. The company cannot at the same time be principal and agent. It cannot own the water or the right to appropriate and sell it, and at the same time

<sup>24</sup> *San Diego Land Co. v. National City*, 74 Fed. 79 (1896), affirmed 174 U. S. 739, 758 (1898).

<sup>25</sup> Weil: *Water Regulation in Western States* (3rd Ed.) §§ 1315-1328; *Crow v. San Joaquin, etc., Canal Co.*, 130 Cal. 309, 62 Pac. 562; *Boise City Town & Land Co. v. Clark*, 131 Fed. 415 (1904); *San Joaquin, etc., Canal Co.*, *supra*, note 1.

<sup>26</sup> *Supra*, note 1, at page 895.

be the agent of the public in appropriating it for a public use. The logical relationship of such a company to its appropriated water is that it is an agent of the owner of the land in diverting and bringing the water to the land for which it had been appropriated. But it is immaterial whether the company is deemed to be the agent of the public in diverting and carrying the water owned by the public to the consumer who owns the right to its beneficial use, or the agent of the consumer in diverting and carrying the water to his principal for a beneficial use. In either case, while the carrier is entitled to be paid for his services as carrier a reasonable compensation under such regulation as the law may prescribe, he is not the owner of the water carried or the water right created by its diversion, and he cannot compel the consumer to purchase it, and to pay for its use, either in the way of an annual or other rate upon its supposed value as a property right."

This ruling was reversed by the Supreme Court in an exceptionally short opinion of Mr. Justice Holmes.<sup>27</sup> There appear to be two main points in his discussion. The utility is the owner of the water it appropriates from the stream and is entitled to have it valued. The declaration in the state constitution that "the use of all water now appropriated, or that may hereafter be appropriated, for sale, rental and distribution is hereby declared to be a public use," does not prevent such a utility from having a private ownership in the water appropriated, and "does not necessarily mean more than a few within reach of the supply may demand it for a reasonable price." And as the water is private property when appropriated, "it is unreasonable to suppose that the constitutional declaration meant to compel a gift from the former owner to the users . . . ." This is consistent with the state decisions holding that the water is private property when appropriated,<sup>28</sup> and is a common sense view of the question. Aside from the question whether it is a "water right" or not, there can be no doubt but that the utility ought to have a return on the water they appropriate and distribute.

The other point made by the Court was that as the utility has the sole right to furnish this water, the owner of the irrigated

<sup>27</sup> 223 U. S. 454 (1914).

<sup>28</sup> *Hildreth v. Montecit Creek Water Co.*, 130 Cal. 22 (1903); *Palmer v. R. R. Commission*, 167 Cal. 163, 173, 174 (1914).

lands cannot get it except from the utility, "and it would be unjust not to take that fact in account in fixing the rates." This cannot be given serious consideration, for it is, in other words, placing a premium upon monopoly, whereas the monopolistic features have always been held to add no value to a plant.<sup>29</sup> It is not conceivable that a railroad could charge higher rates simply because it had the sole right to furnish the transportation.

The last species of intangible property is the franchise value. This is one of the great bones of contention in rate regulation. As the question is much more a question of law than the others, it has been dealt with more at length, and for this reason, the discussion of it is given in a separate section.

#### FRANCHISE VALUE.

Although much has been written on the franchise value, and many commissions and state courts have considered the question, nevertheless it has been squarely presented to the Supreme Court but once during the thirty years of rate regulation. Then the whole question was decided in twenty-one words.<sup>1</sup> The language of Mr. Justice Harlan in *Smyth v. Amcs*,<sup>2</sup> that "the apparent value of the property and franchises used by the corporation, as represented by its stocks, bonds, and obligations" was not alone to be considered, does not indicate that the franchise was then held by the Court to be a property value in rate cases. The point does not appear to have been argued, and this case is noted for laying down broad language which later had to be restricted.

Before discussing the problem of franchise value, it is essential to determine just what the term franchise includes.

<sup>29</sup> *Supra*, "Good Will Value."

<sup>1</sup> *Willcox v. Consolidated Gas Co.*, 212 U. S. 19 (1909): "It cannot be disputed that franchises of this nature are property and cannot be taken or used by others without compensation." In *Lincoln Gas Co. v. Lincoln*, 182 Rep. 926 (1909), Judge Munger refused to allow the franchise value in a rate case. Upon appeal this question was argued by counsel on both sides and authorities cited, but the case was sent back to a Master for further findings by Mr. Justice Lurton without any comment on this question, 223 U. S. 349 (1911).

<sup>2</sup> 169 U. S. 466, 544 (1898).

There are two divisions of franchise, known as the primary franchise and the secondary franchise. The primary franchise is the right or privilege given by the state to two or more persons of being a corporation.<sup>3</sup> This franchise belongs not to the corporation, but to the incorporators,<sup>4</sup> and it cannot be alienated by them except under express legislative sanction which points out the mode of transfer.<sup>5</sup> The secondary franchise includes "the right to carry on or transact a particular kind of business, as in the case of the privileges granted to a water company with the right to take tolls, *etc.*; or the right of a railroad to collect rates; or of a toll road company to exact toll for services performed."<sup>6</sup> It is the franchise to act as a corporation and belongs to the corporation.<sup>7</sup> If the corporation is private, the franchise can be alienated, but if the corporation is *quasi*-public the general rule is that it cannot be alienated except by legislative authority.<sup>8</sup> It is evident that a franchise from a municipality to lay pipes, sell gas or water, is a secondary franchise. And it is also evident that what the utilities demand is a value on this secondary franchise.

The leading case on this subject is the Willcox case,<sup>9</sup> which dealt with the valuation of the plant of the Consolidated Gas Company in New York City. Seven companies had consolidated in 1884 under an existing statute which permitted the capitalization of the franchise and rights. In 1906 legislation reduced the price of gas and the utility brought a bill to enjoin the enforcement of the law. In the summer of 1906, a special Master was appointed by the federal court to take testimony, make computations and fully find the facts. Among the findings was the item of twenty million dollars for franchises and good will. This item was attacked and the question was squarely raised before Judge Hough, "whether a public service corporation is entitled

<sup>3</sup> Home Insurance Co. v. New York, 134 U. S. 594, 599 (1889).

<sup>4</sup> Baldwin: American R. R. Law (1904), 26.

<sup>5</sup> *Ibid.*

<sup>6</sup> Joyce: Franchises (1909), §8.

<sup>7</sup> *Ibid.*, citing State v. Topeka Water Co., 61 Kan. 547; 60 Pac. 337 (1900).

<sup>8</sup> *Ibid.*, §§ 463, 464.

<sup>9</sup> *Supra*, note 1.

to add the value of its franchise to the assets from which a fair return may be lawfully demanded?"<sup>10</sup>

The Judge frankly admitted that were he deciding this as an original question he would not allow the claim, but he thought that he was bound by certain precedents to hold that the franchise was property in rate regulation and a value must be allowed.<sup>11</sup> His conclusion was affirmed by the Supreme Court.

The reasoning which the Judge considered binding upon him was as follows: (1) A franchise to place and maintain gas mains in the city streets is property. (2) If the franchise is property in eminent domain proceedings, then it must be property of value in rate regulation, for the later is regarded as *pro tanto* condemnation.

The mere fact that such a franchise is property does not *per se* solve this question. The question is deeper than that, *i.e.*, is it property which must be given a value in rate regulation? Even its status as property is not very satisfactorily explained. "While it is frequently asserted that the right granted is an incorporeal hereditament and therefore property, the statement throws but little light upon its real nature. That it is at least a unique form of property is quite apparent; for strictly, it has no inheritable quality, and may as properly be considered personally as realty. Nor in the absence of statutory authority, can it be leased, mortgaged or sold; and a statute authorizing these transactions operates, according to the better reasoning, merely to invest the franchise-holder with the power to appoint another to enjoy a like privilege. Finally, as against the state, except where otherwise provided in the grant, it lacks the element of exclusiveness which is the essence of the conception of property."<sup>12</sup> Hence merely to say that the franchise right to lay the mains is property does not relieve the utility of the

<sup>10</sup> 157 Fed. 849, 876 (1907).

<sup>11</sup> *Accord*: Spring Valley Water Works, 124 Rep. 590 (1903); Railroad v. Ala., 196 Fed. 800 (1912); 197 Fed. 954 (1912). *Contra*: Lincoln Gas Co. v. Lincoln, 182 Fed. 926 (1909).

<sup>12</sup> 9 Col. L. Rev. 160 (1909), where citation for the statements will be found.

burden of proving that in rate regulation this franchise is a property right which must be valued.

In the valuation of a property for rate regulation, the better view is that the utility is allowed to include as an item of value property which is used and useful in the business, although not owned by it.<sup>13</sup> The right of the utility to have this valued is a property right and must be allowed or there is confiscation. But merely to say that it is a property right which is protected by the Constitution, would not be correct, for in eminent domain proceedings the occupier of such property has no property right which is protected,<sup>14</sup> and even if he has erected buildings on such land he cannot recover compensation for them.<sup>15</sup> It has also been held that a right of way of necessity, based on estoppel, is not such an interest or right in land as would entitle the owner to compensation where it is taken for a public street.<sup>16</sup> The reason it is not a property right in eminent domain and is a property right in rate regulation (for certainly these would be so regarded) is the difference in the purpose for which the powers are exercised.

This is the crux of the whole argument. It is submitted that simply because a privilege is termed a property right under eminent domain proceedings is no reason to have it termed a property right in rate regulation. The cases which Judge Hough considered as binding him to hold that a franchise was a property right which must be valued, were eminent domain cases.<sup>17</sup> It has just been pointed out that a privilege may not be a property value in condemnation, yet is a property value in rate regulation. In condemnation proceedings, no property value is taken from one who has a mere license from the city to use the land, revocable in its nature, and the value of its use is a mere gratuity

<sup>13</sup> Consolidated Gas Co. v. New York *et al.*, *supra*, note 10; Gas Light Co. v. Cedar Rapids, 144 Iowa, 426, 435 (1909). *Contra*: San Joaquin River Canal Co. v. Stanislaus County, 191 Fed. 875, 886 (1911). See *infra*, "Property Used by the Utility, but Which It Does Not Own," where this question is treated.

<sup>14</sup> Rooney v. Sacramento Valley R. R., 6 Cal. 638 (1858); Squire Rosa v. M. K. T. R. R., 18 Kan. 124 (1877).

<sup>15</sup> Norris v. Pueblo, 12 Colo. App. 290 (1903).

while the permission lasts,<sup>18</sup> yet it is a property value in rate regulation if it is necessary in the proper conduct of the present business. The good will of a business cannot be considered as a property value when the freehold is taken by eminent domain, although it is conceded to be of value,<sup>19</sup> yet it has been frequently urged upon the courts and commissions as an item of property value in rate cases.<sup>20</sup> Other instances of differences between eminent domain and rate regulation as to what are considered property rights could be cited, but the above are sufficient to show that what is property in one is not necessarily property in the other.

The difference between the powers justifies the difference in the property rights. It has been said that an attempt to distinguish the right to value a franchise in rate regulation from the right in eminent domain proceedings is too subtle for the layman—the final arbiter of the law; that the man on the street can recognize no real difference between a power which takes all of his property and one which regulates the use of his property, the exercise of which may take from him part of his former income.

This is confidently denied. Such a thought would also deny that the man on the street could recognize a distinction between the general exercise of the police power and the eminent domain power. It would admit that he could see no justification between the taking of one's home without compensation to prevent the spread of an epidemic,<sup>21</sup> and the confiscation of it by the

<sup>18</sup> *In re East 142d Street*, 82 N. Y. Supp. 445 (1903).

<sup>19</sup> *People v. O'Brien*, 111 N. Y. 41 (1888); *Monongahela Navigation Co.*, 188 U. S. 312 (1893). These cases were also the ones which the Supreme Court relied upon. It is true that two cases cited by Judge Hough, *San Diego Water Co. v. San Diego*, 118 Cal. 556, 567 (1897) and *Spring Valley Water Co. v. San Francisco*, 124 Fed. 574, 594 (1907), were rate cases, and the argument put forth in them was the same as Judge Hough's.

<sup>20</sup> *Kingsland v. Mayor of New York City*, 110 N. Y. 569 (1888). See also, *Ranlet v. Concord R. R.*, 62 N. H. 561 (1883).

<sup>21</sup> *Edmonds v. Boston*, 108 Mass. 535 (1871); *Ranlet v. Concord R. R.*, *supra*, note 18; *In re Matter of N. Y., etc., R. R.*, 35 Hun, 633 (N. Y. 1885); *In re Race Street*, 24 Pa. C. Ct. Rep. 453 (1900).

<sup>20</sup> Whitten, §§ 632, 635.

<sup>21</sup> Lewis: *Eminent Domain* (3rd Ed. 1909), vol. I, §7, and cases cited.



state for its use as a state building. It would deny that he could see a just distinction between a law which restricted the height of buildings in cities,<sup>21a</sup> and the taking over by the State of the building. It has been said that rate regulation is *pro tanto* condemnation.<sup>22</sup> This is denied,<sup>23</sup> but granted that it is, yet cannot the average laymen see that a restriction on height of buildings is *pro tanto* condemnation without compensation? Does not the owner of the land own from the center of the earth to the skies?<sup>24</sup>

The answer is too obvious. He is conscious that every man holds his property subject to a reasonable regulation for the protection of all; that any contribution of his to aid in the protection of all is only one form of the general duty which organized society exacts from him. But he also is conscious that organized society cannot take his property and then use it for their benefit without granting him compensation for its use. When he is prevented from using his own property as he pleases, society gains no tangible property from him, but it is only protected from his unwarranted use of it. On the other hand, when society takes his property by condemnation, it takes not only the lawful use but the very property itself, and then uses the self same property. In other words, the state substitutes itself in the place of the owner. In rate regulation no property is taken, but only the public welfare is promoted by

<sup>21a</sup> *Ibid.*, § 243, and cases cited. It may be argued that the analogy between the regulation of the height of city buildings and the regulation of rates is not sound, inasmuch that *all possible buildings* are subject to the same municipal conditions, while in rate regulation only public utilities are so regulated. But the answer as to this is that the municipal regulation can be confined to certain specified districts in the city, and also apply only to certain specified kinds of buildings. See cases cited by Mr. Lewis in this section.

<sup>22</sup> Judge Hough said on page 875: "If regulation is to be regarded as *pro tanto* condemnation, then the same train of reasoning which requires compensation for franchises when all the property protected by the franchise is taken away requires that same compensation shall be left when the earning power only is reduced. This is the crucial point of the inquiry and the highest tribunal has not yet encountered the necessity of answering it."

<sup>23</sup> See, *supra*, argument in section on "Where Is the Power to Regulate Rates to Be Classified?"

<sup>24</sup> Broom: *Legal Maxims* (8th Ed. 1911), 309, *et seq.*, and cases cited.

regulating and restricting the use of the property. In eminent domain the public welfare is promoted by the taking of the property from the owner and appropriating it to the public use.<sup>25</sup> So it is logical that if the state were to take property which a person were using but did not own, that person would be entitled to no compensation for he had no property right in the land which was taken. But in rate regulation the property is not taken, and the thought is not what property does the utility lose, but what property is needed in its present business; if the property in question is useful a value must be allowed.

Apply the same argument to the question of the franchise. In condemnation the utility is entitled to value its franchise as against the public, for the franchise is to be taken away from it. The state is depriving the utility of its contract right to carry on the business in the future, and from earning further returns on its investments. For this deprivation of its rights the utility certainly is entitled to have its franchise protected, as the contract of the state was that it would not deprive the utility of its franchise unless compensation was made. But in rate regulation the state does not deprive the utility of its contract right to carry on its business. It does not take over the property and forbid it to earn returns on its investments; the utility still carries on its business and exercises its legal rights. What the state does is to say to the utility: "From now on you must do what you always were legally required to do, that is to say, you can only charge reasonable rates." There is no taking in this. Any proper regulation has never been held to be a taking. Of course, if the rates will not allow the proper return, that is not a regulation but a confiscation under the guise of regulation.

Before any property of a public service corporation is valued in eminent domain proceedings it must be taken for some use other and higher than the one to which it is now subjected.<sup>26</sup> In rate regulation the property is not taken for some other use; the same property is employed in the same use. One of the

<sup>25</sup> *Supra*, note 21, vol. 1, § 6.

<sup>26</sup> *In re Condemnation of Land at Nahant*, 128 Fed. 185 (1904).

distinctive features of condemnation is that the state substitutes itself for the owner of the property. In fact, it enjoys the same freedom as the owner. This is not true of rate regulation, and the Supreme Court have recently said "broad as is the power of regulation, the state does not enjoy the freedom of the owner."<sup>27</sup>

This was clearly brought out in *Monongahela Navigation Company v. United States*,<sup>28</sup> where a lock of the company was condemned by the Government without the allowance for the value of the franchise. Mr. Justice Brewer, in holding that it would be confiscation to take over the lock without payment for the franchise to collect tolls, said:

"And here it may be noticed that, after taking this property, the Government will have the right to exact the same tolls the Navigation Company has been receiving. It would seem strange that if by asserting its right to take the property, the Government would strip it largely of its value, destroying all that value which comes from the receipt of tolls, and, having taken the property at this reduced valuation, immediately possess and enjoy all the profit from the collection of the same tolls."

However, in rate regulation, the Government does not deprive the utility of its franchise to collect tolls; it does not step into the shoes of the utility and enjoy its rights and privileges. All that it does is to make it unlawful for the utility to charge anything but a reasonable rate. As there is no substitution, it cannot be regarded as a part of eminent domain. In a recent article<sup>29</sup> an authoritative writer in arguing for the valuation of franchises makes much of the language of the Court in the *Willcox* case, where it was said that a franchise to lay mains in the city streets is property, "and cannot be taken or used by others without compensation." He says, "here it will be observed, not only the franchise, but the use of the franchise is stated to be property which cannot be taken without compensation." But it is to be noted that the language of the

<sup>27</sup> *N. P. R. R. v. N. Dak.*, Nos. 420 and 421, Oct. Term, 1914, decided March 8, 1915.

<sup>28</sup> *Supra*, note 1, at page 337.

<sup>29</sup> 15 *Col. L. Rev.*, 97, 99 (Feb., 1915).

Court in the Willcox case was borrowed from the Monongahela case, and, as explained, the whole idea of that case was that the Government was substituted in the place of the private corporation. The franchise would be used in such a case, but in a rate case, the franchise would not be *so used* nor would its *use be taken* by the public for there is no substitution.

The difference between the franchise as a property right in eminent domain and rate regulation can be best shown by the following illustration. A contracts with B that B is to make A a desk and A will pay B a reasonable price on his investment. If B would assign this contract to C, it is conceivable that the contract with A is a valuable right to B. Or if A would subsequently seek to deprive B of this contract, he could not except by making compensation. But if B sues A for the reasonable price on his investment can B include as a part of the investment the value of this very contract that A made with B? Is this not exactly what the utility is trying to do when it demands a valuation which includes its franchise? The people, through their various governmental agents, have contracted with the utility that it shall furnish them with service at reasonable rates. The franchise is the contract,<sup>30</sup> whereby the utility contracts to furnish the service for a compensation which is to be a proper return on the investment. To deny B in the civil suit his contention to include the value of the contract and to allow its inclusion in rate making, does not seem to be consistent with sound justice.

There is no investment value in the franchise itself, unless expressly stated, and in such case it should be allowed. No one has better expressed the idea than Judge Hough when he said:

"Return can be expected only from investment and he that invests must part with something in the act of investing. He that hath not sown shall not reap, and can it be said that the complainant here, or any other corporation similarly situated, has invested its franchise in its business? It did not invest its franchise because it did not part with it in the same way that it parted with money or

<sup>30</sup> Dartmouth College Case, 4 Wheat. 518 (U. S. 1819).

money's worth on acquiring or creating mains or plants. The investment of property was made not in the franchise but *under* the franchise and *on the faith* thereof."

It is true that the franchise makes the physical property productive, but that can be said of other elements which are not considered as property value in rate cases. For example: Through the sagacity and wisdom of its president a railroad was brought up from a losing business adventure to a highly profitable business. It was this man's ability that made the physical property valuable. If the president were willing the railroad could sell his services to another for a large sum. Yet could the railroad in a rate case contend that this man's connection with the business was worth so many hundred thousand dollars which must be added to the physical value of the property?<sup>30a</sup>

It is true that an exclusive franchise to serve the public in a community is of value, but not value in the sense it is used in rate regulation. The exclusive franchise gives the utility a legal monopoly, but the monopolistic feature cannot be valued in a rate case. Take the case of a public utility which has no franchise, such as a warehouse, but has a practical monopoly of the business. This feature cannot be added to the investment. There is no difference between a legal and a practical monopoly in valuation for rate regulation.

It would seem that whatever value the franchise adds to the plant in operation is included in the going concern value, although the two values are said to be independent.<sup>31</sup> That value is given because the plant is in successful operation and earning a return. This is exactly what the franchise protects for the materials in operation would only be worth their scrap value were it not for the protection of the franchise. The plant could not be in operation were it not for this grant for otherwise it would be a nuisance. To allow a going concern value and also a franchise value smacks of a double taxation evil. De-

<sup>30a</sup> "The realization of the benefit of property always depends in a large degree on the ability and sagacity of those who employ it; but the appraisal is of an instrument of public service, as property, not the skill of the users. . . ." Hughes, J., in *Minn. Rate Case*, 230 U. S. 352 (1913).

<sup>31</sup> *Omaha Water Works v. Omaha*, 218 U. S. 180, 202 (1910).

manding a return on an item of value which has been twice valued is every bit as odious as double taxation which the Supreme Court dislike.<sup>32</sup>

A recent New Jersey case<sup>33</sup> has held that the franchise must be valued in a rate case because the state had taxed it as property. This position is untenable. Even the Supreme Court have indicated that that is no reason why the franchise should be given a value in rate regulation.<sup>34</sup> A franchise is taxed for the simple reason that it is a revenue producing privilege; many things are taxed upon which the utility could demand no return. It is plain sophistry to argue that if the state value this privilege for taxation, surely the state must value it for regulation. The tax on the franchise is part of the expense of operation which must be provided for before the question of return can be considered. The utility loses nothing by such taxation since the consumer pays the tax in the price for the service. It is absurd to argue that simply because the consumer pays the tax he must also pay an increased rate in order to pay a return on the very privilege on which he has paid the tax.<sup>35</sup>

Another view of the problem has been suggested.<sup>35a</sup> This view is premised on the hypothesis that the public utility is owned by the bondholders, stockholders, and public. The first two have contributed the money and the latter the franchise, and each element is just as necessary as the other. The former are entitled to a proper return and the public to a proper rate. Now if A and B went into a joint enterprise, A could only claim as against B a return on the sum he contributed; he could not demand a return on B's contribution in absence

<sup>32</sup> *Kadd v. Ala.*, 188 U. S. 730, 732 (1903); *Hawley v. Halden*, 232 U. S. 1, 13 (1914).

<sup>33</sup> *Public Service Gas Co. v. Board of Public Utility Comr's et al.*, 92 Atl. 606 (Dec. 9, 1914), reversing 84 N. J. L. 476, 87 Atl. 651. But see recent decision in *Pub. Service Gas Co. v. Board of Public Utility Comm.*, 94 Atl. 639 (N. J., June, 1915).

<sup>34</sup> *Willcox case*, *supra*, note 1.

<sup>35</sup> See for further criticism of the New Jersey decision; 9 ILL. L. REV. 498 (Feb., 1915), and 28 HARV. L. REV. 501 (March, 1915).

<sup>35a</sup> "The Ethical Principle of Physical Valuation for Rate Making," THE POPULAR SCIENCE MONTHLY (Feb., 1915).

of an express contract to that effect. In the public utility A represents the bondholders and stockholders, and B, the public. Therefore as against the public the bondholders and stockholders have no right to demand a return on the public's investment in the joint enterprise.

It may be asked of those who contend that a franchise is a property whose value must be included in a constitutional valuation: What contract have the many made with the few whereby the few claim the right to value the public property (the franchise) as against the many? In absence of express and clear statutory authority where do the few receive the sanction to transform the public property into private wealth?

After the Court in the Willcox case decided that the franchise was property and a value must be allowed, the next question was its value. "The important question is always one of value." It is in this connection that the pseudo doctrine of estoppel played an important part. Under a general incorporation law of 1884<sup>36</sup> which provided for a consolidation of companies in the same business, the directors of all the corporations were to enter into an agreement which, among other provisions, was to state "the amount of its capital stock, which shall not be larger in amount than the fair aggregate value of the property, franchises, and rights of such corporations." Without any state supervision the value of all the franchises was estimated by the directors themselves at about eight million dollars. Stock was issued in the new corporation and sold to the proverbial "widows and orphans."

On the day the decision was announced, Mr. Justice Peckham made a brief summary of the position of the Court, which contained the following:<sup>37</sup>

"At the time of the consolidation, the value of the franchises of the constituent companies was fixed by them at \$7,781,000 and that amount formed part of the capital of the complainant for which it issued stock. The consolidation was effected pursuant to the state statute and the state has never questioned the validity or fair-

<sup>36</sup> Consol. Laws of New York, vol. I, p. 243.

<sup>37</sup> 212 U. S., p. 19 in a foot note.

ness of the valuation. Since the consolidation the stock so issued has been dealt in up to the present time as valid stock of the consolidated company capitalized pursuant to the statute, at not more than the fair aggregate value of the property, franchise and rights, of its constituent companies. The state should not now be heard to question the value of the franchises at the time of the consolidation."

And in the opinion of the Court, which was handed down a week later, the Justice again thought that "the courts ought to accept the valuation of the franchises fixed and agreed upon under the act of 1884 as conclusive at that time." The reasons given were that the act provided for the valuation, the agreement as to value has always been regarded as valid, and the stock has been dealt with for more than twenty years on the basis of the validity of the valuation.

This raises a neat point in the law of estoppel as applicable against the state, and one, it is submitted, which the Court should have dealt with at length and not merely assumed as a simple proposition without the citation of one authority to uphold their view. The rule is well settled in England that estoppel does not work against the Crown. In the United States, however, there has been a relaxation of this rule, due to the growing belief that the state has lost its personal aspect and the worn-out doctrine that "it can do no wrong," and when it seeks to have equitable principles applied to its gain, it must in like turn be bound by them. The whole subject is treated by Mr. H. Campbell Black very thoroughly and the rule is stated to be:<sup>38</sup>

"If the plea of estoppel is based upon some action of the legislature of the state, the case is different from that just considered. The authorities are nearly unanimous in agreeing that a state may be estopped by the enactments or resolution of its legislative body."

For this he cites numerous authorities which, while bearing out his contention, yet are no authorities for the position taken by the Court in the Willcox case. Upon examination the cases cited by Mr. Black (and which are generally cited for this rule)

<sup>38</sup> A note in 16 C. C. A, 353, 355.

<sup>39</sup> Opinion of the Justices, 49 Mo. 216 (1872).



are found to involve the impairment of a contract entered into by the state,<sup>39</sup> specific grants of land specially authorized or recognized by the legislature,<sup>40</sup> or a special statute where the legislature authorized the doing of a specific act by a certain person and is then estopped to deny the validity of that act.<sup>41</sup> Not one of the cases which are ever cited for the broad proposition of estoppel has held that where a state by a *general* consolidation act authorized the capitalization of the franchise it is forever estopped to deny the validity of the valuation which was made solely by the owner of the franchise. The legislature did not authorize the specific valuation of nearly eight million dollars for the seven franchises, and therefore, the state is not in the same position as the state is in the cases cited in the notes. In all the cases of estoppel, the legislature of the state has confirmed or authorized a specific grant or act. Hence it may be seriously doubted whether the state of New York could be estopped to deny the validity of the valuation solely on the ground that the legislature passed the general law authorizing a consolidation.

The doctrine at its best is dangerous. In a recent federal case, a Master in making his report to the District Court, said that under the authority of the Willcox case, the state is estopped to deny that the franchise is property, because it had passed an act requiring the franchise to be rated and taxed as tangible property.<sup>42</sup> And this was approved by the District Court.<sup>43</sup> This cannot be justified even on the authority of the

<sup>39</sup> U. S. v. *Williamette Co.*, 54 Fed. 807 (1892); *Alexander v. Ga.*, 56 Ga. 478 (1876); *Comm. v. Andre*, 3 Pick. 224 (Mass. 1825); *Commonwealth v. The Pejepscut Proprietors*, 10 Mass. 154 (1876); *Winfield v. Permit*, 5 N. H. 280 (1830); *Texas v. Galveston Co.*, 38 Tex. 13 (1873); *Saunders v. Hart*, 57 Tex. 8 (1882), *dicta*.

<sup>41</sup> *Mower v. Kemp*, 8 So. (La. 1890), where the state specially authorized a railroad to execute a mortgage, and later was estopped to impeach the validity of it. *Girard Estate*, 43 U. S. (2 How.) 127, 191 (1844), where the legislature of Pennsylvania by special act, authorized the Mayor and Alderman of Philadelphia to carry out the trust in the Girard will. Mr. Justice Story by way of *obiter* said that the state would be estopped to deny the competency of the city to act as trustee under the city charter.

<sup>42</sup> See *Whitten* (1914 Supp.), § 1400.

<sup>43</sup> *Railroads v. Alabama*, 196 Fed. 800 (1912); 197 Fed. 954 (1912).

Willcox case, for that case only held that the state was estopped to deny the valuation. Before the Court dealt with the problem of value it had decided that the franchise was property of value in rate cases. And they expressly ruled that the mere fact that the state had taxed the franchise was not material.

If the doctrine of the Willcox case is correct, how can the Court logically rule out the capitalization of the stock as a proper means to determine the fair value? A state has passed an incorporation act, a utility has incorporated and watered the stock. But the state has never attacked this issue, and as it has been dealt with as valid investment, the state under the application of this pseudo estoppel ought to be estopped to say that it is not a proper method to determine the fair value. And yet the decisions are nearly unanimous in giving no weight to capitalization value, one reason being that it has been generally inflated.<sup>44</sup>

Or take the question of good will. It has been held that good will of a business is property and may have a value independent of any specific tangible property, and at least in New York it can be capitalized under the corporation law.<sup>45</sup> Suppose the Consolidated Gas Company had capitalized their good will, would the Supreme Court have held that the state of New York was not only estopped to deny the value placed upon the good will, but also that it was a property value? In fact, the report of the Master in the Willcox case<sup>46</sup> shows that, "the \$7,781,000, was considered to represent at the time (1884) the franchise and business and contracts and patents and *good will*, —everything in fact except the tangible property." And yet a good will value was not allowed in this case by the Supreme Court.<sup>47</sup>

The only other ground of estoppel applicable, is the doctrine of *laches*. The Court spoke of the length of time the stock issued on this basis had been dealt with as valid stock, and that the state never had questioned the legality of it.

<sup>44</sup> See *supra*, where this is discussed.

<sup>45</sup> Washburn v. National Wall Paper Co., 26 C. C. A. 315 (1897).

<sup>46</sup> Whitten (1912), § 684.

<sup>47</sup> 212 U. S. at page 51.

This may be true, but the doctrine of *laches* is not applicable as against the state. In order to have an estoppel against the state, it must have taken some affirmative action upon which the estoppel asserter has relied.<sup>48</sup> The doctrine of *laches* stands upon different grounds than the doctrine of estoppel. The government can transact business only through agents, and they are so numerous and its operations so various that the public would suffer great losses even if the utmost vigilance were maintained.<sup>49</sup>

In conclusion it is submitted: (1) A franchise is not a property value which must be included in the investment sum upon which a proper return is allowed in rate regulation. As it is still an open question in the Supreme Court whether the value of donated lands can be included in a fair value,<sup>50</sup> it might not be futile to consider the inclusion of a value of a franchise which is also donated, as yet of doubtful propriety. (2) Even if the Court do hold it to be property to be so valued, as the franchise is either realty or personalty, its value must be determined by the same method as other realty and personalty is valued, that is to say, by the reproduction-less-depreciation theory. Its value can rise no higher than that sum which at the date of the valuation is required to obtain anew such a privilege.

#### PROPERTY USED BY A UTILITY, BUT WHICH IT DOES NOT OWN.

A very interesting point has arisen whether a utility should be allowed to include in its total valuation a value on the property used in the regular course of its public service although not owned by it. The question has never been passed upon by the Supreme Court, but has been considered by the lower courts in cases which eventually went to the highest federal court. So it is thought useful to include these cases, for they may be of some value when the point is finally presented to the Supreme Court.

<sup>48</sup> See 16 C. C. A. 356.

<sup>49</sup> U. S. v. Kirkpatrick, 7 Wheat. 720 (U. S. 1824); U. S. v. Van Zandt, 11 Wheat. 184 (U. S. 1826).

<sup>50</sup> Minnesota Rate Cases, 230 U. S. 352, 456 (1913).

In *Consolidated Gas Company v. New York et al.*,<sup>1</sup> the gas company occupied land owned by the city, but to which the city never asserted title. Judge Hough allowed the present value of the property for the simple reason that if the company did not occupy that land it would, of necessity, be occupying some other land in the vicinity, of almost equal value. The propriety of this seems clear. This was not a suit to try title, but to establish the value of a plant useful in serving the public.

The same point was raised in *Gas Light Company v. Cedar Rapids*,<sup>2</sup> but the value was allowed to the company on the ground that "none save the state might challenge its rights thereto." This does not seem to be as satisfactory a reason as that given by Judge Hough. It is not a question of ownership of the property, but what is its present value. And if it is needed in the utility's business, it should be included in the valuation.

But some doubt is cast upon these cases by the ruling in *San Joaquin and King's River Canal Company v. Stanislaus County*.<sup>3</sup> The utility offered to prove the value of two hundred eighty-six miles of fences, but the Master rejected the claim. In overruling an exception to this ruling of the Master, Judge Morrow said:<sup>4</sup>

"The Master held that the inquiry he was called upon to make was the cost of reproducing the plant at the time the rates in question were fixed, and that such cost of reproduction must be applied to the property that was owned by the complainant. He was of the opinion that if the fences had not been built by the complainant, and, therefore, did not belong to the complainant, it would not be entitled to have them valued as part of its property. I see no reason for sustaining the exception to the finding."

Whether the learned Judge was aware of the two decisions opposed to his view, is not known for he cited no cases. However, it is submitted, that this view is not correct and is not based on a sound application of the reproduction theory. The utility is entitled to a fair return on the value of the property used in

<sup>1</sup> 157 Fed. 849, 858 (1907).

<sup>2</sup> 144 Iowa, 426, 435 (1909).

<sup>3</sup> 191 Fed. 875 (1911).

<sup>4</sup> *Ibid.*, page 886.

the public service. It is not entitled to a fair return upon the property *owned*,<sup>5</sup> but only upon that which is *used*. Hence the question of title is not so important as the question of usefulness. There can be no doubt that if the utility did not have sufficient property to satisfy the present needs that a value would have to be allowed in estimating the present value of the plant for the additional property actually needed.<sup>6</sup> And there is no difference in result simply because the utility is using property to which it has no title. At any time within the statutory period, the parties owning the property thus necessary for the present use may assert their rights and the utility will have to buy them out or acquire other property of like usefulness. In that case a value would be unfair unless the value of this property had been included.

It sometimes happens that the utility is using rented property. In such case, shall it be allowed to include as a value, the

<sup>5</sup> *Manning v. Chesapeake, etc., Tel. Co.*, 186 U. S. 238, 247 (1901), where it was said: "It appears that some portion of the defendant's (the telephone company) business is of a purely private nature, the receipts whereof are spoken of in its reports as private rentals, and as to such business Congress could not, if it would, prescribe what shall be charged therefor." *San Diego Land & Town Co. v. Jasper*, 189 U. S. 439, 446 (1903): "If a plant is built, as probably this was, for a larger area than it finds itself able to supply, or apart from that, if it does not, as yet, have the customers contemplated, neither justice nor the Constitution requires that, say two-thirds of the contemplated members, should pay a full return." *Willcox v. Consolidated Gas Co.*, 212 U. S. 19 (1908), affirms this point decided by the lower court in 157 Fed. 849, 857 (1907): *Gas Light Co. v. Cedar Rapids*, 144 Iowa, 426, 435 (1909), affirmed in 223 U. S. 665 (1912); *Minnesota Rate Cases*, 230 U. S. 352, 434 (1913).

The ruling of Judge Treber in *In Re Arkansas Rate Cases*, 187 Fed. 290 (1911), that the utility must add to its income that derived from *all* sources is not sound. In *Shepard v. N. Pac. R. R.*, 184 Fed. 765, 802, Judge Sanborn said: "In the absence of competent evidence segregating the property of a railroad company devoted to transportation from its other property, all its property represented by the market value of its stocks and bonds is presumed to be devoted to public use." His only authority for this broad statement is *A. T. & S. F. R. R. v. Sullivan*, 173 Fed. 456, 465 (1909), which was a valuation for *taxation*. It seems extremely doubtful from what was said by Hughes, J., in the *Missouri Rate Cases*, 230 U. S. 474 (1912), as to the use of taxation figures in rate regulations, whether this rule can be applied to such a valuation.

<sup>6</sup> This is borne out by the reasoning of Judge Hough in *Consolidated Gas Co. v. New York, et al., supra*, note 1, p. 857. The utility had some property which was not being used in the present service, but wanted its value included in the total valuation on the theory that it would need it in the near future. It was disallowed, but only for the reason that there was not proof "of necessity near at hand." If the utility had been able to prove that it was actually needed for proper service, it is evident that the value of the land would have been included.

present value of the leased property or only be allowed to charge the rent in its expense account? For example: A gas company may have a nine hundred and ninety-nine year lease upon the land it is using with an annual rental of six thousand dollars. Suppose at the time its property is being valued for the purpose of rate regulation, the property is worth three hundred thousand dollars. There are three possible positions that could be taken by the regulating body: (1) include the item of three hundred thousand dollars in the total valuation, (2) charge to the cost or expense account a reasonable rental for the property of that value; or (3) only allow the sum stipulated in the lease to be charged as an item of cost or expense.

Only one federal case could be found which bore on this question.<sup>7</sup> A railroad which complained of a rate fixed by the commission of California operated part of its system as lessee and paid an annual rental of six hundred thousand dollars as per agreement. Judge McKenna, then sitting on the Circuit Court, allowed this to be charged as an item of operating expense after noting that it must a *bona fide* lease and the rental in proper proportion to the value of the property. Although the point here in question was not raised, yet the case seems to stand for the proposition that the rent named in the lease, if it be *bona fide*, is the rent to be charged as an operating expense. It is submitted, however, that under the application of the reproduction-less-depreciation theory, the utility ought to be allowed to charge as an expense account the fair rental value which the utility would be charged today if it were re-renting the property.<sup>8</sup> This would apparently be in accord with what Mr. Justice Hughes said in the Minnesota Rate Cases:<sup>9</sup>

"It is clear that in ascertaining the present value, we are not limited to the consideration of the actual investment. . . . As

<sup>7</sup> Southern Pacific R. R. Co. v. Board of Commissioners, 78 Fed. 236, 269 (1896).

<sup>8</sup> In Steenerson v. Gr. N. Rwy., 69 Minn., 353, 72 N. W. 713 (1887), it was held that if the rent stipulated in the lease is higher than is now justified, the rent will have to be lessened to the rate of the income on the reproduction value of the property. Hence the reverse of this must be true.

<sup>9</sup> *Supra*, note 5.

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 property involves the recognition of its fair value if it be more than its cost.”

The solution of the problem of leased property suggests another method of treating the property used by a utility for the present service, but to which it has no title. It may be that the Supreme Court would consider the utility in no better position than a lessee of the property used, and only permit it to charge as an expense account the fair rental value of the land.

#### THE BUSINESS THAT CAN BE REGULATED.

It is not the entire business of a public service corporation that can be regulated but only that business which is affected with a public interest and subject to the dominant control of the regulating power. A state can only regulate the intrastate rates of a railroad which does both intrastate and interstate business.<sup>1</sup> A city can only regulate the rates within its corporate boundary and cannot regulate the rates for service to its bordering neighbor.<sup>2</sup>

If a utility is doing both a public and a private business, only the former can be regulated.<sup>3</sup> Therefore it is essential in the valuation of a utility to separate the property which is subject to regulation from that which is not subject to regulation.

When the property is divided into that which can be regu-

<sup>1</sup> *Smyth v. Ames*, 169 U. S. 466, 541 (1897). When only the freight rates are being regulated, the earnings and losses from passengers must be kept separate. *Minn. Rate Cases*, 230 U. S. 385, 434 (1912). But a state commission may, in the absence of Congressional action, regulate the rates charged for natural gas service within the state, although some of the gas is piped from other states, *Manufacturers' L. & H. Co. v. Ott*, 215 Fed. 940 (1914).

<sup>2</sup> *San Diego Land Co. v. National City*, 174 U. S. 739 (1898); *Knoxville Water Co. v. Knoxville*, 212 U. S. 1 (1908).

<sup>3</sup> *Manning v. Chesapeake and Potomac Tel. Co.*, 186 U. S. 238 (1901). There is *dicta* in *Yeatman v. Towers*, 98 Atl. 158; *P. U. R. 1915 E. 811* (Md. 1915), to the effect that where a plant which was doing only a private business is absorbed with a public utility, the public service extends to the *entire* plant. The property owned by the utility which is not necessary for present use cannot be valued, but must be kept separate. *Consolidated Gas Co. v. New York City*, 15 Fed. 849, 857 (1907); *Gas Light Co. v. Cedar Rapids*, 144 Iowa 426, 435 (1909).

lated and that which cannot, it is obvious that the one can have no possible effect upon the other; for if this were not so, the regulating power would in effect be regulating the property over which it has no control. The large return from interstate business cannot be made to bear the loss from a reduced rate on intrastate business on the theory that the total return is non-confiscatory.<sup>4</sup> Neither can the loss due to the rates of the public service business outside a municipality be saddled on the city consumers.<sup>5</sup>

One of the greatest problems in rate regulation is the apportionment of the values of a railroad which does both intrastate and interstate business. A state can only regulate the intrastate rates and these rates can only be regulated on the basis of the value of the property used in intrastate business. It is easy to state the rule, but difficult to apply it. Probably the first method advanced and the one generally used,<sup>6</sup> because it is "a simple method, easily applied," has been the apportionment of the value of the property between intrastate and interstate business based upon the gross revenue derived from each. For example: The total reproduction-less-depreciation value of a railroad in a state is ten million dollars. The gross revenue from both the intrastate and interstate business is one million dollars; one half derived from each business. Therefore the value of the property used in intrastate business purely would be one half of the total value, or five million dollars, and the rate of return would be ten per cent on intrastate business. This was defended by Judge Sanborn in *Shepard v. Northern Pacific Railway*,<sup>7</sup> on the ground that it is an apportionment according

<sup>4</sup> *Smyth v. Ames*, *supra*, note 1. "Nor can the carrier justify unreasonably high rates on domestic business upon the ground that it will be able only in that way to meet the losses on its interstate business."

<sup>5</sup> *San Diego Land Co. v. National City*, *supra*, note 2, at page 758. "This is so clear that we deem it unnecessary to do more than to state the conclusion reached by us on this point."

<sup>6</sup> *Chicago, M. & St. Paul R. R. v. Tompkins*, 90 Fed. 363, 370 (1898); *N. Pac. Rwy. v. Keyes*, 91 Fed. 47 (1898); *St. L. & S. F. R. R. v. Hadley*, 168 Fed. 317, 355 (1909); *M. K. & T. Rwy. v. Love*, 177 Fed. 493, 497 (1910); *Shepard v. N. Pac. Rwy.*, 184 Fed. 765, 810-812 (1911). For an attack upon the use of this method by the federal courts see an article by Hon. Grant G. Martin, "Recent Federal Court Decisions," 21 *YALE L. JOUR.*, 117 (1911).



to the *value of the use*. This, says he, is the basis of all capitalization; of all rate making.

But this method of apportionment has been twice before the Supreme Court and twice has been condemned. In *Chicago, Milwaukee and St. Paul v. Tompkins*,<sup>8</sup> Mr. Justice Brewer used the illustration given above, and in pointing out the defects, said:

"The interstate receipts being unchanged, let the local receipts by a proposed schedule be reduced to one-fifth of what they had been, so that instead of receiving \$500,000 the company only receives \$100,000. The total receipts for interstate and local business being then \$600,000, the valuation of \$10,000,000, divided between the two, would give to the property engaged in earning interstate receipts in round numbers \$8,333,000, and to that engaged in earning local receipts \$1,667,000. But if \$1,667,000 worth of property earns \$100,000, it earns six per cent. In other words, although the actual receipts from local business are only one-fifth of what they were, the earning capacity is three-fifths of what it was. And turning to the other side of the problem, it appears that if the value of the property engaged in interstate business is to be taken as \$8,333,000 and it earned \$500,000, its earning capacity was that employed in local business—six per cent. So that although the rates for interstate business be undisturbed, the process by which the trial court reached its conclusion discloses the same reduction in earning capacity of the property employed in interstate business as that employed in local business, in which the rates are reduced."

The criticism of the gross revenue theory was approved by Mr. Justice Hughes in the Minnesota Rate Cases:<sup>9</sup>

"But it would seem to be clear that the value of the use is not shown by *gross earnings*. The gross earnings may be consumed by expenses, leaving little or no profits. If, for example, the intrastate rates were so far reduced as to leave no net profits, and the only profitable business was the interstate business, it certainly could not be said that the value of the use was measured by the gross revenue."

But the Justice not only disapproved of the gross revenue theory, but also of the theory of the value of the use when it is measured by the return:

"The value of the use, as measured by the return, cannot be

<sup>7</sup> *Supra*, note 6.

<sup>8</sup> 177 U. S., 167, 176 (1900).

<sup>9</sup> *Supra*, note 1, pages 460, 461.

made the criterion where the return itself is in question. If the return, as formerly allowed, be taken as the basis, then the validity of the state's reduction would have to be tested by the very rates which the state denounced as exorbitant. And, if the return as permitted under the new rates be taken, then the state's action itself reduced the amount of value upon which the fairness of the return is to be computed."

He added by way of suggestion:

"When rates are in controversy, it would seem to be necessary to find a basis for division of the total value of the property independently of revenue, and this must be found in the use that is made of the property. That is, there should be assigned to each business, that proportion of the total value of the property which will correspond to the extent of its employment in that business."

This much at least can be said: The property which is used for intrastate business is to be valued according to the *extent* of its use, and not according to the *value* of its use.

How this is to be determined is a different question. Some of the men who have been actively engaged in the valuing of properties for the various commissions, and have given this question much reflection have come to the conclusion that no one rule can be laid down. No matter what formula is adopted, some fact, incapable of proof must be accepted as true. This is borne out in the well-known formula of ton miles and passenger miles. Under this theory, the value of the property used in intrastate freight is found by multiplying the reproduction-less-depreciation value of the railroad property in the state by a fraction which has for its numerator the number of intrastate ton miles, and for its denominator the sum of the interstate and intrastate ton miles and the interstate and intrastate passenger miles. The weakness of this formula is that it must be arbitrarily assumed that it costs the same to move one ton of freight a mile as it does to carry one passenger a mile. It cannot be proved.

The same sort of an objection can be put to the train mile formula, and the engine mile formula, that is, at some point in the formula a fact must be assumed to be true which is extremely doubtful. In a recent case before a state commission, a railroad offered values of its property devoted to intrastate passen-

ger business as determined by the use of all the known theories. This appears to be the safest course for the utilities to pursue. It may be, that the Supreme Court has laid down an impracticable rule; time alone will tell.

*(To Be Concluded.)*

*Douglass D. Storey,  
Law School, University of Pennsylvania.*