

GOING VALUE

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Going Value by Halford Erickson

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Member Wisconsin Railroad Commission.

Before Indiana Electrical Convention, Indianapolis, Sept. 23d, 1914.

The subject assigned to me for this paper was "Valuation for Rate-Making Purposes". When a few days ago I got down to work on the paper, however, I found this subject to be so comprehensive that neither the time nor the space at my disposal would have enabled me to cover it as fully as it should be covered, or as its importance demands. In view of these facts I was forced to limit my paper to only one part of the subject, namely, that of "Going Value."

One of the storm centers in the modern theory of rate regulation is the problem of "going value", or, as it is sometimes called, the "value of an established business". This problem has proven a difficult one to solve because from its very nature it concerns itself with something intangible and because those who have introduced the problem to us have been guilty of some rather careless thinking. The self-interest of advocates has found it to be a convenient means of pressing large claims for value. This tendency has in its turn brought a reaction against it from many who now demand that nothing should be allowed for this so-called "intangible". So it has come about that in the strife of conflicting interests we are in danger of losing our economic basis for price fixing, for the real basis of both price and value are economic. In addition to the above, what has brought further difficulty is the tendency in some quarters to draw conclusions quickly without a proper sensing of the problem in all its phases.

The object of this paper is to briefly explain what is meant by going value, the position of the courts upon this subject, how it is determined, and what should be done with it. In addition

to this, illustrations are included which show how the costs which form the bases of going value, as understood by the Wisconsin Commission, are actually determined. Incidentally, certain criticisms of the Commission's methods in determining values will also be touched upon.

WHAT IS MEANT BY "GOING VALUE"?

Like most other intangible concepts, the concept of value can be made definite and distinct when we begin to think about it in an ordinary common sense way. Similarly the concept of going value can be made tangible and distinct when we cease thinking about it vaguely. Just as value in general has been defined in the sense of reasonable or normal cost and just as by means of this definition we have been able to get reasonably close valuations of tangible physical property, so by a similar definition will it be possible to get reasonably close valuations of an intangible element like "going value". The cost principle contained in this definition will, if properly applied, act as a chemical reagent to precipitate what was formerly held in solution. This definition of "going value" is about as follows: "Going value represents the reasonable cost or financial sacrifice incurred by the investor in building up a business which will yield a fair return upon the fair value of the tangible physical property."

In explanation of the principle contained in the above definition, I will quote from what I said in one of the early decisions of the Wisconsin Railroad Commission (in *Hill v. Antigo Water Co.* 3 W. R. C. R. 623, 706, one of its earliest decisions on the subject). The opinion reads:

"A mere physical plant, no matter how perfect or how well it is adapted to the purpose for which it is intended, amounts to but little unless it has or can obtain a paying business. Without business it is a dead mass instead of a living concern earning profits. To have profits it must have business or customers who avail themselves of the services it renders at rates that yield an adequate income. But new plants are seldom paying at the start. Several years are usually required before they obtain a sufficient amount of business or earnings to cover operating expenses, including depreciation and a reasonable rate of interest upon the investment. The amount by which the earnings fail to meet these requirements may thus be regarded as deficits from operation. These deficits constitute the cost of building

up the business of the plant. They are as much a part of the cost of building up the business as loss of interest during the construction of the plant is a part of the cost of its construction. They are taken into account by those who enter upon such undertakings, and if they cannot be recovered in some way, the plant fails by that much to yield reasonable returns upon the amount that has been expended upon it and its business. Such deficits may be covered either by being regarded as a part of the investment and included in the capital upon which interest is allowed, or they may be carried until they can be written off when the earnings have so grown as to leave a surplus above a reasonable return on the investment that is large enough to permit it. * * * Whether they should go into the capital account, or whether they should be written off, as indicated, are questions that largely depend on the circumstances in each particular case."

This, in brief, explains the position of the Wisconsin Commission on "going value". Nor has it ever departed from this position in any decision since the one just quoted. Whatever else may in some quarters have been assumed to have been included by it in "going value" is a pure assumption and has no foundation in fact. To be sure, it has at times varied the methods by which going value is appraised, but the principle upon which such appraisals rest has never varied.

It is of course a fact that if the rates could be fixed, as in rare instances they actually have been, at a sufficiently high point in the beginning to cover all legitimate expenses, including a reasonable return on the investment, the deficits might be greatly reduced and the cost of developing the business almost wiped out. Generally speaking, however, such rates seem to be almost entirely out of the question. Until a sufficient number of customers have been obtained, such rates would as a rule be too high. Instead of increasing the earnings they would be likely to decrease them. There are even cases where such rates might be entirely prohibitive and result in no earnings whatsoever.

Hence we find that it is the almost universal experience of plants to show deficits below what are reasonable earnings for at least some of the early years. The plants do, of course, try to overcome these deficits both by necessary adjustments in the rates and by direct expenditures to develop new business. Since public service enterprises are in a measure businesses of increasing returns, it is in line with good business principles that such

methods be adopted. In the face of all this, should a public regulating body, charged with the responsibility of adjusting the relations between investors and consumers upon legal and equitable bases, deliberately disregard this condition? It is submitted that this can not be done and still enable the regulating body to square itself with existing law and sound economics.

At a recent meeting of the American Economic Association, Professor J. H. Gray of the University of Minnesota read a paper on "The Regulation of Public Service Corporations". Discussing what he calls "The vagaries of valuation", the author definitely commits himself to the policy of adjusting the relations of consumers and public service companies upon the legal basis of "principal and agent". This basis the author defines briefly to be about as follows: "An agent is entitled to a just compensation for his services, including his outlay of money for the principal, but in no case to any gains or profits on any transaction undertaken or carried on for his principal". While it is my opinion that the theory of principal and agent can not be made to apply here, the discussion of its applicability being entirely outside the scope of this paper and one to be reserved to those more learned in the law, it seems that the cost principle of determining going value outlined above very well meets the requirements of even the theory of principal and agent. It is also a little difficult to understand the reasons for insinuations by the same author against the fairness of the Wisconsin Commission's method of determining the value of public service properties:

"The limit, up to the present, to which this vagary has carried us is found in the claims of the companies in the recent Superior, Wisconsin, rate case. The Commission's engineers, on their well known liberal principles of estimating the cost of reproduction, found the value of the combined plants to be \$1,349,523. This, of course, includes contingencies, interest during construction, organization expenses of all sorts, contractors' profits, and so on. The company demanded an additional value for rate purposes of \$182,734 for accrued and unmet depreciation on existing property, \$202,200 discount on bonds, \$5,448 on organization expenses, \$24,914 for gas connections which they do not own, \$92,516 on property previously discarded, or a total addition of \$508,085, or 36 per cent of the value, not of the investment in the physical plant, but of the hypothetical cost of reproducing that plant."

The above skillfully worded assertion was evidently meant to convey the idea that the Commission, if it did not actually allow the items enumerated, was largely and wrongly influenced in making its final valuation by the claims advanced. He then evidently sought to mitigate the above insinuations by a foot-note in which he quoted a figure which he assumed to be the valuation fixed by the Commission, which figure did not greatly exceed the present value of the physical properties. His position in the matter, however, deserves some notice.

The theory of principal and agent which he resorts to in order to obtain some basis upon which to exclude from the valuations of public utilities such items for going value as those allowed by the Commission does not only fail to sustain his position in the matter, but on the contrary it supports the course of the Commission. Under this theory the agent or utility is entitled to "just compensation for his services including his outlays of money for his principal." If this means anything it is that the losses incurred because the plant failed to earn reasonable compensation is a just charge against the public. It means that the plants must be compensated for such losses or outlays of money not only during a development period of normal length only, as assumed by the Commission, but for the entire time such losses have appeared. The principal and agent theory is thus in effect even more favorable to the utilities in this respect than the Commission has ever been. That this is the case becomes clear when it is pointed out that many utilities, especially among the smaller ones, have earned less than what is ordinarily regarded as reasonable returns not only during a development period that might be considered normal, but for a much longer time than this.

Again, by saying "the Commission's engineers, on their well-known liberal principles of estimating the cost of reproduction," he evidently intends to convey the impression that the Commission and its engineers are unduly liberal in favor of the utilities. Now this insinuation must be based on hearsay evidence only, for it is contrary to the facts and is not supported by any evidence. In order to pass upon the fairness of a valuation, it is necessary to examine in detail the inventories of the property, its character and condition, the unit prices used in computing the costs, the bases upon which its depreciation was determined, and many other facts of this nature. These facts are available

in the office of the Commission, but they have not been examined by Mr. Gray, either personally, or, as far as known, through any competent engineer. It might be added in this connection that several of the Commission's valuations, on appeals, have successively passed through the courts, not one being reversed. They have also been subjected to other tests equally severe without serious effect. Many of its valuations are also accepted without any contest by engineers and attorneys who represent the municipalities or the public, as well as by those who represent the utilities.

Of the items thus enumerated by Mr. Gray as specific examples of the "vagaries" which he says have crept into the valuations fixed by "learned courts and tethered commissions", there are several which may contain important features which deserve serious consideration and which can by no means be justly brushed aside in the easy offhand manner in which he evidently thinks they should be disposed of. Such items as he classes as vagaries are met with in most of the more important appraisals; but no competent and conscientious appraiser who has had experience in such matters ever peremptorily dismisses them from consideration until they have been fully and fairly examined and their merits and demerits determined. When the claims for discounts on bonds, for example, are thus analyzed, it is frequently found that they are made up of various items that deserve little or no consideration, as well as of various other items that may deserve a great deal of consideration. Discounts on bonds necessarily incurred in order to obtain needed capital are of the nature of interest charges, and must as a rule be provided for either by being charged to the cost of construction, like the direct interest charged for the period involved on the capital used, or by higher rates of interest later on, charged against the cost of operation.

In order to illustrate the nature and importance of discounts of this sort a few figures will be given. During the past few years, bonds issued by the smaller utilities bearing interest at 5 per cent covering not more than about 80 per cent of the cost of the plant and business, have had to be offered to the public at discounts of from 8 per cent to 15 per cent, or thereabouts. In addition to this, a selling expense of from say 2 per cent to 5 per cent or more must be met, which selling expense covers the charges of bond houses and bankers for distributing the bonds

among their customers. The total discount which the utilities thus have to bear often amounts to 15 per cent or more. A discount of this amount on a 5 per cent twenty year bond means that the annual cost of the capital obtained is thereby increased from 5 per cent to about 6 per cent.

Such discounts, however, are as much a part of the cost of obtaining capital as is the rate of interest stipulated in the bond. They must be assumed by the utilities in order to obtain the necessary capital for new plants and for new additions to existing plants. They must also be borne by the public. If they are not so borne, the public will, in the long run, have to do without much needed service. In this connection it is well to bear in mind that utilities, the same as other enterprises, must obtain their capital in the open market at prices fixed by economic forces over which they have no control.

Whether discounts of this kind should, like the balance of the interest charges during construction, be charged to the construction for which they are incurred, or covered by higher interest charges later on, as suggested above, is a question that for each plant must be settled in the light of the conditions by which the plant is surrounded. They must, however, be disposed of in the one way or the other. Mr. Gray did not give his reasons for stating that such discounts should not be considered in the appraisals; but it would be interesting to know on what principles of equity and public policy his position is based.

In analyzing other items in the "vagary" group, similar conclusions are reached. Ordinarily, the Commission allows about one per cent of the construction cost for organization, legal and certain other expense items, including clerk hire and office rent during the construction period. In many cases this allowance is found to be high enough, but in other cases again it is far from sufficient. In cases where law suits and other complications are met with, the legal expenses alone are apt to amount to several times as much as this allowance. Again, when it comes to depreciation and superseded property or to claims therefor, no engineer or appraiser of integrity would feel justified in passing upon the same without knowing the extent of and the reasons for such supersession, whether in the past the depreciation allowances and the earnings for the same have been sufficient, and many other equally pertinent facts. In many cases much of the property of a utility may have had to be discarded long