RATE MAKING AND THE REVISION OF THE PROPERTY CONCEPT[1]

In determining how much of a company's earnings are "reasonable," the conventional assumption is that courts and commissions are not concerned with the creation of a policy. They are supposed to give practical effect to one already enunciated by the Fourteenth Amendment and discovered there by the United States Supreme Court. That policy is supposed to be expressed unequivocally in the formula that rates must be sufficient to cover reasonable operating expenses, plus a proper allowance for depreciation, plus a fair return upon the value of the property. The commission or court in each case is supposed to ascertain that value, just as a tax commission or a jury might ascertain value; the problem is supposed to call for research, not policy. Its ascertainment, however, in the words of the Supreme Court, is not "a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts."[2]

Facts relevant to what? to some other fact? or to some policy? to the measurement of a "value" whose meaning is taken for granted in the statement of the constitutional rule, or to the choice of some standard to which the word "value" shall be attached? The court's language generally implies the former. But difficulties arise. What is the meaning of "value" as the court uses it in this connection? The court does not in practice protect a fair return upon the "value" in the ordinary sense of *exchange value*—the sense in which the term is used in proceedings before tax commissions and juries. The exchange value is a capitalization of the net earnings anticipated under existing rates, and those earnings must of necessity constitute a fair return upon that value; any reduction whatsoever in the net earnings would be held unconstitutional were a fair return on the exchange value to be effectively protected.[3] The "value" upon which a fair return is in fact permitted, whatever the court's theory, is not the exchange value. Nor according to the court's dicta, is it the original cost—that might have been extravagant;[4] nor is it original cost even when not extravagant—the "value" on which rates

[1] The substance of a paper read at the Round Table on Public Utilities at the meeting of the Association of American Law Schools in Chicago, in December, 1921.

[2] *Minnesota Rate Cases* (1913) 230 U. S. 352, 434, 33 Sup. Ct. 729.

[3] For a more detailed demonstration, see Hale, *The "Physical Value" Fallacy in Rate Cases* (1921) 30 Yale Law Journ. 710-13. Frequently the court seems to intend to protect the exchange value, without realizing that actually to do so would invalidate all reductions of net earnings.

[4] *San Diego Land Co.* v. *National City* (1899) 174 U. S. 739, 19 Sup. Ct. 804; *San Diego Land Co.* v. *Jasper* (1903) 189 U. S. 439, 23 Sup. Ct. 571; *Stanislaus County* v. *San Joaquin C. & I. Co.* (1904) 192 U. S. 201, 24 Sup. Ct. 241.

are to be based may be "found" to be more than the original cost;[5] nor is it the reproduction cost new or reproduction cost less depreciation. The Des Moines Gas Company was not allowed a return on the reproduction cost when that included the hypothetical cost of cutting through municipally laid paving to install the mains.[6]

The so-called value upon which a return is required by the Fourteenth Amendment is none of the things enumerated above; yet it is apparently something on which they all throw light. But there is nothing (unless it is exchange value) whose size can be judged by a consideration of original cost, reproduction cost and the other familiar items. Some figure can be found, it is true, after considering all those items, but what will it represent? A figure can be derived from a consideration of (a) the number of soldiers who fought in France, (b) the aggregate railroad mileage in the United States and (c) the tonnage of the Japanese navy; but no such figure indicates the magnitude of any conceivable reality. No more does the figure derived in the composite value cases—unless it represents exchange value. If it does, and does so with accuracy, it nullifies the power to reduce.

The "reasonable judgment," then, which must be exercised, is not a judgment as to the size of some "value" whose definition can be taken for granted. How can a commission exercise judgment as to the measurement of something when it does not know what it is that it is to measure? The commission can exercise its judgment only as to the choice of a standard to which, as a matter of policy, the exchange value should be made to conform.[7] Even so, the policy might conceivably be not the commission's own, to be threshed out and formulated, but a policy imposed on the commission from without—either by statute or constitution, or by a court of superior jurisdiction, or by some universally recognized principle of economics or morals. If the policy is imposed from without, the commission need not consider its merits, but only the means for effectuating it. At first the Supreme Court found no mandatory policy at all in the Fourteenth Amendment.[8] Subsequently Mr. Justice Brewer found the policy that property values must not be reduced by rate regulation.[9] The formula calling for a fair return on the value was originally adopted as a method of effectuating that policy. This it succeeds in doing only if "value" means "exchange value," and if all reductions of net earnings are forbidden. But they are not. If

[5] *Willcox* v. *Consolidated Gas Co.* (1909) 212 U. S. 19, 52, 29 Sup. Ct. 192; *Minnesota Rate Cases, supra,* footnote 2, p. 454.

[6] *Des Moines Gas Co.* v. *Des Moines* (1915) 238 U. S. 153, 172, 35 Sup. Ct. 811.

[7] This is ably pointed out by Gerard C. Henderson, *Railway Valuation and the Courts* (1920) 33 Harvard Law Rev. 902.

[8] *Munn* v. *Illinois* (1876) 94 U. S. 113.

[9] *Ames* v. *Union Pacific Railway* (C. C. 1894) 64 Fed. 165, 176-77; see also *Reagan* v. *Farmers' Loan & Trust Co.* (1894) 154 U. S. 362, 410, 14 Sup. Ct. 1047.

commissions are constrained to follow any policy dictated to them from without, it is not that found by Mr. Justice Brewer.

Some can be found who contend that the policy of the Fourteenth Amendment is to protect all physical (as distinct from "intangible") values from reduction. In this view, the court's occasional statements that franchises are property entitled to protection,[10] are to be accepted with reserve, or at any rate in a sense which does not include the entire intangible element.[11] Assuming it to be possible to segregate the physical from the intangible part of the value of the property, which is a highly doubtful assumption,[12] such a policy, unlike that of Mr. Justice Brewer, is at any rate capable of application without defeating all utility regulation. Yet in any case where high earnings increase the value of physical property, rather than of intangible, the public would get no protection under this policy. Such was the situation in *Munn* v. *Illinois,* where it was nevertheless held that the public was entitled to protection.[13] In that case, the warehouses owed their monopoly entirely, it seems, to their strategic location. The right to own land in a particular strip was what carried with it the monopoly. Whatever excessive earnings the warehouses could obtain, therefore, would add to the value of the land, not to any "intangible." To reduce the earnings, however high they might be, would leave less than a fair return on the former value of the land, and would thus diminish that value. If the constitutional policy is to protect the value of physical property from confiscation, then the effect of *Munn* v. *Illinois* is to say that whenever the warehousemen shall be getting too much from their customers, their rates may be reduced, but in reducing them, the conclusive presumption is that the existing rates are legitimate. You may cut out the man's heart provided you draw no blood.

If commissions and courts in valuation cases are merely to execute a policy derived from without, that policy is not, then, the one of protecting all property values, or even all *physical* property values. What is it? Perhaps it is one derived by intuition from the institutions of the land. Some rate bodies profess to feel an obligation to refuse to reduce the value of "property affected with a public use" below the level which similar property would have if used in a competitive business.[14] Under modern conditions, it may be thought, some industries, because of

[10] *E. g., Willcox* v. *Consolidated Gas Co., supra,* footnote 5, p. 44.

[11] See Hale, *Valuation and Rate Making: The Conflicting Theories of the Wisconsin Railroad Commission* (1918) 31-34. It seems impossible, however, to reconcile the physical value theory with Justice Pitney's insistence on a fair return on the value *as a going concern,* in *Denver* v. *Denver Union Water Co.* (1918) 246 U. S. 178, 38 Sup. Ct. 278.

[12] *Cf.,* Henderson, *Railway Valuation and the Courts* (1920) 33 Harvard Law Rev. 1031, 1048-50 (second article); and *The "Physical Value" Fallacy in Rate Cases, supra,* footnote 3, p. 718.

[13] *Supra,* footnote 8.

[14] See *State Journal Printing Co.* v. *Madison Gas & El. Co.* (1910) 4 Wis. R. C. R. 501, 579.

monopolistic features, are in a position where, but for regulation, they would enjoy special favors at the expense of the rest of the community. The rest are on some sort of equality with one another, brought about perhaps by competition. The function of regulation is to put the favored ones on a level with the rest. Commissions need not consider the wisdom or unwisdom of unearned increments or anything else. Interest on capital and unearned increments may accrue to anyone under competition; they must be allowed to accrue to the same degree, but no more, to the utility companies. To fail to allow the utilities as much, would not put them on an equality with the rest, but would put them in an inferior position.

The above policy may perhaps be derived by intuition from some highly respectable source—the Fourteenth Amendment, or the genius of our institutions, or Herbert Spencer, or the Fourteen Points. But it is incapable of application. The advantages which various businesses possess cannot be classified into those peculiar to utility companies on the one hand, and those common to everyone else on the other. There is scarcely a single advantage possessed by a business affected with a public use which cannot be matched in the case of some unregulated concern. Neither intangible values nor virtual monopolies are confined to concerns now subject to regulation. On the other hand there is not a single income-yielding property right, inside or outside the utility field, which can be enjoyed on equal terms by *everyone*. To speak of equal rights of property is ridiculous. Is the right of property of some unemployed tramp equal to the right of property of the owner of the La Salle Hotel? If all have equal property rights, why are the courts so occupied with disputes over the title to property?

Perhaps it is meant that all have equal rights to acquire property? But what is the nature of a "right to acquire property?" It is not an enforceable right. One cannot get a decree of conveyance against anyone else on the mere ground that the plaintiff has a "right to acquire property." Nor is it a permissive right, a "privilege" in the Hohfeldian sense; one who goes about acquiring property without regard to anyone else will soon find that he had a duty not to do so. True, one may acquire property by consent of a previous owner. The government generally puts no restriction on this sort of acquisition—no restriction other than the very important veto power of the existing owner. It restricts or not, at his pleasure. Again, it may be asserted that anyone may acquire title to property by producing it. But here again, it is not lawful for most persons to handle the apparatus and materials essential for the production of any given kind of property, without first getting consent; and that consent is frequently attainable only on condition of abandoning all claim to title in the product.

But as a practical matter, it will be said, the consent of previous owners is obtainable by all on equal terms—by paying the market price.

There are two flaws in this reasoning. The payment of the market price is not an equally practical matter for all, any more than an equally practical burden is imposed on all when the law in its majestic equality forbids rich and poor alike to sleep under the bridges or on the park benches (to quote from Anatole France). Moreover, a greater inequality lies in the fact that there are some whom the law has enabled to acquire the title without paying the market price. One man bought land very cheap around which a city has subsequently grown up, another inherited valuable property by will or by intestate succession. Will it be contended that the generality, who have to buy these objects at the market price or go without, are on a practical level with the fortunate ones named above? It can be argued even here that everyone had the same opportunity before the law to acquire property in these ways—even that everybody had the same right to be born the son of an intestate millionaire. But such arguments can scarcely be called practical.

Perhaps sufficient has been said to demonstrate the fallacy in the assumption that all (outside of utility companies) have equal rights or equal practical opportunities of acquiring property. It follows that a rate-making body cannot successfully pursue a policy of bringing about an equality between utility companies and the owners of other property. A thing cannot be made equal to a number of other things which are not equal one to another.

The truth which most rate bodies lack the courage to face is, that in regulating the rates of utilities the law is trying the experiment in one limited field of turning its back on the principles which it follows elsewhere. The experiment may perhaps be extended to other fields if successful. We are experimenting with a legal curb on the power of property owners. In applying that curb, we have to work out principles or working rules—in short a new body of law. Those principles will necessarily differ from the ones upon which the law acts in other fields—for in other fields it acts on the assumption that whatever income a property owner can get without fraud by virtue of his ownership is legitimately his. In the utility field, standards of what it is proper for an owner to get out of his ownership have to be worked out *de novo*. Because, therefore, the law permits various kinds of income outside the regulated field, it does not follow that similar forms are to be approved within the regulated field.[15] The revision of property rights worked out within the utility field may very well serve as a model, wherever applicable, for the revision of other property rights; but what the law still allows elsewhere is no proper guide in formulating this new code.

[15] The utility company, of course, must be allowed whatever earnings may be necessary to attract capital in competition with less restricted bidders therefor. This does not, however, require that they be put on a level with the most favored owners in the unregulated field, as the writer has attempted to show elsewhere. *The "Physical Value" Fallacy in Rate Cases, supra,* footnote 3, pp. 725-26.

We have already observed that there is no equal right to acquire property. Let us analyze the legal nature of property somewhat more closely. The right of ownership in a manufacturing plant is, to use Hohfeld's terms, a *privilege* to operate the plant, plus a *privilege* not to operate it, plus a *right* to keep others from operating it, plus a *power* to acquire all the rights of ownership in the products.[16] The analysis is not meant to be exhaustive. Having exercised his power to acquire ownership of the products, the owner has a *privilege* to use them, plus a much more significant *right* to keep others from using them, plus a *power* to change the duty thereby implied in the others, into a privilege coupled with rights.[17] This power is a power to release a pressure which the law of property exerts on the liberty of the others. If the pressure is great, the owner may be able to compel the others to pay him a big price for their release; if the pressure is slight, he can collect but a small income from his ownership. In either case, he is paid for releasing a pressure exerted by the government—the law. The law has delegated to him a discretionary power over the rights and duties of others.[18] Ownership is an indirect method whereby the government coerces some to yield an income to the owners. When the law turns around and curtails the incomes of property owners, it is in substance curtailing the salaries of public officials or pensioners. Frequently the owner can only exercise his power of coercion as a result of having rendered in the past some service in the production of wealth, or of having abstained from consuming all the wealth which he might lawfully have consumed. For this and other reasons of policy it would be as bad to abolish all incomes arising from ownership as it would be to abolish all salaries and pensions. On the other hand it would be as absurd to justify any particular utility values on the ground that their legitimacy is generally recognized in other fields, as it would be for a municipal administration to justify a salary of a sinecure on the ground that some other administration of some other city still pays that sort of salary. Any value which is still to

[16] A "privilege" or "liberty" or "permissive right" is that sort of "right" (in popular parlance) which implies no duty on the part of anyone else. A "right" in the strict Hohfeldian sense, or an "enforceable right," implies a duty on the part of others. A "power" is the ability to alter the "rights," "privileges" etc., of other people regardless of their consent. For a detailed analysis of these and other terms which, in popular legal usage, are all loosely grouped under the name "right," see Wesley N. Hohfeld, *Fundamental Legal Conceptions* (1919). The analysis also appeared in (1913) 23 Yale Law Journ. 16, and (1917) 26 Yale Law Journ. 710.

[17] It should be noted that when an owner is required by law to furnish service to all applicants who pay a prescribed price, and when he is forbidden to serve any at less than that, the owner's *immunity* from having the *duty* of outsiders changed into a *privilege* has been distroyed. He still has a *right* to exclude others, but also a *liability* to lose that right if they exercise their corresponding *power* to deprive him of it. This they can exercise by tendering the price. Only those possessed of sufficient money to pay that price have this power, of course.

[18] For a more detailed exposition of this point of view, see Hale, *Law Making by Unofficial Minorities* (1920) 20 COLUMBIA LAW REV. 451.

be allowed to a utility company must be justified on some independent ground of policy.

Commissions and courts, however, are reluctant to cut loose from the familiar. To avoid doing so, they make flimsy distinctions. When a gas company has laid its mains at low cost, cutting through a dirt street, there is no apparent reason, as the courts see well enough, for allowing it a value greater than would otherwise be allowed merely because *if* it were to lay its mains today it would have to undergo the more expensive process of cutting through pavement which was laid at the expense of other people. If this reasoning is sound, it leads to the conclusion that a company should not be given a value greater than would otherwise be allowed merely because *if* it were to buy its land today it would have to pay more than what it in fact did have to pay. Yet to reach this conclusion would suggest a question as to why the familiar privately enjoyed increments should be permitted. Fearing to make this suggestion Judge Miller of the New York Court of Appeals sought to distinguish the two—chiefly on the ground that the paving did not increase the cost to the company of producing gas.[19] The argument plainly fails to distinguish the paving from the land increment, which likewise does not increase the cost to the company of producing gas.[20] To take another example: the Wisconsin Commission sought in one case to avoid the question of the legitimacy of private increment by asserting that land increment is not the result of unreasonable rates.[21] This also fails to distinguish from values which admittedly may be reduced. In the Esch-Cummins Act it is specifically recognized that an income may be excessive though there are particular reasons for not reducing the rates.

"Inasmuch as it is impossible . . . to establish uniform rates upon competitive traffic which will adequately sustain all the carriers which are engaged in such traffic and which are indispensable to the communities to which they render the service of transportation, without enabling some of such carriers to receive a net railway operating income substantially and unreasonably in excess of a fair return upon the value of their railway property . . . it is hereby declared that any carrier which receives such an income so in excess of a fair return, shall hold such part of the excess, as hereinafter prescribed, as trustee for, and shall pay it to, the United States." [22]

It may similarly be that a private landowner is not charging excessive rates or prices, yet that social policy requires him to pay part of what he collects by the aid of the government, back to the government for wider distribution.

Into the merits of the unearned increment, so-called, it is not

[19] *People ex rel. Kings County Ltg. Co.* v. *Willcox* (1914) 210 N. Y. 479, 495, 104 N. E. 911.

[20] The attempted distinction is criticised in detail in *The "Physical Value" Fallacy in Rate Cases, supra,* footnote 3, pp. 730-31.

[21] *State Journal Printing Co.* v. *Madison Gas & El. Co., supra,* footnote 14, p. 579.

[22] Interstate Commerce Act § 15a (5), (Amendment of 1920) 41 Stat. 489.

proposed to enter here. It is probably true that a certain amount of increment is necessary, but not nearly all that accrues today.[23] All that is contended here is that the merits of this, and of all property rights, ought to be thoroughly canvassed by courts and commissions in rate cases. Their failure to do so is an evasion of the real issues. To do so would be to work out a body of law for the revision of property rights where they need revision, and for their preservation where they need preserving; then when the power of taxation is added to that of price-reduction as a method of revising property rights, this body of law might be gradually extended. The result might be radical; if so it would be because on a piecemeal and candid review, many of the incidents of property would prove themselves to be without justification. If property is not revised methodically by its friends, it is likely to be revised unmethodically by its enemies, with disastrous results. Courts may be too busy and may possess too little flexibility of mind to attempt the task. There is much to be said for Mr. Henderson's proposal[24] that the courts return to the dictum in the *Munn* case and leave the matter to legislatures and commissions within much wider limits than at present. The commissions, on the other hand, have as a rule been as evasive as the courts of the real issue of policy. This might perhaps be avoided, however, if the courts, particularly the United States Supreme Court, would repudiate the metaphysics which has hitherto misled the commissions, and would redefine the issues.

Whether the ultimate determination of this important policy question ought to rest in the hands of small bodies of men not chosen primarily because of their views of policy, is another question. It raises the whole problem of representative government and involves international complications at times. It might be better for some official or unofficial body to draft a detailed report on the revision of the entire institution of property. Meantime the fact remains that the immediate, if not the ultimate, determination of this policy *is* in the hands of courts and commissions. Nothing is to be gained by their failing to make a candid reexamination of the functions of ownership. The man at the steering-wheel, regardless of his personal qualifications, has to use his own best judgment where to steer, pending definite instructions from the "boss."

He who expects the present generation of judges and commissioners, however, to deal constructively with the problems presented to them in these cases, instead of continuing to evade them, is indeed an optimist.

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[23] *The "Physical Value" Fallacy in Rate Cases, supra,* footnote 3, pp. 726-27.

[24] *Railway Valuation and the Courts, supra,* footnote 12, pp. 1055-57.