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The Public's Interest in the O'Fallon Decision

BY L. D. MCPHERSON

Did the supreme court of the United States in its recent opinion in the O'Fallon case, which was a test case on railroad valuation, decide "the greatest lawsuit in history"? It had been thought in many quarters that valuation of railroads would give rise to "the greatest lawsuit in history," and the O'Fallon case, which was started in 1924, has been generally discussed as such a case because it involved principles for the determination of railroad values and operating income applicable to all roads. The O'Fallon decision held that the valuation order made by the interstate commerce commission must be vacated because no consideration had been given the present cost to reproduce the railroad as required by the act of congress and the law of the land. The decision did not indicate the weight that should be given such cost in determining value, but indicated that there were, perhaps, many railroads which should be valued far below their present reproduction cost. As previous decisions had been consistent with this one, the public had generally discounted the probable effect of it as rendered. The extent to which the general public may be affected, favorably or adversely, by the decision may be best estimated by enumeration of some of the interests involved.

EFFECTS OF THE DECISION

Rates will not be increased because of the decision—certainly not for several years, or until valuations are finished. Some claim that the cost of most railroad property has increased about 85 per cent.; others, that the net increase is not more than 40 per cent. Under these views the maximum increase in rates that the decision could possibly effect would be from 5 to 10 per cent. Therefore, this decision could not dominantly influence changes in rates.

The "prudent investment" theory used by the commission in the O'Fallon case failed to receive the approval of the supreme court. In applying this theory the commission priced and depreciated railroad property which had been installed prior to the late war without first enhancing its cost for subsequent increases in prices. All property added later was considered at actual cost.

The decision should result in cheaper discount and brokerage commissions for underwriting the sale of railroad securities, because of the reassurance investors receive.

Prosperous railroads, according to the principles upheld, may be relieved, to a substantial extent, of paying to the government one half of their net railway-operating income in excess of 6 per cent. on the value of their property. They are relieved of interest on such income until its amount is determined.

There will be continuation, for several years at least, of the high expense to the public (so far about $155,000,000), in federal taxes and transportation rates, of administering the valuation and transportation acts, but even though these expenses seem high, there are important uses to be made of the railroad valuations, including regulation of rates, security issues, depreciation, accounting, consolidations and recovery of excess railway-operating income.

The decision may clarify economic thought as to the reasons, if any, for differences in valuations for rate regulation, recapture, financing, consolidations and taxation.

DECISION MAY AFFECT VALUATION

Legislation will doubtless be advocated on behalf of the public to build extensions to national highway systems to provide competition to the railroads. An effort will be made to eliminate as arbitrary, fictitious and uneconomic some provisions of the interstate commerce act and to propose instead a principle which allows railroads a fair return for the services rendered the public. A repeal of the provisions for finding or considering reproduction cost in fixing railroad values will probably be sought.

The repeal would not accomplish its object as long as the established interpretation of the constitution is followed. Similar laws have been held void as an invasion by the legislative branch of government into the separate and exclusive domain of the judiciary. If legislation of the type suggested is advocated, the railroads may propose amendments to permit determination of their net railway-operating income as an average over a reasonable period of lean as well as prosperous years, instead of for a a single year.

The railroads may find it difficult to assemble conclusive proof of current or reproductive costs for even the major portions of their property. If the data are available, the serious problem of qualifying them as proof of an accurate measure of such cost still remains. The railroads may have to prove that all their facilities are a present necessity and convenience of the transportation plant; that they are efficient, economical and adaptable to transportation needs. If such a showing were made by railroads, the bureau of valuation of the commission, or interveners, might prove the contrary by the data taken from the numerous and frequent reports made by the railroads to the commission and other governmental agencies. These data may include a wealth of statistics as to such features as ill advised location, uneconomic grades and curvature, obsolescence in equipment, bridges, tunnels, shops and other buildings and structures, the shifting of traffic to competing forms of transportation and the probable cost of substituting for the railroad a more economical and efficient plant which would be capable of rendering the required service. On such showings, conflict in evidence might be so great that doubts might be resolved by the commission against the railroads. If the members of the commission agreed, and recited in the valuation order that it had duly considered all evidence before it, it would be difficult for a railroad to reverse that order in court, even in a case where confiscation of property was alleged to result. Strength for such a disposition of the evidence by the commission is found in the regulation under which the renewal or replacement of railroad property as it is exhausted, damaged or retired from service is paid for as a current railway-operating expense. As prices advanced the increased cost of such renewals as are found in the present-day railroad would properly have been paid for at these advanced prices from the rates collected for service. If rates collectable have not been adequate to pay the advances in the costs of renewals plus a just contribution to depreciation reserves and a fair return on the value of the railway, the failure of the management to collect sufficient rates may have been due to economic causes. If the owners, by waiving a fair return, have borne some or all of the higher costs of renewals there is more equity in the demand for rates to yield a return on the property valued at the present advanced cost of reproduction. If not, the payment of the higher costs by the rate-payers shifts to the owners the burden of proving that this is not a duplication of charges.

INCREASED RAILROAD VALUATION STIMULATES OTHER FORMS OF COMPETITION

The value of railroad property is not insensible to competition which has been fostered by federal government aids to shipping through the opening and operation of the Panama Canal, through intercoastal and inland waterway development and harbor improvements, and through the building of highways of more than one third the length of all main-line railway mileage. Such automobile highways connect with other systems and constitute altogether a mileage of three fourths the full length of all railway main-line mileage. Motor-bus, motor-truck and private-passenger-automobile operation on these highways has depressed the rates and volume of railroad passenger traffic, express, and package and less-than-car-load freight, even for long distances. The highways carry much freight that formerly went in car loads. Some applications have been granted to reduce passenger train fares as much as one half. The commission annually grants numerous petitions by railroads for reduction in service and abandonment of lines. This causes some compensation to the railroads, as the local trains discontinued and the lines abandoned were generally unprofitable before competition on the highways was effective. However, full consideration of all problems of highway transportation raises a doubt that it will increase further as competition to railroads.

Pipe-line construction has also provided considerable competition to the railroads. Competition between rail and water carriers at many points depresses rates to those common points. To avoid discrimination, which is forbidden by law, charges for shorter hauls to stations between these common points generally can not be higher than for the longer haul to the competitive points. This alone has tended to depress rates at nearly all stations. Other laws defeat possible economies in transportation, such as "full train crew" laws which put unnecessary employees on some trains, and franchises, ordinances, contracts, etc., which regulate or interfere with the speed of operation, with station stops and with the abandonment of locations for roadway, stations, shops, etc., which are no longer useful.

On valuation questions many railroad labor unions opposed the claims of the owners. Their opposition was apparently based on the idea that the less the owners took out of the revenue, the more there would be for the workers.

RAILROAD VALUES LESSENED

Changes in conditions due to science and progress apparently had not been taken fully into account by the commission and were dealt with in the majority opinion in the O'Fallon decision only by inference. In a dissenting opinion emphasis is laid upon the extent and effect of obsolescence in decreasing the value of railroad property. Most railroads, including many trunk lines, operate over grades which were economical only for the traffic and equipment of a generation or two ago. On the other hand, the great amount of modern equipment and facilities which has been substituted for obsolete property by the railroads within the past few years has increased the net revenue. Investments for these improvements were commended in the dissenting opinion in the O'Fallon case. These improved facilities were the means of eliminating nearly one seventh of the number of employees previously required, and the dissenting opinion indicates that much further economy of operation might be effected by retirement of substantial quantities of obsolete facilities still in service.

While under the decision the commission can justify a failure to value a railroad at or near the current cost of reproduction, a valuation at less than such cost might not be justified solely on estimated net reductions to be effected in the cost of transportation by substituting the most modern facilities. It might be justified if it were shown that in the operation of modern equipment at or near its capacity over a roadway modernized to meet its requirements transportation expenses would be reduced enough to pay the increase in fixed charges for financing the improvements. Such expensive betterments should be required by traffic which has outgrown existing facilities before the latter should be depreciated for obsolescence.

While foreclosure prices are not close criteria of the value of railroads, the disparity between the present cost of reproduction and the upset or sale price is nearly always great enough to suggest caution in the use of such cost as a measure of value. A railroad or a branch or division thereof which would not be useful in consolidations and for which honest, economical and efficient management over a reasonable period of normal years can show no net earnings or other results of operation beneficial to owners, is worth little, if anything, more than salvage value. Railroad construction that was ill advised, lines which have been built for traffic which has been exhausted and lines which are unable to hold sufficient remunerative traffic against modern competitive forms of transportation constitute considerable railroad mileage which should be abandoned.

Much wasteful transportation would be avoided by a discontinuation of service over such lines. The success of local interests in delaying the abandonment of such railroads is not generally merited by transportation necessity. The abandonment of main-line mileage within the past 15 years has greatly exceeded the mileage of new construction. Much information as to cause, extent and progress of obsolescence in railroad property has been accumulated with the increasingly numerous applications filed with the commission for the privilege of abandoning railroads or reducing service.

These strong reminders of the blight of obsolescence in railroad facilities may be expected to affect the judgment of the commission in fixing the actual value of the railroads for the purposes of rate-making and recapture.

PUBLIC AS A SECURITY OWNER BENEFITED

A benefit to the investing public is the effect of the O'Fallon decision to discourage rate reductions. The increased diffusion of railroad securities among the general public since the valuation was begun has created an interest in supporting higher valuations. Interlocked with the interest of these investors is the indirect interest of the great multitude in all occupations and stations in life which is substantially affected by dividends received from mutual insurance companies, savings banks, trust companies, etc., having large holdings in railroad securities.

The commission is not so limited by the decision that it must ignore a railroad's financial structure. If it did this and relied exclusively or largely on the current cost of reproduction as the measure of a railroad's ultimate value it would enable stockholders who carried the smaller risk to receive the greater profit. The borrowers receive all the benefit of an increased valuation, the lenders, little. As an incident to the commission's whole problem of regulation of railroads it can mitigate the burden on rates from an increased valuation by reducing the rate of return heretofore established by it as fair. It has changed the rate to 5¾ per cent. If it should find that 4¾ per cent. would attract the capital needed by railroads when valued at current reproduction cost the loss of 1 per cent. would annul approximately one fourth of the gain from the increases in the parts of the railway value due to changed costs. Practically, such reduced rate of return might be difficult for the commission to sustain in view of the findings by an eminent economist that a rate of 6½ per cent. had necessarily been paid to attract capital required by twenty-four representative railroads having established credit.

PRESENT TAXES AFFECT RATES MORE THAN THE DECISION

The O'Fallon decision is not as apt to be the cause of an increase in rates as the taxes now collected, since railway taxes have an important bearing on rates. An increase in valuation due to increased cost of reproduction or other cause would be promptly used as a basis for increasing railroad taxes. Increases in railroad taxes from 1913 to 1928 consumed more than one half of the net revenue derived from the shipments of the principal products of the soil of the representative agricultural sections of the country. Within this time taxes on a typical railroad system increased to nearly four times as much as they previously were, and now consume approximately one half of all gross passenger revenue.

RATES ARE NOT LIKELY TO BE INCREASED

The chief concern of the public is the effect of the decision on future rates, although there is no indication that the railroads intend to use it as a foundation for wholesale upward revision of rates. No one wishes to establish rates so high that they will check production or transportation of goods or retard the prosperity of the territory served.

It is rather to the interest of all railroads to attract new and regain lost traffic. About twenty years ago the United States supreme court decided that it was the duty of public-utility managements to collect rates that would pay a fair return on the property used in the service and would provide the cost of replacement of items of property when their usefulness was exhausted in service. The managements of many public utilities could not fully enforce this right. Others would not attempt it. The decision in the O'Fallon case is even a less definite and positive grant of power to public-utility managements. Rates high enough to pay a fair return on the current cost of reproduction of all railroads are not likely to be enforced now for the same or equally good reasons. Railroads make their money out of the growth of gross earnings over a long period (heretofore averaging about four per cent. per annum) and by their ability to reduce operating expenses. These considerations indicate that rates should gradually decline. Significant among the economies formerly available to railroads, but realized more fully in recent years, are the savings in rentals paid by one railroad on the cars of another. Floodlights in freight yards permit operation for twenty-four hours every day and this has greatly increased the mileage per diem of cars and locomotives. The reduced number of cars required for the larger volume of freight avoided the consequences of car shortages. Mileage between locomotive terminals has also been greatly increased.

One analysis of the effect of the O'Fallon decision on railroad rates, if reproduction costs are taken as the sole measure of the value of railroad property, shows that the probable increase in rates required would range between 5 and 10 per cent., the variations being due to differences in conclusions regarding the real increase in costs. This estimate is made from calculations in which the commission's tentative valuation of all railroads as of 1920 was the basic figure. From this latter figure deductions were made for land, working capital and intangibles to obtain the amount which represented that part of the property which would be affected by the fluctuations in costs which were in controversy in the O'Fallon case. This fluctuating part of the railroad cost was raised to current cost by multiplying by index numbers. Non-depreciable property included in this new cost was deducted to obtain the sum to be depreciated, from which depreciation was deducted. To the present cost of such fluctuating property, depreciated, were added intangibles, working capital, additions and betterments (since 1920) and non-depreciable property, including land, to obtain the ultimate value by giving full weight to increased costs. A return at the rate of 5¾ per cent. on this ultimate value was computed. It produces a sum to provide which at a conservative estimate would require payment of rates from 5 to 10 per cent. higher than those collected in 1928.

General increases to this extent in all rates would be difficult to effect in periods of comparative economic stability. As a result of the general disturbance in prices incident to the world war the commission in 1920 increased freight rates from 25 per cent. to 40 per cent., and passenger rates 20 per cent. following a previous increase of 40 per cent. Business did not then readily adjust itself to such great changes. Gross revenue rose in 1921, varying from 59 per cent. to 96 per cent. Reductions were sought by both shippers and travellers, and to a considerable extent by railroads. In 1921 rates on farm products were reduced 10 per cent. or more. In 1922 the commission ordered a general reduction on all other freight amounting to 10 per cent. Further reductions in 1923 lowered rates approximately 5 per cent. more. Lowering of railroad revenue per ton-mile and per passenger-mile has since continued from year to year. These reductions occurred because of actual or potential competition, despite the commission's recognition of its obligation under the law to establish remunerative rates and its denial of many railroads' applications for permission to reduce rates substantially.

The influence of the O'Fallon decision may be relegated to a minor place by the unavoidable lapse of time before the commission can make ultimate valuation of the railroads. Or its influence may be minimized by increased economies in transportation by railroads and their competitors; by other economic causes including the shifting of general price levels and cost of railroad construction and equipment; by changes in the laws or their administration, or by railroad labor agreements.