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LEGAL APPROACH TO PUBLIC UTILITY REGULATION

BY

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INTRODUCTION

The study of public utilities carries one into at least four fields of knowledge: economics, engineering, law and political science. Special stress must be laid on the legal field because of the authoritative contribution of the Supreme Court of the United States in matters of economics. For a complete understanding of public utility economics, that body must be taken into consideration, for, to quote Professor Commons "....... that court occupies the unique position of the first authoritative faculty of political economy in the world's history." [1]

In this respect, Professor Thompson says, "One comes, therefore, to the logical conclusion that the study of public utility economics is but an aspect of the broader field of institutional economics. Our study is in that area in which the forces of custom and law, rather than primitive unchecked forces of economics, are the major controls of prices and service ......Our problem, therefore, is twofold; first, to find and account for these institutional limits and, second, to show how the interplay of economic forces act and react within these legally defined boundaries." [2]

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1. Commons : Legal Foundations of Capitalism, p.7.
2. Thompson, Woody C and Smith, Wendell R : Public Utility Economics, 1941, p.9.

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To get a true picture of public utilities through the legal approach entails a study of cases brought up before the Supreme Court. In this essay, I try to picture the development of public utility regulations through the case approach.

DEVELOPMENT OF PUBLIC UTILITY REGULATION

The history of the judicial treatment of public utilities can be divided into five periods [1]: the first period (1600-1870), the "common calling" period, in the early days of the common law in Great Britain and the British colonies in America; the second period (1870-1890), the "Granger cases" period of the 1870's, introducing the doctrine of legislative finality in matters of public utility regulation; the third period (1890-1930,) characterized by Regan v. Farmers' Loan and Trust Co. in 1894, introducing the doctrine of judicial review, and Symth v. Ames in 1898, establishing a cost-of-reproduction theory; the fourth period (1930-1940), the period of prudent investment theory suggested by the Los Angeles case in 1933 and stimulated by New Deal pressures of the Roosevelt Administration since 1930 on valuation theory; the fifth period (1940-), the period of public regulation chiefly by national regulatory bodies through control of accounting systems.

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1. Mr. Charles W. Smith of the Federal Power Commission divides the development of public utility regulation into four stages: the first stage, from the Granger cases in 1877 to the Symth case in 1898; the second stage, from the Symth case to United Railway v. West in 1930; the third stage, from the United Railway case to the Hope Natural Gas Co. case in 1944. (Charles W. Smith: Prudent Investment Theory in Public Utility Rate Making, The Accounting Review, July, 1946.)

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ORIGIN OF PUBLIC UTILITY REGULATION

The phrase "public utility" is of modern origin, and yet the idea of subjecting certain occupations and activities to special treatment, such as regulation of their rates and conditions of service, is old. Our modern public utility concept can be traced back to the early days of the formation of the common law in England, "where the doctrine of public interest was developed to justify special price and service regulations of barbers, surgeons, innkeepers, gristmillers, wharfingers and carriers."[1] These occupations became known as "common callings."

We can find the legal antecedent of our modern public utility concept in the early common law of England. In the Rich v. Kneeland case in 1613, the carriers which were engaged in water transportation between London and Kent were called "common carriers" and were prohibited from showing discrimination among passengers and shippers. These carriers were regarded as being "affected with a public interest" and special obligations were imposed upon them as such.

The "common calling" or "common carrier" idea was transplanted to the British colonies in the New World. The same regulations of business as existed in the mother country were applied in the New World. "In 1775, for instance, it was not uncommon to find the colonial legislature fixing scales of bread prices and establishing rates for the various kinds of skilled and unskilled labor. Of course, the common callings of carriage by land and water had already been subjected to minute direction."[2]

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1. Thompson and Smith : op. cit. p.3
2. Thompson and Smith : op. cit. p.58

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This situation was thus described by Chief Justice Waite in the Munn case in 1877.

"..... It has been customary in England from time immemorial, and in this country from its first colonization, to regulate ferries, common carriers, hackmen, bakers, millers, wharfingers, innkeepers, etc., and in so doing to fix a maximum of charge to be made for services rendered, accommodations furnished, and articles sold."[3]

With the westward movement following the War of 1812 and the appearance of the laissez-faire philosophy, most, if not all, of these general price regulations had been swept away. As Prof. Hunter has shown, "many of the states continued to regulate carriers, bridge companies and turnpikes in matters of rates, service, securities and accounts."[4] Compared with modern regulation, it must be admitted, however, that these efforts were more formal than effective.[5]

THE GRANGER CASES AND THE DOCTRINE OF LEGISLATIVE FINALITY

From 1860 to 1880, American industry grew rapidly, transforming what was mainly an agricultural country into an industrial country. The railroads began to occupy a prominent place in the economic structure. This change, coupled with the postwar readjustment in agriculture and industry and the longest depression then known in American history brought about a new attitude towards the carriers and the need arose for the regulation of the railroads. The Patrons of Husbandry, commonly known as the Grange, initiated a

3. Munn v. Illinois, 94 U.S. 113 (1877)
4. Dorau, Herbert B.: Materials for Studies of Public Utility Economics, pp. 283-294.
5. For further discussion of the origin of common callings, see Swenson, The National Government and Business, pp. 133-143.

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regulatory movement, the so-called Granger Movement, starting in the 1870's to regulate current railroad practices. The legal theory of the common calling with its many affirmative duties was revived.

The various so-called Granger laws of the 1870's had been passed by certain Midwestern states to control railroad rates and other related business such as grain elevators. These laws were immediately challenged, mainly on the ground that they violated the property protection of the Fifth and Fourteenth Amendment to the Federal Constitution. These amendments provide, in short, that no one shall be "deprived of life, liberty, or property, without due process of law."[1] The test cases on this question are called the "Granger cases": —— Munn v. Illinois, 94 U.S. 113 (1877); Chicago B. & Q. R. v. Iowa, 94 U. S. 115 ; Peik v. Chicago & NorthwesternR, 94 U. S. 164 ; Chicago, M. & St. P. R. v. Ackley, 94 U.S. 176 ; Winona & St. Peter R. V. Blake, 94 U.S. 180 ; and Stone v. Wisconsin, 94 U. S. 181

Munn v. Illinois ——The first and most famous of the Granger cases is that of Munn v. Illinois in 1877. The Constitution of Illinois had been so drawn up as to permit the regulation of railroads and grain elevators. Under the Illinois law of 1871, a statute had been enacted to establish certain maximum rates for the handling of grain. Munn and Scott, partners in the grain elevator business in Chicago,

1. Fifth Amendment : "No person shall.... be deprived of life, liberty, or property, without due process of law ; nor shall private property be taken for public use, without just compensations."
Fourteen Amendment : "No State shall....., deprive any person of life, liberty, or property, without due process of law, nor deny to any person within its jurisdiction the equal protection of the laws."

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refused to conform to the provisions of the law. The law was upheld by the Supreme Court of the United States. Two major doctrines were made clear in this case: (1) the doctrine of public interest, (2) the doctrine of legislative finality.

(1) *The revival of the doctrine of public interest* —— The doctrine of public interest was given legal recognition and the legal basis of regulation was established in this and other Granger cases.

In the course of the decision in Munn v. Illinois, quoting the writings of Lord Hale, an English jurist of the sixteenth century, Chief Justice Waite said: [2]

> Looking, then, to the common law, from whence came the right which the Constitution protects, we find that when private proverty is 'affected with a public interest, it ceases to be juris privati only". .... property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. [3]

(2) *The establishment of the doctrine of legislative finality*

The second principle of the Munn case brought about was the doctrine of legislative finality.

In the argument of counsel before the Court in the Munn case, it had been urged in defense of the elevator operators that "the owner of property is entitled to a reasonable compensation for its use, even though it be clothed with a public interest, and that what is reasonable is a judicial and not a legislstive question." On

2. Munn v. Illinois, 94 U.S. 113 (1877)
3. Bauer J. and Gold N.: Public Utility valuation for Purpose of Rate Control, 1934, p. 33

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this point, the Court said : [4]

In countries where the common law prevails, it has been customary from time immemorial for the legislative to declare what shall be a reasonable compensation under such circumstances, or, perhaps more properly speaking, to fix a maximum beyond which any charge made would be unreasonable ...... If there are no statutory regulation upon the subject, the courts must be determine what is reasonable .... To limit the rate of charge for services rendered in a public employment, or for the use of property in which the public has an interest, is only changing a regulation which existed before. It establishes no new principle in the law, but only gives a new effect to an old one.

We know that this is a power which may be abused; but that is no argument against its existence. For protection against abuses by legislatures the people must resort to the poll, not the courts.

Thus, the court declined to accept the authority of judicial review upon the reasonableness of a legislative regulation. [5]

THE DOCTRINE OF JUDICIAL REVIEW AND THE COST-OF-REPRODUCTION THEORY

The third period (1890-1930) was characterized by two famous cases : Regan v. Farmers' Loan and Trust Company, 1894, and Smyth v, Ames, 1894. The doctrine of judicial review was introduced definitely by the former case and the Fair Return Principle based on the Fair Value Principle by the latter case.

4. 94 U.S. at 135, 134

5, Thompson and Smith : op. cit. pp. 143-145

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(1) *The Doctrine of Judicial Review*

Since the Munn case, the doctrine of legislative finality had never been successfully challenged. After several preliminary thrusts at the principle of legislaitive finality in matters of utility regulation, the Court finally faced the problem squarely in the case of Regan v. Farmers' Loan and Trust Company. There it said : [1]

> It has always been a part of the judicial function to determine whether the act of one party... operates to divest the other party of any rights of person or property. In every constitution is the guaranty against the taking of private property for public purposes without just compensation. The equal protection of the laws' which, by the Fourteenth Amendment, no State can deny to the individual, forbids legislation, in whatever form in may be enacted, by which the property of one individual is, without compensation, wrested from him for the benefit of another, or of the public.

In spite of various attempts[2] to curb the scope of judicial review, the courts have continued to reserve to themselves the right to review all legislative and commission findings relative to public utilities.

(2) *The Fair Return upon the Fair Valuation Principle*

In the words of Professor Thompson, " No particulaly effective attempts had been made to regulate rates prior to the Granger movement in the 1870's ; and except in a few eastern states, no valuation problems of consequence arose until the late 1880's or early 1890's."[3]

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1. Regan v. Farmers Loan and Trust Co., 154U.S. 362 (1894)
2. Chicago, M. & St. P. R. v. Minnesota, 134 U.S.418,457 (1890) ; Ohio Valley Water Co. v. Ben Avon Borough, 253 U.S. 287,289 (1920); St. Joseph Stock Yards Co. v. United States, 298 U.S. 38,14 P.U.R. (N.S.) 397
3. Thompson and Smith: op. cit. p.279

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The decision in the Regan case in 1894 forced the Court to formulate some standard of judicial judgement.

The Fair Return the Fair Valuation Principle was finally formulated in 1898 in Smyth v. Ames. The Court laid down the following proposition : [4]

> ...the basis of all calculations as to the reasonableness of rates... must be the fair value of the property used ...for the convenience of the public. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience.

Smyth v. Ames

Nebraska had fixed a schedule of railroad rates, which was challenged by the railroads operating in the state. Nebraska urged cost of reproduction, whereas these railroads urged the sum of their securities. The Court, speaking through Mr. Justice Bryan, ruled as follows :

> ....And in order to ascertain that value,
>
> 1. the original cost of construction,
> 2. the amount expended in permanent improvements,
> 3. the amount,
> 4. and the market value of its bonds and stock,
> 5. the present as compared with the original cost of construction,
> 6. the probable earning capacity of the property under particular rates prescribed by statute,
> 7. and the sum required to meet operating expenses
>
> are all matters for consideration.

This valuation theory suggested in Smyth v. Ames is found in the phrase "the present as compared with the original cost of construction,.. By common consent, these

[4]. Smyth v. Ames, 169 U.S. 466,546 (1898)

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words are taken to suggest a cost-of-reproduction theory, though they could certainly be argued to mean something else. "according to Professor Thompson.[5]

Knoxville v. Knoxville Water Co.

The cost-of-reproduction theory was definitely established by Knoxville v. Knoxville Water Co,[6] and Willcox v. Consolidated Gas Co. in 1909.[7] It is also important to know the recognition of depreciation by the Court in the Knoxville water Co. case, in which the Court spoke as follows :

' The items composing the plant depreciate in value from year to year in a varying degree... (Utility assets) begin to depreciate with more or less repidity from the moment of their first use... But it is clear that some substantial allowance for depreciation ought to have been made in this case.

Owing to the trend of prices, the cost-of-reproduction theory had been dominant during the 30 years following the Smyth case.

THE PRUDENT INVESTMENT THEORY AND THE ENACTMENT OF THE JOHNSON ACT

(1) *The Prudent Investment Theory*

Cost of reproduction as a method of valuation has its several weaknesses. From the Smyth case in 1898 to the depression of 1929, the criticism of this doctrine was entirely academic. For during all these years, prices were either rising or else stabilized at relatively high levels. But between 1929 and 1937, prices declined perilously. Cost of reproduction no longer held with valuation in declining price periods.

The next rules of valuation is the Investment Theory.

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5. Thompson and Smith : op. cit., p.285
6. Knoxville v. Knoxville Water Co., 212 U.S.1 (1909)
7. Willcox v. Consolidated Gas Co., 212 U.S.19 (1909)

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To guard against imprudent investment or fraud, the term "prudent investment" is used. In my definition of prudent investment, I shall cite the words of Mr. Justice Brandeis in a leading case.[1]

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 judgement, unless the contrary is shown.

The strongest argument for prudent investment was credit stability for public utilities, that is, "valuations by this rule yield adequate income to pay interest and dividends in both good and bad times, a prime requisite to credit stability."[2]

In the Los Angeles Gas case in 1933, the Court approved the valuation of the California Commission which had used investment as a basis of valuation, making no ddeuctions for depreciation and an obsolete plant and adding nothing for going-concern value. This decision was thought by many advocates of prudent investment, to be a first step by the court toward prudent investment theory. But two years later, in the Chesapeake and Potomac Telephone case,[3] the Court once more switched back to cost of reproduction[4]

The general tendency, however, of valuation had been toward investment in this period. This tendency had been given impetus by the pressures of the Roosevelt Administ-

1. Southern Bell Telephone Co. v. Public Service Comm., 262 U. S. 276, 289, (1923)

2. Thompson & Smith, op. cit., p.284
Bauer and Gold, Public Utility Valuation, p. 371

3. Los Angeles Gas & Electric Corp. v. Railroad Commissin. 289U.S. 287. P.U.R. 1933 C 229 (1933)

4. West v. Chesapeake & Potomac Co., 295. U.S.662. 8 P.U.R. (N.S.) 433 (1935)

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ration since 1933. To quote professor Thompson, "Finally, the president, in a press release in January, 1937, went on record as favoring prudent investment. According to one press report, he attacked cost of reproduction as not being consonant with the common law from which regulation developed and as being actually 'unconstitutional' under the Constitution of the United States."[5]

The new theory was established by Federal Power Commission v. Natural Gas Pipeline Co., in 1938, in which the Court declined to adapt cost of reproduction as a valuation basis.

(2) *The Enactment of the Johnson Act in* 1934

Prior to the enactment of the Johnson Act in 1934, utilities could proceed from any commission hearing into either a federal or state court, there to have the entire case tried over, even to the taking of testimony. The Johnson Act, passed by Congress in 1934, is an attempt to meet this problem through federal legislation, assuming its constitutionality. It provided that no federal district court shall take jurisdiction to restrain the enforcement of a state administration of a state administration board or commission "where jurisdiction is based solely upon the ground of diversity of citizenship, nor the repugnance of such order to the Constitution of the United States, where such order (1) affects rates chargeable by a public utility, (2) does not interfere with interstate commerce, and (3) has been made after reasonable notice and hearing, and where a plain, speedy, and efficient remedy may be had at law or in equity in the courts of such state."[6]

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5. Thompson & Smith : op.cit. P. 299
6. Thompson & Smith : op. cit. pp. 149-150

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PUBLIC REGULATION BY REGULATORY BODIES THROUGH CONTROL OF ACCOUNTING SYSTEMS

The Development of State Regulation

In the history of the regulatory bodies, the first agency is a municipal commission concerned only with the municipality that a gas plant, a water-works, even a telephon company served. Economic boundaries no longer confoimed to political boundaries With the growth of the utilities in size and areas of service, state commission regulations come after a period of local municipal regulation. As to railroad regulation, the early railroad commissions were created in New Hampshire and Rhode Island in 1844. As has been discussed, as an important result of the Granger movement in the post-Civil War days, railroad commissions were created to enforce "Granger laws" controlling railroad rates, service and practices, centering in the four states of Illinois, Iowa, Minnesota and Wisconsin. This development spread to surrounding states. At the present time there is only one state, Delaware, which does not have a commission with some jurisdiction over railroads.

Though the type of these state commissions are "advisory" or "mandatory," they are administrative bodies, empowered to enforce the law and are not clothed with judicial power.

The Movement to National Regulation and Control of Accounting Systems

Prior to the sixth period, the regulation of public utilities had been almost the exclusive function of the states. The movement to national regulation, however, has been

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strengthened in this period and the predominance of public regulation through control of accounting systems by national regulatory bodies has been recognized.

Wisconsin, New York and Massachusetts were the first states in accounting control, but only half the state commissions have power to prescribe accounts and accounting practices.

The Interstate Commerce Commission has developed the field of railroad accounting since 1906. It set up uniform systems of accounts for urban transportation in 1909, for telephone utilities in 1913, for telegraph and cable companies in 1915. This development of uniform systems of accounts, however, has been sluggish. "In 1922, the National Association of Railroad and Utilities Commissioners adopted a Uniform Classification of Accounts for Electric Utilities and recommended it to the member state commissions for adoption. The association subsequently adopted uniform classifications for gas and water utilities. The federal utility commissions have likewise developed systems, patterned largely on those developed by the Interstate Commerce Commission."[1]

Since the creation of the federal utility commissions, such as the Federal Communications Commission in 1934, the Federal Power Commission in 1920, the Federal Power Commission in 1920 and the Federal Radio Commission in 1927, they and the state commissions have cooperated closely in the matter of utility accounting systems, so that utilities are subjected, in general, to the same system by both state and federal agencies.

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1 . Thompson and Smith, op. cit. p. 273