

# University of Pennsylvania Law Review

FOUNDED 1852

Formerly  
American Law Register

---

---

VOL. 94

OCTOBER, 1945

No. 1

---

---

## DEVELOPMENTAL COSTS UNDER THE PRUDENT INVESTMENT THEORY

By WILLIAM C. BURT † and JAMES L. HIGESAW \*

### I. INTRODUCTION

The recent Supreme Court cases of *Federal Power Commission v. Hope Natural Gas Co.*<sup>1</sup> and *Federal Power Commission v. Natural Gas Pipeline Co.*<sup>2</sup> open a new era in judicial review of rates set by administrative bodies. What these cases decide for the future of rate making is not clear. It is, however, certain that in procedure at least they mark a clean break with past decisions. Rate-making bodies will no longer be confined in a judicial strait-jacket of a present value rate base. Commissions will have wider discretion in fixing rates.

Moreover, the court has given some encouragement to those who with Mr. Justice Brandeis have maintained that under the Constitution a public utility is not necessarily entitled to a fair return on the present value of its holdings measured by the cost of reproducing the present plant. While the Court did not impose the rule of "prudent investment" on rate making, it at least indicated that Commissions under certain circumstances may measure the rate base by the prudent investment in property useful to the public service without risk of automatic reversal by the courts.

---

† B. S., 1937, LL. B., 1939, University of Illinois. General Counsel Staff, Civil Aeronautics Board. Lt., U. S. M. C. R., assigned to *Leatherneck Magazine*.

\* A. B., 1935, Princeton University; LL. B., 1941, Harvard University. General Counsel Staff, Civil Aeronautics Board.

The opinions expressed in this article are those of the authors and do not necessarily represent the views of the United States Marine Corps or the Civil Aeronautics Board.

1. 320 U. S. 591, 64 Sup. Ct. 281, 88 L. Ed. 333 (1944).

2. 315 U. S. 575, 62 Sup. Ct. 736, 86 L. Ed. 1037 (1942).

The more general acceptance of these views is not the end of a struggle, but the beginning of a new conception of rate making. These concepts are now being haltingly and somewhat vaguely articulated by a court that agrees on overthrowing the rigid standards of the past, but cannot agree on standards or even the necessity of standards for the future. The sharp disagreement on new concepts of rate making means that the new standards for the judicial review of rates will not be hastily stated and dogmatically held, but will be tempered by free discussion and sharp disagreement until new standards are formed which will stand the test of argument.

The very fact that the court austerey refrains from commenting on how rates should be fixed puts the burden of developing the new concepts of rate making on the administrative agencies. Since these agencies have a nodding acquaintance with the general nature of the prudent investment theory, it is likely that they will embrace the familiar. In fixing rates for many utilities during the next few years this method will be widely used.

When rate-making bodies thus freed of many judicial restrictions get down to deciding specific cases, it will be found that the general counsel of "prudent investment," valuable as it may be as a frame of reference, offers little specific guidance. It is believed, however, that the decisions of the court under the present value theories have slowly evolved specific concepts of determining a rate base which offers guidance to rate-making bodies in fixing rates under the prudent investment theory. These concepts will offer some relief from the pandemonium of judicial schizophrenia forecast by the sharp split in the court in the *Hope* case.

Previously the court had required that rates received by a utility be high enough to give a utility a fair return on the "present value" of its property. Otherwise the rate was considered confiscatory and unconstitutional. A classic method of computing "present value" has been to estimate the cost of reproducing under present conditions a plant identical with the utility whose rate base is being established. Thus evidence of "reproduction cost" was accepted as proof of present value upon which fair return must be allowed. In computing the "present value" or "reproduction cost," the court early recognized that a well-developed going concern had more "present value" than an incipient, immature enterprise. Allowance was required for this, and a concept of "going concern" was developed.

There would, of course, be no going concern value as such under the prudent investment theory. Prudent investment is concerned with past capital invested in the enterprise rather than an appraisal of

“value” at the present time. It is the “past investment” in rather than the “present value” of the enterprise that counts. One such capital investment, however, is the cost of developing the business to a going concern. This capital investment in developmental cost is roughly equivalent to what has been regarded as “going concern” value under the present value doctrines. The technique of the courts in measuring these developmental costs is believed pertinent in any attempt to establish a rate base under the prudent investment theory. This article is concerned with how developmental costs should be measured in a prudent investment rate base.

## II. GENERAL CONSIDERATION OF THE PRUDENT INVESTMENT THEORY

There has been little discussion by the United States Supreme Court as to what governs the determination of a prudent investment rate base. The concurring opinion of Mr. Justice Brandeis in the case of *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*<sup>3</sup> contains the classic discussion. Mr. Justice Brandeis stated:

“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.”<sup>4</sup>

“What is now termed the prudent investment is, in essence, the same thing as that which the Court has always sought to protect in using the term present value. Twenty-five years ago, when *Smyth v. Ames* was decided, it was impossible to ascertain with accuracy, in respect to most of the utilities, in most of the States in which rate controversies arose, what it cost in money to establish the utility; or what the money cost with which the utility was established; or what income had been earned by it; or how the income had been expended. It was, therefore, not feasible, then, to adopt, as the rate base, the amount properly invested or, as the rate of fair return, the amount of the capital charge. Now the situation is fundamentally different.”<sup>5</sup>

In a footnote, Mr. Justice Brandeis discusses the identity of prudent investment with historical cost,<sup>6</sup> stating:

---

3. 262 U. S. 276, 289, 43 Sup. Ct. 544, 547, 67 L. Ed. 981, 985 (1923).

4. *Id.* at 290, 43 Sup. Ct. at 547, 67 L. Ed. at 986.

5. *Id.* at 308, 43 Sup. Ct. at 553-4, 67 L. Ed. at 994.

6. Massachusetts, unlike Mr. Justice Brandeis, distinguishes historical cost from prudent investment. Prudent investment is measured by the amount of money prudently invested by bondholders and stockholders. Historical cost looks to the other

“(d) Historical cost, i. e., the proper cost of the existing plant and business, estimated on the basis of the price levels existing at the respective dates when the plant and the additions were constructed. This is often called prudent investment. Historical cost would, under normal conditions, be equal in amount to the original cost. . . . In determining actual cost, whatever the evidence, there is no attempt to determine whether the expenditure was wise or foolish, or whether it was useful or wasteful. *Historical cost, on the other hand, is the amount which normally should have been paid for all the property which is usefully devoted to the public service. It is, in effect, what is termed the prudent investment.* In enterprise efficiently launched and developed, historical cost and original cost would practically coincide both in items included and in amounts paid. That is, the subjects of expenditure would coincide; and the cost at prices prevailing at the time of installation would substantially coincide with the actual cost.”<sup>7</sup>

Under the prudent investment theory as conceived by Mr. Justice Brandeis the rate base is measured by the capital employed in the enterprise, i. e. the amount devoted by the investor to the public use. Prudent investment is equal to historical cost, and the historical cost “is the amount which normally should have been paid for all the property which is usefully devoted to the public service.”

In *Federal Power Commission v. Natural Gas Pipeline Co.*<sup>8</sup> temporary rates had been fixed by the Federal Power Commission on the basis of reproduction cost. The Court had been asked by counsel to rule definitely upon the propriety of the use of a prudent investment base and as to the propriety of refusing to consider reproduction cost testimony. The Court, after upholding the constitutionality of the Natural Gas Act of 1938<sup>9</sup> and the validity of the interim order, discussed the scope of judicial review of rates as follows:

“*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 or-*

---

side of the balance sheet and is the amount prudently invested in assets used and useful in the public service. The Massachusetts concept of prudent investment is peculiarly applicable where the Commission has control over issuance of securities by the utility. Otherwise a rate might be paid on watered or overvalued securities.

7. *Id.* at 295, 43 Sup. Ct. at 549, 67 L. Ed. at 998. (Italics supplied.)

8. 315 U. S. 575, 62 Sup. Ct. 736, 86 L. Ed. 1037 (1942).

9. 52 STAT. 821 (1938), 15 U. S. C. § 717 (1941).

der, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end.”<sup>10</sup>

This statement of the Court gives some sanction to the use of the prudent investment theory for the determination of the rate base. If rate-making bodies are not bound “to the service of any single formula or combination of formulas,” certainly a rate-making body is free in some cases to exclude evidence of reproduction cost and to fix the rate on the sole basis of the prudent investment.<sup>11</sup> It should be noted, however, that since the interim rate fixed by the Commission was based upon reproduction cost, the case cannot be interpreted as a holding that prudent investment is proper. Nor does the case give any specific indication of what should properly be included in a prudent investment rate base.

In *Federal Power Commission v. Hope Natural Gas Co.*<sup>12</sup> the majority opinion upheld a rate order issued by the Federal Power Commission reducing the rates chargeable by the Hope Natural Gas Co. The commission in fixing the rate had used a prudent investment rate base composed of “actual legitimate cost” less depletion and depreciation and plus unoperated acreage, working capital and future capital additions.

The Court upheld the rate. It held that the method used to fix the rates was immaterial as long as the sum produced was sufficient to maintain the capital integrity of the enterprise. Mr. Justice Douglas in speaking for the majority of the Court stated:

“It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. . . .

“The rate-making process under the Act, i. e., the fixing of ‘just and reasonable’ rates, involves a balancing of the investor and the consumer interests. . . . From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. Cf. *Chicago & Grand Trunk Ry. Co. v. Wellman*, 143

10. 315 U. S. 575, 586, 62 Sup. Ct. 736, 743, 86 L. Ed. 1037, 1049-50 (1942). (Italics supplied.)

11. The concurring opinion of Justices Black and Douglas interpret the majority opinion as freeing the commission “from the compulsion of admitting evidence of reproduction cost” and permitting the adoption of prudent investment as a rate base. While this is not controlling, it is nevertheless persuasive. It should further be noted that in the *Hope* case Mr. Justice Jackson stated that he did not believe the opinion in the *Natural Gas* case sanctioned the use of “prudent investment” in all cases of utility regulation, but conceded it would be proper in some cases.

12. 320 U. S. 591, 64 Sup. Ct. 281, 88 L. Ed. 333 (1944).

U. S. 339, 345-346. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. See *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission*, 262 U. S. 276, 291 (Mr. Justice Brandeis concurring). The conditions under which more or less might be allowed are not important here. Nor is it important to this case to determine the various permissible ways in which any rate base on which the rate is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint."<sup>13</sup>

"Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, *even though they might produce only a meager return on the so-called 'fair value' rate base.* . . ."<sup>14</sup>

This case set up a unique test for checking the validity of a rate. It examined the right- rather than the left-hand side of the balance sheet and tested the end result produced by the rate on the financial structure of the enterprise. It is not the purpose of this article to discuss the merits of this procedure.<sup>15</sup> It is sufficient to say, however, that the majority specifically sustained a rate based on the prudent investment theory even though it would have produced a "meager" return on the present value of the enterprise.<sup>16</sup> Apparently, too, unless the lump sum produced by the rate is obviously insufficient, it will be upheld by the Court. A broad discretion is permitted the commission.

The case, however, gives no clue as to what elements should be considered in determining prudent investment rate base. If the end result satisfies the test, the Court will sustain the rate. It specifically refused to consider whether well-drilling and other costs should under the prudent investment theory be included in the rate base.<sup>17</sup>

13. *Id.* at 602, 603, 64 Sup. Ct. at 288, 88 L. Ed. at 345.

14. *Id.* at 605, 64 Sup. Ct. at 289, 88 L. Ed. at 346. (Italics supplied.)

15. The test used by the Court apparently assumes that the present capital structure of the utility is sound. If, for example, a utility had watered or overvalued security, an administrative agency should not be required to pay a rate high enough to maintain the "financial integrity" of the inflated security. Unquestionably the general test of the *Hope* case will be refined and particularized in future cases.

16. The dissenting opinions of Justices Jackson, Reed, and Frankfurter concur in the propriety of using a prudent investment rate base at least under some conditions.

17. The Court stated: "In view of this disposition of the controversy we need not stop to inquire whether the failure of the Commission to add the \$17,000,000 of well-drilling and other costs to the rate was consistent with the prudent investment theory as developed and applied in the particular cases." *Id.* at 605-6, 64 Sup. Ct. at 289, 88 L. Ed. at 346-7.

### III. DEVELOPMENTAL COSTS UNDER THE PRUDENT INVESTMENT THEORY AS THE EQUIVALENT OF GOING CONCERN VALUE UNDER THE PRESENT VALUE THEORY

While the cases *supra* offer little in the way of detail as to what items should be included in a prudent investment rate base, they do offer a useful general concept. The rate base is the amount which normally should have been paid for all the property which was usefully devoted to the public service. As a matter of inference, capital invested to develop the business to its present state as a going concern may be logically included in prudent investment rate base.

Moreover, in fixing a rate base under the present value theory the standards and tests of measuring "going concern value" were employed which were as appropriate to the prudent investment theory as they were inappropriate to the present value theory. The Supreme Court had long felt that a well-developed "going concern" had more "present value" than an incipient business, and it tried to measure this in two general ways. In the first place, it has been measured as an *increment of value* accruing to the property used in the public service because it is an established plant doing business and earning money, i. e. a going concern.<sup>18</sup> Actually this increment was on any realistic basis indistinguishable from "good will" which the court had brusquely refused to include in the rate base.<sup>19</sup> In some cases this has been computed as a separate addition to the value of the physical property.<sup>20</sup> In others the general appraisal of the physical assets is held to appraise the plant as a going concern.<sup>21</sup> This first measure of going concern is a value concept peculiarly pertaining to the reproduction cost theory where the attempt is to compute the "present value" of the plant. It has no relation to the prudent investment theory where the rate base is limited to and measured by the "investment" of the past rather than an appraisal of "present value."

In the second place, going concern value has been measured by the cost of developing the business to a going concern. The procedure and standard of measurement used by the Court in ascertaining the

---

18. *McCardle v. Indianapolis Water Co.*, 272 U. S. 400, 47 Sup. Ct. 144, 71 L. Ed. 316 (1926); *Denver v. Denver Union Water Co.*, 246 U. S. 178, 38 Sup. Ct. 278, 62 L. Ed. 649 (1918).

19. *Willcox v. Consolidated Gas Co.*, 212 U. S. 19, 29 Sup. Ct. 192, 53 L. Ed. 382 (1909).

20. *McCardle v. Indianapolis Water Co.*, 272 U. S. 400, 47 Sup. Ct. 144, 71 L. Ed. 316 (1926).

21. *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio*, 292 U. S. 398, 54 Sup. Ct. 763, 78 L. Ed. 1327 (1934); *Los Angeles Gas & Electric Corp. v. Railroad Commission of Cal.*, 289 U. S. 287, 53 Sup. Ct. 637, 77 L. Ed. 1180 (1933).

cost of developing a business to going concern are directly applicable to a rate base measured by prudent investment.

The leading case defining "going concern" under the present value doctrine is *Des Moines Gas Co. v. Des Moines*.<sup>22</sup> Going concern was analyzed as follows:

"That there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced, is self-evident. This element of value is a property right, and should be considered in determining the value of the property, upon which the owner has a right to make a fair return when the same is privately owned although dedicated to public use."<sup>23</sup>

*"Included in going value as usually reckoned is the investment necessary to organizing and establishing the business which is not embraced in the value of its actual physical property. In this case, what may be called the inception cost of the enterprise entering into the establishing of a going concern had long since been incurred."*<sup>24</sup>

The Court held that in the evaluation of the physical plant and in determining the overhead charges, the Master had already included going concern value and hence no separate estimate of the amount was necessary. In this reproduction cost rate base, going concern value was measured by the "investment necessary to organizing and establishing the business which is not embraced in the value of its actual physical property." It was considered the "inception cost" entering into the establishment of a going concern. This measurement of going concern value under the reproduction cost theory is essentially the same as the measurement for developmental costs under the prudent investment theory.

*Galveston Electric Co. v. Galveston*<sup>25</sup> furnishes the only direct authority on what should constitute developmental costs under the prudent investment theory. The utility attempted to compute the cost of developing to a profitable going concern by capitalizing its past deficits. The Master allowed this amount but the lower court disallowed it. Mr. Justice Brandeis delivered the decision of the Supreme Court, affirming the action of the lower court, stating:

*"If the rule were that a prescribed rate is to be held confiscatory in case net earnings are not sufficient to yield 8 per cent. on the amount prudently invested in the business, there might be propriety in counting as part of the investment such amount, if any,*

22. 238 U. S. 153, 35 Sup. Ct. 811, 59 L. Ed. 1244 (1915).

23. *Id.* at 165, 35 Sup. Ct. at 815, 59 L. Ed. at 1251.

24. *Id.* at 165, 35 Sup. Ct. at 815, 59 L. Ed. at 1251. (Italics supplied.)

25. 258 U. S. 388, 42 Sup. Ct. 351, 66 L. Ed. 678 (1921).



*as was necessarily expended at the start in overcoming initial difficulties incident to operation and in securing patronage.* But no evidence of any such expenditure was introduced; and the claim of the company does not proceed upon that basis. What was presented by the witnesses are studies, on various theories, of what past deficiencies in net income would aggregate, if 4 per cent. were allowed as a depreciation annuity and 8 per cent. compound interest were charged annually on the value of the property used.”<sup>26</sup>

“A company which has failed to secure from year to year sufficient earnings to keep the investment unimpaired and to pay a fair return, whether its failure was the result of imprudence in engaging in the enterprise, or of errors in management, or of omission to exact proper prices for its output, cannot erect out of past deficits a legal basis for holding confiscatory for the future, rates which would, on the basis of present reproduction value, otherwise be compensatory. *Knoxville v. Knoxville Water Co.*, 212 U. S. 1, 14.”<sup>27</sup>

This is the only appropriate statement in the Supreme Court cases on the measure of developmental costs under the prudent investment theory. It is recognized, of course, that the statement is only dictum and indicates what might be considered rather than what must be considered. Developmental cost as computed by the Master would include a capitalization of losses due to imprudence in engaging in the enterprise, the errors in management and omission to exact proper prices. Obviously, developmental cost, including these items, would not be a proper cost to be added to any rate base. It seems clear, however, that under the prudent investment theory such developmental cost “as was necessarily expended at the start in overcoming initial difficulties incident to operation and in securing patronage” would be properly included.

Bauer and Gold<sup>28</sup> summarize the result of the case, as follows:

“Judge Brandeis swept aside the entire conception that past losses and inadequate returns can be taken as the basis of present valuation. As a matter of investment he recognizes that actual and necessary developmental costs might be included, if duly established; but not past losses.”<sup>29</sup>

These cases were concerned with particular situations, and so developmental costs were rather narrowly defined. They are limited to expenditures “to overcome initial difficulties incident to operation and in

26. *Id.* at 394, 42 Sup. Ct. at 354, 66 L. Ed. at 682. (Italics supplied.)

27. *Id.* at 395, 42 Sup. Ct. at 354-5, 66 L. Ed. at 683.

28. BAUER & GOLD, PUBLIC UTILITY VALUATION FOR PURPOSES OF RATE CONTROL (1934).

29. *Id.* at 330.

securing patronage." They embraced mere "inception costs" or "investment necessary to organizing and establishing the business." Thus, developmental costs are so defined as to relate only to the beginning of the enterprise. But old businesses develop as well as new. It is submitted that if a cost relates to the development of the business and can be considered a capital item it is immaterial at what time it occurs. For example, if an established airline secures a new route, it is believed, that developmental cost relating to that route should be treated on the same basis as those which occurred at an early stage of the enterprise. Any cost at any time in the history of the business which contributes to the development of the business should logically be included.

#### IV. DEVELOPMENTAL COSTS UNDER THE PRUDENT INVESTMENT THEORY

(1) *Developmental costs may be included as capital items in a prudent investment rate base or may be written off as an operating expense.*

In two cases the Supreme Court has held rates computed under the "present value" theory to be confiscatory because there was no allowance for going concern value.<sup>30</sup> The basic language relied on in both of these cases is that in the *Des Moines Gas Co.* case<sup>31</sup> where it is said with reference to going concern value:

"This element of value is a property right, and should be considered in determining the value of the property, upon which the owner has a right to make a fair return when the same is privately owned although dedicated to public use."<sup>32</sup>

This statement is reiterated in the *Los Angeles Gas Co.* case<sup>33</sup> where the Court approved the evaluation of the commission only because there was an increment of value above historical cost which might include going concern value.<sup>34</sup>

30. *McCardle v. Indianapolis Water Co.*, 272 U. S. 400, 47 Sup. Ct. 144, 71 L. Ed. 316 (1926); *Denver v. Denver Union Water Co.*, 246 U. S. 178, 38 Sup. Ct. 278, 62 L. Ed. 649 (1918).

31. 238 U. S. 153, 35 Sup. Ct. 811, 59 L. Ed. 1244 (1915).

32. *Id.* at 165; 35 Sup. Ct. at 815, 59 L. Ed. at 1251.

33. 289 U. S. 287, 53 Sup. Ct. 637, 77 L. Ed. 1180 (1933).

34. Two qualifications to this general rule should be noted. (1) A separate evaluation is not necessary and a general appraisal of the physical assets in actual operation may sufficiently include going concern value. *Cedar Rapids Gas Light Co. v. Cedar Rapids*, 223 U. S. 655, 32 Sup. Ct. 389, 56 L. Ed. 594 (1912); *Denver Union Stock Yard Co. v. United States*, 304 U. S. 470, 58 Sup. Ct. 990, 82 L. Ed. 1469 (1938); *Des Moines Gas Co. v. Des Moines*, 238 U. S. 153, 35 Sup. Ct. 811, 59 L. Ed. 1244 (1915); *Dayton Power & Light Co. v. Public Utilities Commission of Ohio*, 292 U. S. 290, 54 Sup. Ct. 647, 78 L. Ed. 1267 (1934); *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio*, 292 U. S. 398, 54 Sup. Ct. 763, 78 L. Ed. 1327 (1934); *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 62 Sup. Ct. 736, 86 L. Ed. 1037 (1942). Under the prudent investment theory the rate base is determined

Under the prudent investment theory developmental costs may be handled in one of two different ways. (1) They may be treated as a current account and included in operating expenses. (2) They may be treated as a capital account and included in the rate base. In dicta in the *Galveston* case,<sup>35</sup> Justice Brandeis went so far as to say that under the prudent investment theory "there might be propriety" in counting developmental costs as a part of the investment.<sup>36</sup> But there is nothing to indicate that such costs must be included.

While the cases are inconclusive, apparently a commission may treat developmental costs as either current or capital items as long as the utility is compensated for it in one way or another. Today regulatory agencies generally determine the proper disposition of such items in their uniform system of accounts.<sup>37</sup> It is believed that whatever method is followed by the commission would be approved by the Court.<sup>38</sup>

(2) *It is preferable to capitalize developmental cost in a prudent investment rate base.*

Developmental costs properly proved and not previously paid out of earnings should under the prudent investment theory be capitalized in the rate base rather than charged as a current expenditure. Once capitalized, however, it is believed desirable to write them off over a period of years rather than retain an intangible asset in the balance sheet indefinitely and permanently burden the rate payer.

As a general accounting proposition, an item should be allocated to as many periods as it is useful in the operation of the business. An item allocated to more than one accounting period is deemed "capitalized." Thus the cost of a building is capitalized because it is used for a period longer than the annual accounting period. A maintenance cost accomplishes its purpose in one accounting period, and should be charged off annually. Since developmental costs generally relate to and affect a period longer than the annual accounting period, the incidence of the cost should be borne by the longer period. It should be

---

by the amount actually invested. There is no general appraisal which is likely to include developmental costs. (2) Where the past rates charged have been sufficient to write off developmental costs as current expenses, the Court has not required their inclusion in the rate base. (See IV (4) *infra*.)

35. 258 U. S. 388, 42 Sup. Ct. 351, 66 L. Ed. 678 (1921).

36. *Id.* at 394, 42 Sup. Ct. at 354, 66 L. Ed. at 682.

37. Federal Power Commission—Capital account. California Railroad Commission—Current account. Wisconsin Commission—Current account. Massachusetts Department of Public Utilities—Current account.

38. See, however, Mr. Justice Jackson's dissent in the *Hope* case, where he states: "This attributes a significance to formal classification in account keeping that seems inconsistent with rational rate regulation." 320 U. S. 591, 643, 64 Sup. Ct. 281, 307, 88 L. Ed. 333, 367 (1944).

capitalized and written off over the period which it affects. The effect on the total cost of each particular year should be charged to the operating expenses of that year. Obviously the incidence of an item like developmental cost cannot be computed with precise accuracy and the writing-off of such cost will necessarily be somewhat arbitrary. It is suggested that a write-off period of twenty years might be acceptable.

Not only are developmental costs logically a capital item, but it is more equitable to capitalize them. If they are treated as current items, higher rates must be charged during developmental periods to compensate for these expenditures. This puts an unfair burden on rate payers during the developmental period. It is equitable to spread the charge over a longer period of time. The longer period reaps the benefit of developmental costs and should share the burdens.

The rationale of permitting developmental costs relating to more than one account period to be capitalized has been set forth in Bauer and Gold:

"If there were such costs, they stand basically as any other capital costs incurred for the public service. While they are not attached to physical or other items of property, they were nevertheless incurred for the benefit of the properties as a whole. . . .

"The additional cost incurred during the development period is properly recognized as capital expenditure no different from investment in physical properties or intangible rights. It is analogous to interest and other general overheads during construction. . . . It is a part of the total investment required to establish the business as a going concern."<sup>39</sup>

There are, however, strong arguments in favor of charging these developmental costs to operating expenses. In the first place, the distinction between capital and current accounts is not altogether clear. Moreover, if developmental costs are treated as a capital item and not written off at all, they are a permanent burden on the rate payer. Furthermore, investment in developmental costs does not represent an investment in a tangible item. It is generally considered desirable accounting practice to squeeze the tangibles out of the balance sheet.

Most state commissions using the prudent investment theory have treated developmental expenses as current items.<sup>40</sup> It should be noted that in these cases developmental cost had already been recouped, and the utility was attempting to obtain a double charge for the costs. In

39. BAUER & GOLD, PUBLIC UTILITY VALUATION FOR PURPOSES OF RATE CONTROL (1934) 309-310.

40. See, for example, *Dept. of Public Service v. Pacific Power & Light Co.*, 13 P. U. R. (N. S.) 187 (Wash. 1936); *Re Los Angeles Gas & Electric Corp.*, P. U. R. 1931 A 132 (Cal.); *City of Marinette v. City Water Co.*, 6 P. U. R. (N. S.) 501 (Wis. 1934). With regard to Massachusetts, see WEBER, PRINCIPLES OF PUBLIC UTILITY REGULATIONS (1941) 135-6.

other cases there were no records and the best guess was that such costs had been charged to current accounts and had already been compensated in the rate charged. In regulating older utilities, it seemed likely that the rates charged in the past had covered developmental expenses, and there was a natural tendency to refuse to capitalize them in the rate base.

In most cases, however, developmental costs relate to more than the annual accounting period and should be treated as a capital item. Charging them as current expenses puts an unfair burden on the early rate payer. A legitimate distinction can be drawn between ordinary recurrent operating expenses and extraordinary nonrecurrent expenditures relating to a period of time longer than the annual accounting period. By writing developmental costs off over a limited period of years the objections raised to their capitalization are nullified.

(3) *The utility has the burden of proving developmental cost.*

The Supreme Court has in several cases indicated that the burden of proving developmental costs is on the utility. Thus in the *Dayton Power & Light Co. v. Public Utilities Commission of Ohio*,<sup>41</sup> the Court stated:

“. . . upon proof of its existence it [going concern value] may have a place in the base upon which rates are to be computed. . . . Going value is not something to be read into every balance sheet as a perfunctory addition. ‘It calls for a consideration of the history and circumstances of the particular enterprise.’ ”<sup>42</sup>

In the *Galveston* case<sup>43</sup> no allowance was made because “no evidence of any such expenditure was introduced.” Likewise in *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio*<sup>44</sup> no allowance was permitted because “no evidence was offered by the appellant that expenses had been incurred” in overcoming difficulties incident to operation and securing patronage. In the *Des Moines* case<sup>45</sup> the Court stated: “it is not to be presumed, without proof, that a Company is under the necessity of making up losses and expenditures incidental to the experimental stages of its business.”<sup>46</sup> While these cases were decided under the reproduction cost theory, the principle is believed applicable to a determination under the prudent investment theory.

41. 292 U. S. 290, 54 Sup. Ct. 647, 78 L. Ed. 1267 (1934).

42. *Id.* at 308-9, 54 Sup. Ct. at 656, 78 L. Ed. at 1280.

43. 258 U. S. 388, 42 Sup. Ct. 351, 66 L. Ed. 678 (1921).

44. 292 U. S. 398, 54 Sup. Ct. 763, 78 L. Ed. 1327 (1934).

45. 238 U. S. 153, 35 Sup. Ct. 811, 59 L. Ed. 1244 (1915).

46. *Id.* at 166, 35 Sup. Ct. at 815, 59 L. Ed. at 1251.

In certain cases under the reproduction cost theory, expert testimony had been introduced to estimate what the developmental cost would be were the plant reproduced. These estimates of experts have been generally repudiated by the Supreme Court. In the *Los Angeles Gas Co.* case,<sup>47</sup> for example, expert witnesses had computed going concern value by compiling various estimates. The Court summarily dismissed their testimony stating:

"It is unnecessary to analyze the testimony of these witnesses, as it is obviously too conjectural to justify us in treating the failure to include their estimates as a sufficient basis for a finding of confiscation."<sup>48</sup>

In the *Columbus Gas Co.* case<sup>49</sup> the Court sustained the refusal of the Commission to include a separate allowance for going concern value in a present value rate base. In refusing the estimates of the company's "experts" as to what the costs of developing a business to going concern should be, the court administered a classic judicial drubbing to such "expert" computations stating:

"Thus, some of the appellant's experts have included interest or return unearned during the business development period as a factor contributing to going value, one witness placing this factor as high as \$6,300,000. Their method of computation was condemned by this court in *Galveston Electric Co. v. Galveston*, 258 U. S. 388, 394, in very similar conditions. No evidence was offered by the appellant that expenses had been incurred 'in overcoming initial difficulties incident to operation and in securing patronage.' *Galveston Electric Co. v. Galveston*, *supra*. . . .

"Other experts, who reject the factor of interest unearned during the period of development, build their estimates of going value upon the cost of attaching new customers to the business, a cost not taken from the books, but merely presumed or estimated at widely variant amounts. So far as such expenses had been actually incurred by any affiliated company, they had already been included as part of the cost of operation. So far as value had been added above the moneys thus expended, there was not even approximate precision in measuring its amount. . . .

"From the testimony as a whole one gains a definite impression that the opinions are derived for the most part from a professed experience and understanding of business conditions generally, and very little from any knowledge of the 'history and circumstances of the particular enterprise.'"<sup>50</sup>

47. 289 U. S. 287, 53 Sup. Ct. 637, 77 L. Ed. 1180 (1933).

48. *Id.* at 319, 53 Sup. Ct. at 649, 77 L. Ed. at 1200.

49. *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio*, 292 U. S. 398, 54 Sup. Ct. 763, 78 L. Ed. 1327 (1934).

50. *Id.* at 412-3, 54 Sup. Ct. at 770, 78 L. Ed. at 1335-6.

In these cases the Court was interested in measuring the "present value" of the utility holdings. It vigorously rejected estimates of what it "would" cost to develop the business to "going concern." Moreover, it indicated a strong preference for proof of developmental costs actually incurred. Certainly if such estimates are rejected under a reproduction cost determination where the whole evaluation is a matter of appraisal, they would be rejected under a prudent investment determination. It is concluded that developmental costs cannot be proved by the estimates of experts or by capitalizing past deficits.<sup>51</sup> There must be proof of actual expenditures made and costs incurred in the development of the business to a going concern.

(4) *The utility must prove the developmental costs have not been recouped out of past earnings.*

In many instances utilities have charged all developmental costs to operating expenses. If the earnings during those years have been reasonable, it is clear that these costs have already been recouped. If a rate payer is to be protected against paying twice, these costs cannot later be included in the rate base.<sup>52</sup>

In the *Des Moines* case,<sup>53</sup> the Court in denying any allowance for going concern value measured by the "investment necessary to organizing and establishing the business which is not embraced in the value of its actual physical property," stated:

"For aught that appears in this record, these expenses may have been already compensated in rates charged and collected.  
 . . . " <sup>54</sup>

This conclusion is supported in the *Columbus Gas* case<sup>55</sup> and the *Driscoll* case.<sup>56</sup>

In *Federal Power Commission v. Natural Gas Pipeline Co.*, *supra*, the Court stated that the company had the burden of showing that developmental costs had not been "recouped from prior earnings of the business." After pointing out that the company had charged all de-

51. See *Galveston Electric Co. v. Galveston*, 258 U. S. 388, 42 Sup. Ct. 351, 66 L. Ed. 678 (1912).

52. It has been argued that in a determination of "present value" if developmental costs create "value" it is immaterial whether they have been recouped from prior earnings. This argument finds some support in the language of some cases. *Lincoln Gas & Electric Light Co. v. Lincoln*, 250 U. S. 256, 39 Sup. Ct. 454, 63 L. Ed. 968 (1919). While the soundness of this argument may be doubted even under a reproduction cost appraisal, it obviously is not applicable to a determination of prudent investment.

53. 238 U. S. 153, 35 Sup. Ct. 811, 59 L. Ed. 1244 (1915).

54. *Id.* at 166, 35 Sup. Ct. at 815, 59 L. Ed. at 1251.

55. 292 U. S. 398, 54 Sup. Ct. 763, 78 L. Ed. 1327 (1934).

56. *Driscoll v. Edison Light & Power Co.*, 307 U. S. 104, 59 Sup. Ct. 715, 83 L. Ed. 1134 (1939).

developmental costs to current operations and yet had made substantial earnings, the Court stated:

"Whether there is going concern value in any case depends upon the financial history of the business. *Houston v. Southwestern Tel. Co.*, 259 U. S. 318, 325. This is peculiarly true of a business which derives its estimates of going concern value from a financial history preceding regulation. That history here discloses no basis for going concern value, both because the elements relied upon for that purpose could rightly be rejected as capital investment in the case of a regulated company, and because in the present case it does not appear that the items, which have never been treated as capital investment, have not been recouped during the unregulated period."<sup>57</sup>

In *Federal Power Commission v. Hope Natural Gas Co.*,<sup>58</sup> the Commission refused to include in a prudent investment rate base \$17,000,000 for well-drilling and similar expenses which had previously been charged to operating expenses. The Court having determined that the lump sum produced by the rate was sufficient to maintain the financial integrity of the enterprise refused to consider whether the Commission should have added this amount to the rate base stating:

"In view of this disposition of the controversy we need not stop to inquire whether the failure of the Commission to add the \$17,000,000 of well-drilling and other costs to the rate base was consistent with the prudent investment theory as developed and applied in particular cases."<sup>59</sup>

Thus the Court upheld the rate determined by the prudent investment theory where the rate did not include large expenditures for well-drilling which had previously been charged to operating expenses.<sup>60</sup>

The utility has the burden of establishing that developmental costs have not been recouped from earnings. In these cases despite the charging of developmental costs to operating expenses, the earnings had been sufficient to provide a reasonable return. No cases have been found where the earnings were insufficient. In such a situation, however, the costs have not been recouped and the objection to including them in the rate base would no longer be applicable.

57. 315 U. S. 575, 591, 62 Sup. Ct. 736, 745, 86 L. Ed. 1037, 1052 (1942).

58. 320 U. S. 591, 64 Sup. Ct. 281, 88 L. Ed. 333 (1944).

59. *Id.* at 605-6, 64 Sup. Ct. at 289, 88 L. Ed. at 346.

60. Mr. Justice Reed dissented from this holding because it was "illogical to throw out the admittedly prudent cost of part of the property because the earnings in the unregulated period had been sufficient to return the prudent cost to the investors over and above a reasonable return." *Id.* at 624, 64 Sup. Ct. at 298, 88 L. Ed. (Adv. Ops.) at 295. Mr. Justice Jackson dissented because "this attributes a significance to formal classification in account keeping that seems inconsistent with rational rate regulation." *Id.* at 643, 64 Sup. Ct. at 307, 88 L. Ed. at 367.



(5) *The utility must establish that developmental expenditures have been prudently incurred.*

It seems apparent that under the prudent investment theory, investment in developmental costs as well as any other investment must be prudently made. The concept of what constitutes a prudent investment was set forth by Mr. Justice Brandeis in a footnote to his opinion in the *Southwestern Bell Telephone* case,<sup>61</sup> in which he stated:

“The term ‘prudent investment’ is not used in a critical sense. There should not be excluded from the finding of the base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown.”<sup>62</sup>

It is undoubtedly true that administrative bodies should not be too critical in determining whether an expenditure is prudent. It must be recognized that a great many items are matters of business discretion and business judgment. The language of Mr. Justice Brandeis, however, in effect raises a presumption of prudence. It is believed that this goes too far for practical purposes. Since the facts respecting the prudence of an investment are in the possession of the utility, it seems desirable to place the burden of proof upon it.

Once the facts supporting the prudence of the investment have been introduced the administrative agency should not interfere with business discretion or substitute its own judgment for that of the utility. The investment should be upheld unless clearly imprudent. But the burden of producing facts justifying the investment should be on the utility.

## V. CONCLUSION

The reticence of the new Supreme Court to interfere with rate-making methods forecasts a new freedom for rate-making agencies. At least, at first, these agencies are likely to turn to the general familiarity of the prudent investment theory. When they do, it will be realized that the new freedom imposes responsibilities of decision in rate making which are complex and difficult.

One of the most difficult determinations, it is believed, will be the measure of prudent investment in developmental costs. It is suggested that before developmental costs be included in a prudent investment rate base, the following be established:

---

61. 262 U. S. 276, 43 Sup. Ct. 544, 67 L. Ed. 981 (1923).  
62. *Id.* at 289, 43 Sup. Ct. at 547, 67 L. Ed. at 986.

- (1) Developmental costs were actually incurred in a specific amount.
- (2) They are proper capital items.
- (3) They have not been recouped out of past earnings.
- (4) They were prudently incurred.

The utility has the burden of proving the amount of developmental costs. This cost may not be proved by the estimates of experts nor may it be computed by capitalizing past deficits. There must be proof of actual expenditures made and costs incurred in the development of a business.

In the second place, it must be established that these developmental costs are proper capital items. A distinction must be drawn between ordinary, recurrent operating expenses and extraordinary nonrecurrent expenditures relating to and affecting a period of time longer than the annual accounting period. The unique nonrecurring developmental costs relating to the long-range activity of the carrier should be capitalized and amortized over a period of years.

In the third place, the utility must establish that developmental costs have not been recouped out of past earnings. If the utility has charged developmental costs to current accounts and the earnings during that period have been sufficient to provide a reasonable return, developmental costs should not be included in the rate base. Otherwise, the rate payer would be paying twice for the same cost.

Finally, the utility must establish that developmental costs were prudently incurred. It must be recognized, of course, that, since expenditures for development are largely matters of business discretion and judgment, they should not be viewed too critically. However, since the facts are in the possession of the utility, it seems desirable to place the burden of proving prudence on the utility.

Of course, rate making is not a matter of formula, but of judgment. The standards outlined are not to be interpreted as rigid requirements, but rather as flexible guides in a complex judgment determination. As such, it is believed that they may be usefully applied in the new, important, formative period of rate making which we are just entering.