

## THE PRUDENT INVESTMENT THEORY

In recent months public attention has been directed to what is known as the Prudent Investment Theory of rate regulation of public utilities as contrasted with the "fair value" method of such regulation. This attention has resulted in a large measure from the enthusiastic espousal of the principle by Mr. Roosevelt and as a result has engendered a sufficient interest in the subject, I hope, to justify a paper having for its purpose an impartial comparison of the two theories.

Before proceeding to attempt a definition of the two contrasting theories it would, I believe, be helpful to consider something of the history of government regulation of private business affected with a public interest.

It has long been accepted as a doctrine of common law that when private property becomes affected with a public it ceases to be private property only and the owner grants to the public the right to be controlled for the common good to the extent of the interest thus created. The owner may withdraw this grant by discontinuing the use but, so long as he maintains the use, he must submit to the control. Lord Hale, eminent jurist of the Seventeenth Century, says:

"The king has" a right of franchise or privilege, that no man may set up a common ferry for all passengers, without a prescription time out of mind, or a charter from the king. He may make a ferry for his own use or the use of his family, but not for the common use of all the king's subjects passing that way; because it doth in consequence tend to a common charge, and is become a thing of public interest and use, and every man for his passage pays a toll, which is a common charge, and every ferry ought to be under a public regulation, viz., that it give attendance at due times, keep a boat in due order, and take but reasonable toll; for if he fail in these he is finable."

This principle of the common law was carried into the statutes of our colonies and later of the states to varying extents. Mr. Brandeis is

authority for the statement that at the time of the adoption of the constitution at least two states were fixing the price of bread by statute. The determination that an enterprise is charged with public interest has varied in the course of the years as economic conditions have changed and at the same time the extent of the regulation has varied with changing conditions. For instance, the regulation of the rates charged by innkeepers was in the early days necessary to prevent extortion while today the principal interest of the regulatory bodies in hotels is in relation to public health and order. In 1925 Oklahoma decreed by statute that the manufacture and sale of ice was charged with public interest and provided among other things that no ice factory could be established except upon a proper showing of convenience and necessity. This law was subsequently declared unconstitutional by the Supreme Court but Mr. Brandeis in most persuasive language dissented from the majority. It will be recalled that the Federal Government has now passed a law regulating the bituminous coal business to the extent of fixing minimum prices on the ground that unbridled competition was injuriously affecting the public interest. The wisdom of this act has been questioned by many and the facts are that at the time of the writing of this paper the administration of this law has "bogged down" to the great confusion of the industry.

The basis of determination of public interest, therefore, rests on many grounds; - the fact that the enterprise is a natural monopoly such as furnishing telephone service to a community - the fact that the enterprise is dependent upon a public privilege such as the right to condemn - the fact that the regulation is necessary for preservation of public health as witness the pure food and drug acts, - The protection of natural resources such as the regulation of oil production - the necessity of regulation to prevent

monopoly, and now the regulation to promote monopoly to avoid the evils of unbridled competition.

The power of the states to regulate and prescribe the rate of return of corporations was first challenged in this country in *Minn. v Illinois* in 1876 when that state attempted to regulate the prices charged by grain elevators. Following the upholding of this statute by the Supreme Court and the decision by that court that such regulation of prices for services by the elevators did not constitute the taking of property without due process of law all of the states gradually began the regulation of the rates of utilities. Such regulation involves several factors the primary ones being (1) the rate of return on the value of the property utilized in public service (or the capital utilized as will be referred to later) and (2) the value to which this rate is applied, this latter figure being the rate base. Following the case of *Minn. v Illinois* the different commissions were using various methods of appraisal and the courts were approving and disapproving these regulatory rulings without the application of any defined formula. Prior to the case of *Smyth v Ames* hereinafter referred to, there seemed to have been no guiding principle except that the toll exacted should be reasonable. In this case which arose in Nebraska in 1893, the state undertook to fix maximum reasonable rates for hauling freight. Wm. Jennings Bryan, then a young Congressman who had already attracted considerable attention as an orator, was of counsel for the state and it was he who first argued for the "fair value" method of fixing the rate base. The railroads argued that they should be allowed to earn on their investment in the property otherwise the stockholders would be deprived of their investment. My Bryan very forcibly pointed out that this investment if injudicious and unwise was not to be used as the rate base for, in this particular case, there had been

unwise and probably dishonest handling of the funds in building the road. A further point was that the reproduction value was the principal criterion for this would have been the basis of ascertaining the value in the event of condemnation. This argument for reproduction cost was heavily emphasized by the state since the country was then in the throes of a panic where such reproduction value was greatly less than would have been the case even on the prudent investment theory, and as a result of using the reproduction value the rates ensuing would have been greatly reduced. The court failed to side entirely with the proponents of either theory, investment or reproduction, but instead adopted a compromise the basis of which is well epitomized in the following quotation from the decision delivered by Mr. Justice Harlan:

"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 stocks, the present as compared with the original cost of construction, the probable earning capacity of the property under the particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters to be given consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience."

There is set forth the rule laid down by the Supreme Court in ascertaining the rate base and which rule has never been altered, that is, the rate base is the fair value of the property and in ascertaining this fair value that all of the factors entering therein must be considered in each particular case. While as will be observed, reproduction value was set forth merely as one element it was thereafter emphasized as the primary

factor in ascertaining present day fair value, that is the reproduction value of the property usefully employed in the public service. This rule fairly observes the principle set forth in a latter case that "It is well established fact that values of utility properties fluctuate and that the owners must bear the decline and are entitled to the increase". In the S. W. Bell Telephone case referred to hereafter, the court said:

"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 future values made upon a view of all the relevant circumstances is essential. If the highly important element of present costs is wholly disregarded such a forecast becomes impossible. Estimates for tomorrow cannot ignore prices of today."

Thus far it would seem that there is little to give grounds for complaint in following such a general rule as using the fair value of the property as the rate base and for about thirty years there was little argument as to the rule itself. However, in the years of rapidly ascending prices during and following the world war the counsel of the utilities became the ardent proponents of the theory they had formerly opposed for the greatly increased reproduction cost, - an important element certainly in ascertaining fair value - inured directly to their benefit. "When the devil was sick the devil a saint would be - when the devil was well the devil a saint was he".

In 1923 the Public Service Commission of Missouri determined the rate base of the S. W. Bell Telephone Co. on a basis which the Supreme Court in a majority opinion held did not reflect present value and that the rates were, therefore, confiscatory. In a dissenting opinion Mr. Justice Brandeis also held that the rates were confiscatory but on a different basis and in this opinion first promulgated the prudent investment theory - that is, that the rate base should be the original cost of the property at the time of

dedication to the public use, less any wasteful, imprudent or improper cost. At this point it may be proper to define some of the terms used in discussions of this subject. "Historical cost" and "estimated original cost" are substitutes, used for "prudent investment" when actual figures thereon are not available and estimates therefor are made. "Book cost" often used for "prudent investment" may be quite a different thing especially in the event the property has changed hands since its original dedication to public use. On the other hand the phrase "reproduction cost" is frequently used in referring to "fair value" when actually it is merely one element in ascertaining fair value. In enunciating this theory Mr. Brandeis carefully sets forth in a foot note at the beginning of the opinion:

"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."

The primary difference between the two theories is found in Mr. Brandeis opinion as follows:

"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."

To contrast with this theory the following is an excerpt from the decision in the Minn. Rate Cases in 1913:

"The property is held in private ownership and it is that property and not the original cost of it of which the owner may not be deprived without due process".

The fundamental difference between the two theories becomes immediately apparent. The fair value plan would have the owners absorb the loss incident to a shrinkage of the value of their property, and on the other hand permit the owners to benefit from any increment in value be that increment earned or unearned. The proponents of the prudent investment theory would say that the owners may not benefit from increased values but on the other hand the regulatory bodies will attempt to prevent the necessity of their absorbing the loss following economic changes which render their property less valuable.

Here it would seem that our accepted ideas of property rights would favor the fair value plan and it is also true that the prudent investment theory fails to share with its opponent the hallowed sanction of common law for it is the brain child of Mr. Brandeis and is just tomorrow celebrating its fifteenth birthday, the opinion having been handed down on May 21, 1923.

On the other hand the advocates of the new conception present many cogent arguments particularly from a practical viewpoint. To ascertain a fair value of a property as wide spread as a modern public utility where the investment or value either will well exceed \$100,000,000 is a tremendous task to say the least. It is stated that the appraisal of the New York Telephone Company cost the company in the neighborhood of \$5,000,000, and it is estimated that to appraise the fair value of all the properties subject to the Public Service Commission of New York even with the cooperation of the utilities and the adoption of short cut methods would run in the neighborhood of \$10,000,000 and consume three years at the end of which time many of the values arrived at would be obsolete. It is further pointed out that any

attempt to estimate reproduction costs are at best guesses since the estimates vary so widely as to render them worthy of little weight especially in considering plants of modern day size. The Supreme Court in an earlier case in referring to the difficulties of arriving at even approximate estimate of replacement cost said: "Every figure that we have set down with delusive exactness is speculative." Again Robert Hale of Columbia University said of the attempt to arrive at reproduction costs, that it "serves merely to divert the time, attention and funds of regulating bodies out of the proper channels into one of the most unreal fields of speculation in which the minds of metaphysicians have disported themselves since the days of medieval schoolmen". Mr. Brandeis in his minority opinion, which incidentally was concurred in by Mr. Holmes, points out that the finding of a present value for a utility presents the impossibility of ascertaining an exchange value since such properties unlike land or merchandise are not commonly bought and sold in the market. Nor can the value be determined by capitalizing earnings since these are directly dependent upon the rates which are sought to be determined and thus a vicious circle would be encountered. The prudent investment theory also without question provides a most desirable condition, a rate base that is certain and stable and thus in theory at least should command the funds of investors along the bond route at a most economical rate since it is certainty and stability that constitute the prime consideration of fixed investments.

The idea of the prudent investment principle has in recent months extended to other fields than the ascertaining of a rate base, notably in the advocacy of this principle by Mr. Lilientahl of the Tennessee Valley Authority in proposing its use in acquiring the properties with which the

government experiment would compete. Such a plan would unquestionably be welcomed by the owners of such properties for the "fair value" would certainly be less when that value was ascertained with a certain threat of competition with the United States Treasury. Incidentally the papers reported that upon a visit to the White House Mr. Wilkie of the Commonwealth and Southern Company had agreed with the President that the prudent investment theory was proper in ascertaining the rate base. Under the circumstances, however, it would seem that his judgment was not entirely unbiased or dispassionate. As I understand the recent reports the Mexican government is proposing to use this theory in compensating the former owners of the expropriated oil properties in that country. It seems not unreasonable, however, to assume that this plan which contemplates paying for the producing properties on a basis of the investment therein, less the value of the oil produced, would exclude all dry holes as "imprudent investments". However, it is hardly wise to judge this plan by its proponents in other fields but rather by its merits in the use under discussion.

As has been pointed out the prudent investment theory is of recent origin and as a matter of fact its legality has not actually been considered by the Supreme Court. In January of this year in the case of Railroad Commission vs Pacific Gas and Electric Co. it was admitted that the rate base was arrived at solely on an underpreciated prudent investment basis with land only taken at its present market value. However, it was shown that the Commission had admitted in evidence the company's reproduction estimate but deeming it to be without probative value had refused to use it as an element of valuation. The Supreme Court held that the admission in evidence of the company's estimate had satisfied the requirement of reaching a fair value

upon consideration of all material elements including replacement cost. This would seem to be very close to an approval of the theory but it misses by a wide margin the clear-cut adoption of the prudent investment as the sole factor in determining the rate base, as is advocated by Mr. Brandeis.

To sum up the advantages and disadvantages of the two plans, they appear about as follows: The fairvalue procedure has not only the sanction of the Supreme Court as the approved plan but fails to do violence to the accepted idea of property rights that private ownership not only involves the burden of absorbing loss due to changing economic conditions but carries the privilege of capitalizing upon increment in value even if unearned. In this connection it is claimed that this theory may not be properly used without either a constitutional amendment or a new judicial interpretation of the Constitution since as at present interpreted the theory deprives the owners of their property without due process of law. It would also appear that although the prudent investment plan contemplates protecting the investor against obsolescence beyond prudent control while as a matter of fact this is actually impossible. For example, it would be difficult to think that the fiat of the State Corporation Commission permitting the Lynchburg Traction and Light Company to earn upon its original prudent investment would go very far to mitigate the loss that company is suffering incident to changed conditions. Senator Norris has even advocated a rather novel plan that the lesser value arrived at by the two methods should be adopted. However, it is hardly probable that such a plan of letting the rate payers have their cake and eat it too has much likelihood of adoption. There is also to be said against the prudent investment theory that it would probably work a curious anomaly to have a modern, up to date utility with a small rate base

as compared to an antiquated, costly plant for the same purpose in an adjoining community with a much larger rate base. On the other hand, it is apparent that the "modern" proposed plan furnishes a means of ascertaining the rate base promptly, and with present regulation of accounting, accurately, as much less cost to both the regulatory bodies and to the utilities themselves. Its stability and certainty are advantages which should produce less controversy and suspicion on the part of the public and command cheaper money rates thus inuring to the benefit of both the public and the stockholders.

Here is the problem - it has not been decided by the Supreme Court and true to tradition this paper does not answer the question it has asked but leaves it to each Sphexian to decide for himself if this theory meets the requirement of being both prudent and fair.