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complicated system of debit and credit accounting whereby the account of each creditor and debtor is separately identified. Shorn of its nugatory ramifications the problem is quite as simple as the theory of set-off itself. "The keeping back of something that is due because there is an equitable reason to withhold it."[12]

Philadelphia, Pa. Ralph B. Umsted.

THE STATUS OF REPRODUCTION COST AS A METHOD OF VALUATION FOR RATE-MAKING PURPOSES

The recent decision of the United States Supreme Court in *Los Angeles Gas and Electric Corp. v. Railroad Commission,*[1] has provoked the present inquiry into the history of constitutional rate-making and more particularly into the status of reproduction cost as a method of valuation for rate-making purposes. A purely analytic discussion of the matter, in view of the many factors involved in the cases, would require a more exhaustive treatment than may be here attempted. The approach is therefore historical.[2]

The panic of 1893 and resultant low price levels made reproduction cost as a measure of value very attractive to consumer representatives. They early urged its advantages upon the courts and commissions,[3] and in at least one

[12]*Michigan Yacht Co. v. Busch,* 143 Fed. 929.

[1]77 L. ed. (Adv. 820) (1933).

[2]The present discussion is largely indebted both for its general method and for much of its source material to the scholarly article of E. C. Goddard, The Evolution of Cost of Reproduction, 41 H. L. R. 564. (1928).

[3]San Diego Water Co. v. City of San Diego, 118 Cal. 556, 50 Pac. 633, 636 (1897). Metropolitan Trust Co. of City of New York v. Houston & T. C. R. Co. et al., 90 Fed. 683, 688 (1898).

case met with success.[4] It was clear however that to prescribe reproduction cost as the sole test of value would precipitate a general failure of utility corporations. Their expenditures had been frequently improvident[5] and investments in them frequently lacked bona fide security.[6] A recognition of current economic facts indicated the need for an elastic measure of value. *Smyth v. Ames*[7] was an attempt to fill that need. The formula there announced is now familiar:

> "We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property."[8]

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[4]Steenerson et al. v. Great Northern R'y Co., 69 Minn. 353, 72 N. W. 713 (1897) where the court said, "No guaranty was ever given by the state to the old road that the price of materials and the cost of construction would not decline, or that capital invested in railroads should not be subject to like viccisitudes as capital invested in other enterprises . .. . the material question is not what the railroad cost originally, but what it would now cost to reproduce it."

[5]In Ames v. Union Pac. R. Co., 64 Fed. 165 (1894) it appears by the defendant's admission that the road might have been reproduced for $20,000 per mile (pp. 187), while the funded indebtedness of the road averaged $46,000 per mile (pp. 185 exhibit 23).

[6]Arguments in Smyth v. Ames, 42 L. ed. 819 (1897); Opinion of Brandeis, J., in Missouri ex rel. S. W. Bell Tel. Co. v. Public Service Commission, 262 U. S. 277, 298, 67 L. ed. 981 (1922); E. C. Goddard, The Evolution of Cost of Reproduction, 41 H. L. R. 564, 567.

[7]Supra. note 6.

[8]169 U. S. at 547, 42 L. ed. at 849.

The decision made it clear that rates based on reproduction cost value alone would be regarded as confiscatory.[9] The "matters for consideration" were not exclusive, nor was any one of them entitled to particular consideration. This compromise measure was satisfactory to the utilities and they were for a time content to concentrate their efforts upon the discovery or invention of new hypothetical cost items for inclusion in the rate base.[10]

An almost unbroken rise in prices from 1898 to 1920 caused the utilities to look with increasing favor upon reproduction cost as a measure of value. They were not slow to urge the advantages of a criterion so manifestly favorable to themselves.[11] The Supreme Court consistently maintained its position that rates levied on a base estimated without consideration for reproduction cost were confiscatory and in violation of the due process clauses.[12] A curious antinomy resulted from the refusal of many commissions to accord the test any consideration whatsoever,[13]

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[9]The argument of Mr. Wm. J. Bryan in Smyth v. Ames, 42 L. ed. 819, 825 squarely presented the issue, " . . . the present value of the roads, as measured by the cost of production, is the basis upon which profit should be computed."

[10]Knoxville v. Knoxville Water Co., 212 U. S. 1, 53 L. ed. 371 (1908); Cedar Rapids Gaslight Co. v. Cedar Rapids, 223 U. S. 655, 56 L. ed. 594 (1911); Des Moines Gas Co. v. Des Moine, 238 U. S. 153; 59 L. ed. 1244 (1914); State Public Utilities Comm. v. Springfield Gas and Electric Co., 291 Ill. 209, 125 N. E. 891 (1919).

[11]See arguments of utility counsel in Knoxville v. Knoxville Water Co., Supra. N. 10; Minnesota Rate Cases, 230 U. S. 352, 57 L. ed. 1511, 48 L. R. A. (N. S.) 1151 (1913); Missouri ex rel. S. W. Bell Tel. Co. v. Public Service Comm., Supra. N. 6. Cf. for earlier utility attitude Stanislaus County v. San Joaquin etc. Co., 192 U. S. 201, 48 L. ed. 406 (1904).

[12]Smyth v. Ames, Supra. Note 6; San Diego Land and Town Co. v. National City, 174 U. S. 739, 43 L. ed. 1154 (1898); Wilcox v. Consolidated Gas Co., 212 U. S. 19, 53 L. ed. 382 (1908); Minnesota Rate Cases, Supra. Note 11.

[13]For vigorous criticisms of reproduction cost see Danbury v. Danbury and B. Gas and E. L. Co., PUR 1921D, 193, 206; Public Service Comm. v. Pac. Tel. & Tel. Co., PUR 1916D, 947, 955; Re Northampton Gas Petition, PUR 1915A, 618, 626. Cf. for later manifestations of same attitude, Boise Artesian Water Co. v. P. U. C., 40 Idaho 690, 236

and the attitude of the commissions was not without its echoes in the courts.[14] Mr. Justice Brandeis has well stated the position of the recalcitrants:

> "When the price levels had risen largely, and estimates of replacement cost indicated values much greater than the actual cost of installation, many commissions refused to consider valuable what one declared to be assumptions based on things that never happened, and estimates requiring the projection of the engineer's imagination into the future, and methods of construction and installation that have never been and never will be adopted by sane men."[15]

In avoidance of the reiterated mandates of the Supreme Court the commission sought to substitute for the application of the rule, its mere profession.[16] Such an evasion was short-lived. The point was raised in *Missouri ex rel. S. W. Bell Tel. Co. v. Public Service Comm.*[17] The commission made the customary statement, "After carefully considering all the evidence as to values before us in this case . . . ",[18] but in fact the replacement cost of only a few units of the property was considered.[19] The Supreme Court of

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Pac. 525 (1925); St. Louis and O'Fallon R. Co. v. U. S., 279 U. S. 461, 73 L. ed. 798 (1929).

[14]Marshall, J., dubitante, in Appleton Water W'ks Co. v. R. Comm. of Wis., 154 Wis. 121, 154; 47 L. R. A. (N. S.) 770, 806; 142 N. W. 476, condemnation proceeding (1913).

[15]Brandeis, J. dissenting in Missouri ex rel. S. W. Bell Tel. Co. v. Public Service Comm., 262 U. S. 276, 300, 67 L. ed. 981, 990.

[16]In State Public Utilities Comm. v. Springfield Gas and Electric Co., 291 Ill. 209, 125 N. E. 891, 900 (1920), the court quoted the commission, '"After considering all the evidence and testimony in this case bearing upon the value of the property herein, . . . , the commission finds the fair value of the respondent's gas property . . .' . . . Notwithstanding this statement of the commission, we are convinced from an examination of the record that it did not give due consideration to that element known as 'going value'." See also Missouri ex rel. S. W. Bell Tel. Co. v. Public Service Comm., 262 U. S. 276, 286, 67 L. ed. 981, 984 (1923).

[17]Supra. N. 6.

[18]idem 286 and 984.

[19]idem 283, 284 and 983.

the State of Missouri upheld the action of the commission.[20] The United States Supreme Court reversed the judgment, saying,

> "It is impossible to ascertain what will amount to a fair return upon properties devoted to public service without giving consideration to the cost of labor, supplies, etc., at the time the investigation is made. An honest and intelligent forecast of probable future values, made upon a view of all the revelant circumstances, is essential. If the highly important element of present costs is wholly disregarded, such a forecast becomes impossible. Estimates for tomorrow cannot ignore prices of today."[21]

In a separate opinion which has become a classic Mr. Justice Brandeis (with the concurrence of Mr. Justice Holmes) championed the prudent investment theory.[22] The court reiterated the rule in *Bluefield Water Works and Improvement Co. v. Public Service Commission,*[23] decided later in the the same year, and in *Georgia Railway and Power Co. v. Railroad Comm.,*[24] decided on the same day as the latter case, fixed its extrinsic limitations. If the constitutional inhibitions on confiscation are to be avoided, reproduction cost must be given actual consideration, but it is not synonymous with fair value nor the sole test thereof.[25]

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[20]State ex rel. S. W. Bell Tel. Co. v. Public Service Comm., . . . Mo. . . . , 233 S. W. 425.

[21]Missouri ex rel. S. W. Bell Tel. Co. v. Public Service Comm., 262 U. S. 276, 287, 288; 67 L. ed. 981, 985 (1923).

[22]idem 289 and 985.

[23]262 U. S. 679, 689, 67 L. ed. 1176, 1181 (1923). The court said, "The record clearly shows that the commission in arriving at its final figures, did not accord proper, if any, weight to the greatly enhanced costs of construction in 1920 over those prevailing about 1915 and before the war, as established by uncontradicted evidence; and the company's detailed estimated cost of reproduction new, less depreciation, at 1920 prices, appears to have been wholly disregarded. This was erroneous." Note: Mr. Justice Brandeis again concurred on separate grounds.

[24]262 U. S. 625, 67 L. ed. 1144 (1923).

[25]idem opinion of Brandeis, J. It is of interest to note that the Pennsylvania Superior Court has recently adhered to this rule in Clark's Ferry Bridge Co. v. P. S. C., 108 Pa. Super. C.. 19, 67; 165 Atl. 261, 267, (1933).

The question did not long remain static. In *Monroe Gaslight and Fuel Co. v. Michigan Public Utilities Comm.*[26] the federal court announced as the rule of the *Southwestern Bell Telephone Case* the proposition that reproduction cost was, "the dominating element in the fixing of the rate base." Like statements were made in other federal lower court decisions,[27] though this novel doctrine was not without its critics.[28] Until 1926 the rule, as extended, did not undergo the scrutiny of the Supreme Court. The question was presented in *McCardle v. Indianapolis Water Co.*[29]

On petition of the Indianapolis Water Company for a higher rate schedule, the Public Service Commission of Indiana made an order, effective January 1, 1924, prescribing new rates based on the cost of reproducing the property of the utility at average prices over a ten year period ending with 1921. The rate base fixed by the commission was $14,904,000. The company brought suit in the United States District Court seeking to enjoin the enforcement of the rate on the ground that it was confiscatory in that the commission had ignored the company's unimpeached evidence of spot reproduction cost in the amount of $19,000,000. The injunction was granted, the District Court saying,

> "Granting that these cases (citing S. W. Bell Tel. Case, Bluefield Case, and Georgia R'y and Power Co. Case) were decided at a time when the court had, as a matter of history in this particular field of jurisprudence, full cognizance of the probative character and the propriety of considering evidence such as is popularly called evidence of historical cost, evidence of reproduction cost upon a certain price level, evidence of

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[26]292 Fed. 139, 143 (1923).

[27]Van Wert Gaslight Co. v. P. U. C., 299 Fed. 670, 673 (1924); New York Tel. Co. v. Prendergast, 300 Fed. 822, 824 (1924); Westinghouse Electric and M'f'g. Co. v. Denver Tramway Co., 3 Fed. (2nd) 285, 297 (1924); Consolidated Gas Co. of New York v. Prendergast, 6 Fed. (2nd) 243, 280 (1925). Cf. master's report in New York and Richmond Gas Co. v. Pendergast, 10 Fed. (2nd) 167, 171 (1925).

[28]Ashland Water Co. v. R. Comm., 7 Fed. (2nd) 924, 927 (1925)

[29]272 U. S. 400, 71 L. ed. 316 (1926).

> value which is called prudent investment value, and, fourth, evidence of what is strictly and technically reproduction spot depreciated at the time of the inquiry; these cases press upon us sharply the query of why these cases, in their results, disclose the emphasis given to the last named of these four characters of evidence; and I am entirely content to accept the characterization made by the judges in the sixth circuit in the so-called Monroe Gas Case; that the necessary implication from their results is that dominating consideration should be given to evidence of reproduction value and, if that means anything, it means that evidence of reproduction value spot at the time of the inquiry must be considered as evidence of a primarily different character from either of the other three kinds of evidence . . . "[30]

On appeal to the Supreme Court the decree was affirmed. The holding there is less explicit. Apparently the pronouncements of the District Court were not sufficiently provocative to elicit a direct response. It was however said,

> "It is true that, if the tendency or trend of prices is not definitely upward or downward and it does not appear probable that there will be a substantial change of prices, then the present value of land plus the present cost of constructing the plant, less depreciation, if any, is a fair measure of the value of the physical elements of the property."[31]

On the facts the Supreme Court was not required to adopt the language of the District Court, and indeed the affirmance demanded no extension of the doctrine of the *Southwestern Bell Telephone Case*. But the language of the court does go beyond the latter holding in giving to reproduction cost a qualified dominance when price levels show no substantial variation. Mr. Justice Brandeis dissented on the ground that the court had made spot reproduction cost the equivalent of value. Mr. Justice Holmes did not concur in this sentiment, and although subsequent

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[30]Supra. N. 5, dissent of Brandeis, J., McCardle v. Indianapolis Water Co., 272 U. S. 400, 422, 71 L. ed. 316, 329 (1926).

[31]272 U. S. 400, 411, 71 L. ed. 316, 325 (1926).

lower court decisions were not too definite in their explanation of the *McCardle Case*,[32] they scarcely seemed to substantiate the Brandeis dissent. Thus the case was not regarded as inconsistent with *Smyth v. Ames*,[33] and it has not been forgotten that the statements of the Supreme Court were qualified.[34]

In *St. Louis and O'Fallon R'y Co. v. United States*[35] the status of reproduction cost as a measure of value was again before the Supreme Court. By paragraph four of section 15a of the Interstate Commerce Act it was provided that in making valuations for purposes of recapture:

> "The commission . . . shall give due consideration to all the elements of value recognized by the law of the land for rate-making purposes . . . "[36]

The commission made a recapture order against the St. Louis and O'Fallon R'y Company. In fixing valuation for the purposes of this order evidence of reproduction cost was before the Commission,[37] but it did not appear that they gave that evidence real consideration.[38] The order was attacked in the statutory federal court on the ground that, "the Commission measured such value upon the assumed prudent investment basis and failed to give 'effective

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[32]See Tenner v. Denver Tramway Co., 18 Fed. (2nd) 226, 228 (1927); Kansas City So. R'y Co. v. U. S., 19 Fed. (2nd) 591, 599 (1926); Graff v. Town of Seward, 20 Fed. (2nd) 816, 818 (1927); Worcester Electric Light Co. v. Atwill, 23 Fed. (2nd) 891, 892 (1927); Cambridge Electric Light Co. v. Atwill, 25 Fed. (2nd) 485, 487 (1928); Los Angeles Railway Corp. v. Railroad Comm., 29 Fed. (2nd) 140, 146 (1928); Queen's Borough Gas & Electric Co. v. Prendergast, 31 Fed. (2nd) 339, 352 (1928); Aetna Ins. Co. v. Hyde, 34 Fed. (2nd) 185, 196 (1929).

[33]Los Angeles R'y Corp. v. R'y Comm., Supra N. 1.

[34]Kansas City So. R'y Co. v. U. S., Supra. N. 32 and Cf. Tenner v. Denver Tramway Co., Supra N. 32.

[35]Supra. N. 13.

[36]41 Stat. at L. 488 Chi. 91, U. S. C. title 49, Sec. 15 a.

[37]Dissent of Stone, J., St. Louis and O'Fallon R'y Co. v. U. S., 279 U. S. 461, 549, 73 L. ed. 798, 809 (1929).

[38]St. Louis and O'Fallon R'y Co. v. U. S., 279 U. S. 461, 486, 73 L. ed. 798, 809 (1929).

and dominant consideration . . . to the cost of reproduction at the price levels existing at the time the issue arises'."[39] The court held, "that the verity of the Commission's valuation herein need not be examined and cannot affect this recapture order . . . ."[40] An appeal was taken to the Supreme Court, and the majority of that body felt that the validity of the Commission's valuation was directly in issue. The court pointed out its own familiar pronouncement that the "elements of value recognized by the law of the land for rate-making purposes" included the element of reproduction cost at the time of valuation:

> "The question on which the Commission divided is this: When seeking to ascertain the value of railroad property for recapture purposes, must it give consideration to current, or reproduction costs? The weight to be accorded thereto is not the matter before us. No doubt there are some, perhaps many, railroads the ultimate value of which should be placed far below the sum necessary for reproduction. But Congress has directed that values shall be fixed upon a consideration of present costs along with all other pertinent facts; and this mandate must be obeyed."[41]

Mr. Justice Brandeis's lengthy dissent, in which Justices Holmes and Stone concurred, took the position that the "main question for consideration is that of statutory construction", and that it was not the intention of Congress that the carrier's property should be valued at its reproduction cost.[42] The language of the majority opinion brings to mind the *Southwestern Bell Telephone Company* and *Bluefield* cases. Certainly it makes no expansion of the doctrine there stated. The rule of the *McCardle Case* was

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[39]St. Louis and O'Fallon R'y Co. v. U. S., 22 Fed. (2nd) 980, 983 (1927).

[40]idem at 984.

[41]St. Louis and O'Fallon R'y Co. v. U. S., 279 U. S. 461, 487, 73 L. ed. 798, 810 (1929).

[42]idem, dissenting opinion of Mr. Justice Brandeis, 279 U. S. at p. 488; 73 L. ed. at 810.

not involved, and the holding there was not affected by the present decision.[43]

The import of the decision of the Supreme Court in *Los Angeles Gas and Electric Corp. v. Railroad Commission*[44] is a matter of some conjecture. It is very natural to give an undue importance to what is recent; it is also a very simple matter to fail to see the woods for the trees. Preliminarily it is necessary that the facts be fully stated.

The Railroad Commission of California had since 1917 fixed the rates of the Los Angeles Gas and Electric Company, issuing orders for that purpose in 1917, 1919, 1921, 1923, 1926 and 1928. Concluding that the return yielded under the order of 1928 was too great, the commission reduced the company's rates by an order of 1930. As the basis of this latter order the commission made two valuations. By an "historical cost" method the value of the utility property was placed at $60,704,000. The commission took the value of the property as established by their order of 1917 and added to that the net additions and betterments shown on the utility books. Allowances for land were made on a basis of present values. The commission included in this valuation an obsolescent artificial gas plant, as the investment therein had been made "prudently and in good faith". Secondly, the commission fixed the "fair value" of the utility property at $65,500,000. This figure represented a calculation of reproduction cost new as of the year 1930, no deduction for depreciation being made.

The utility brought suit in the federal district court to enjoin the enforcement of the order alleging that on the basis of reproduction cost new as of January 1, 1930 the fair value of its property was $95,000,000. It is interesting to compare this figure with the commission's estimate of $65,500,000 reached by the same method. The differences

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[43]"The weight to be accorded thereto is not the matter before us." St. Louis and O'Fallon R'y Co. v. U. S. Supra. N. 13. For the same construction of the decision see New York Tel. Co. v. Prendergast, 36 Fed. (2nd) 54, 59 (1929); Illinois Bell Tel. Co. v. Moynihan, 38 Fed. (2nd) 77, 88 (1930).

[44]Supra N. 1.

are these: The commission made no deduction for depreciation; the utility felt that $3,470,326 should be deducted under that head. Such a deduction brings the commission's figure to $62,029,674. The utility sought to include items of cost of financing, promoter's remuneration and going concern value in the amount of $17,650,137; the commission disallowed these items. Included they bring the figure to $79,679,811. It was the contention of the utility that overheads should be allowed at 24.27%; the commission allowed them at the rate of 6%. The difference in this calculation amounts to $14,557,502. This amount being included the value of the property reaches the sum of $94,247,313 or in round numbers $95,000,000. If this comparison has meaning, it indicates that the controversy involved, not the method of valuation, but the proper elements to be considered thereunder. Then the status of methods of valuation was not presented to the courts in this litigation and their statements in regard thereto have the force of mere dicta. But whatever the logical merits of such a position may be, it is scarcely tenable in the face of the words of the opinion.

The District Court dismissed the bill, observing that the valuation gave weight both to current market prices and the amount of the investment. The utility took an appeal to the United States Supreme Court.

The Supreme Court affirmed the decree of the District Court. The opinion is from the pen of Chief Justice Hughes. Preliminarily it is said that the court in determining whether or not rates are confiscatory is not bound by any artificial formulae.[45] All the relevant facts are to be considered. The language of the court then takes an unfamiliar turn,

> "The actual cost of the property—the investment the owners have made—is a relevant fact. But while cost must be considered, the court has held that it is not an exclusive or final test . . . The property on any admissible standard of present value, may be worth more or less than it actually cost. The time and the circumstances of the outlay, and the effect of

[45]idem 830.

> altered conditions demand consideration. Even when cost is revised so as to reflect what may be deemed to have been invested prudently and in good faith, the investment may embrace property no longer used and useful for the public . . . But no one would question that the reasonable cost of an efficient public utility system 'is good evidence of its value at the time of construction'. We have said that 'such actual cost will continue fairly well to measure the amount to be attributed to the physical elements of the property so long as there is no change in the level of applicable prices'. McCardle v. Indianapolis Water Co. . . . And when such a change in the price level has occured, actual experience in the construction and development of the property, especially experience in a recent period, may be an important check upon extravagant estimates."[46]

Actual cost, then, has taken on new importance. It is considerable evidence of fair value, and the extent to which it coincides with that hypothetical figure will depend upon the extent to which it represents property used and useful, the recentness of the period within which investment has taken place,[47] and (by implication of the facts) the extent to which the investments of the utility have been under the control of the commission.

Reproduction cost is a fact which "should have appropriate consideration."[48] It does not however "justify the acceptance of results which depend upon mere conjecture."[49]

Mr. Justice Butler dissented in a not entirely unambiguous opinion in which Mr. Justice Sutherland joined,[50]

> "The Commission following theories that admittedly are contrary to our decisions in confiscation

[46]idem 830.

[47]idem 831, "In determining the weight to be ascribed in the instant case to historical cost as shown by the evidence, the outstanding fact is that the development of the property had, for the most part, taken place in a recent period."

[48]idem 830.

[49]idem 831 quoting Minnesota Rate Cases, Supra N. 11.

[50]idem 838.

cases, refused to ascertain or consider the value of the property.[51] It made the last reduction upon mere cost figures."[52]

It would seem that the real quarrel of the dissenters is with the tendency of the majority opinion which is clearly favorable to a less arbitrary application of reproduction cost methods. Justices Butler and Sutherland have long stood in the vanguard of the cost of reproductionists.

To attempt a classification of these difficult cases is perhaps a delusive undertaking. If the language of the instant decision is to be taken without adulteration, the cycle from *Smyth v. Ames* is complete, although it may well be that the doctrine of the *Southwestern Bell Telephone Company Case* is not impaired. If the *McCardle Case* is to be interpreted as giving a qualified dominance to reproduction cost as a measure of value, it must be regarded as tacitly reversed. The language of the *Los Angeles Gas Case*, as has been previously indicated, may well be taken with a grain of salt, but its closest parallel in the history of this vexed question is the classic statement of *Smyth v. Ames*.

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[51]This statement is somewhat clarified by an examination of the appended note wherein it is demonstrated that the California Commission has persistently defied the mandates of the Supreme Court by evaluating for rate-making purposes upon a basis of historical or actual cost, taking land at current values.

[52]If this means actual cost can it fairly be said to represent the facts? The commission's reproduction cost figures exactly coincide with its fair value figures.