ETHICS AND THE RATE OF RETURN

by

CAPTAIN DOUGLAS N. JONES, U.S.A.F.
Associate Professor of Economics,
United States Air Force Academy

I. ON GATHERING ONE'S WITS

As I grappled with the topic of this paper, my thoughts about rates of return in the public utility industry were often visited by a scene from Hamlet. Polonius has come to a disturbed Hamlet to say that the Queen would speak with him. Irritated at the muted conspiracy Hamlet plays with the madness others suspect in him, and asks Polonius:

Hamlet: Do you see yonder cloud that's almost in shape of a camel?
Polonius: By th' mass and 'tis like a camel indeed.
Hamlet: Methinks it is like a weasel.
Polonius: It is backed like a weasel.
Hamlet: Or like a whale?
Polonius: Very like a whale.

Then, in an aside, Hamlet says, “They fool me to the top of my bent.” And I suspect that you too from time to time have felt fooled to the top of your bent in cornering that illusive something called “fair rate of return.” It is pretty clear that the courts have. But as has been said of Welfare Economics, “The subject must exist, for people write books and articles about it.” Still, even realizing that the rate of return is only one of several variables, to include importantly property valuation and depreciation, in determining earnings, it is clear that a difference of 1 per cent in rate return makes a large absolute difference in the amount of earnings. By simple arithmetic earnings are 20 per cent higher with a 6 per cent return than with a 5 per cent return. This leads to a few disclaimers at the outset.

The first is that this paper will not treat the rate-of-return in its technical aspects and slide rule computation. It is very difficult to say anything fresh on this score. Also the cost of capital test will be largely ignored in that analysis of that aspect of rate-of-return was the subject of another panel. Reference will frequently be made to other public utilities without precise delineation. The approach is not that of the lawyer, the accountant, or the engineer, for it seems to me that too much attention and effort have been devoted to the legal and methodological matters involved. Rather our approach here is philosophical in character with primary concern for the ethical considerations of rate-of-return determination. While it is not now fashionable to so characterize—not even modest to do so—the tone of the paper is one of economic moralizing. Surely a “fair return” is an ethical notion which derives from the more general philosophical foundations of the whole public utility concept.

II. PHILOSOPHY AND FAIR RETURNS

A good deal has been written by social scientists about the decline and fall of public utility regulation—a good deal more should be. Part of this deterioration in regulation has come with the insidious prostitution of the concept itself. Since this is a paper on ethics and therefore “oughts,” let me argue that regulation did not originally and ought never to contemplate utility commissions sitting as arbiter in impartial judgment, representing equally the interest of the public and the interest of the private company. This is nonsense! The commission must represent the public in order that the
interests of the unorganized many are not compromised by the organized few.

The idea—sometimes voiced—that the interests of the utility and the interests of the public are one and the same seems to me a Readers' Digest view of the unipyrge and largely without foundation. They are not the same in important respects, and the commission must be “on the side” of the consumer. This last has been asserted by the courts on a number of occasions (too infrequently, of late) including the U. S. vs. Merchants’ and Manufacturers’ Traffic Association of Sacramento (1916) and Cotting vs. Kansas City Stockyards Co. (1901), though the implications of the Nebbia decision are clearly on the other side.1

Commission regulation has, of course, always been fraught with peril, for it is a political fact of life that regulatory bodies are subject to pressures from all groups affected and may therefore be subverted from their intended ends. Recall, if you will, the several groups on whose behalf utility regulation traditionally has been justified and note the conflicting motives involved.2 The interest of labor is a long run maximum average wage. The interest of the investor is a maximum return on investment, but the public welfare interest is merely maintaining the credit of the utility, which should involve a minimum. (I have here consciously avoided the usual euphemism, “maintaining the integrity of the investment,” in an effort to strip of undue respectability a notion which at best should be accorded neutral attachment and at worst downright suspicion.)

Management’s interest has historically been identified with stockholder interests, but one may well raise the question, “Ought it to be?” The argument as to whether the first obligation of the management of a private company doing private business is to the stockholder or to society is probably pretty indeterminate: it is a good deal less so in the case of a public utility. Here, as Justice Brewster held in the previously mentioned case of Cotting vs. Kansas City Stockyards Company, the owners of a public utility have intentionally devoted their property to the discharge of a public service, and this intention affects its value—and I would say downward. The language of the Court in this obscure case is worth quoting in that it suggests a tone, and expresses a philosophy now sadly “written on the wind” in commission regulation. The owners of a utility must be “... aware that the state in the discharge of its public duties is not guided solely by profit... Its thought is the general public welfare... If the body which expresses the judgment of the state believes that the particular services should be rendered without profit (the owners are) not at liberty to complain.”3

The interest of the consumer is a minimum long run price consistent with satisfactory standards of service. This to the economist means protection from a price fixed in excess of the necessary cost of production, i.e., that cost which will yield a return to all the factors of production, in a least-cost- combination, sufficient to continue their employment in that production. This should not include, as was held in the United Railways Case, an earnings cushion—in the precision of the Court’s words, “... something to be passed to the surplus account.”4 It should not include, as was


Clair Wilcox in Public Policies Toward Business (Chicago: Irwin, 1955), 503, on this same point describes regulatory commissions as too frequently “... acting as if they were judicial bodies passively waiting for complaints. This attitude of impartiality has served the interest of the utilities, since consumers have usually lacked the knowledge and the resources that would enable them to bring a case.”

2. A portion of the following analysis has been drawn from Reashaw’s article appearing in Journal of Business, October 1958, entitled “Utility Regulation: A Reexamination,” 31: 315-43.


properly held in the Minnesota Rate Case, expensive mistakes in utility management, e.g., over-expansion of plant and equipment, which reasonable intelligence and efficiency could have eliminated. Nor should, on the other side, a company be allowed to keep returns that are more than “fair” or prescribed just because of exceptional skill in management. There is no necessary symmetry involved.

The point made here is twofold: first, that the interests and motives of the several groups affected by utility regulation are frequently, if not generally, in conflict; second, that the regulatory commissions should be committed both philosophically and practically to the side of the consuming public.

III. LEGALITY AND FAIR RETURNS

It is generally felt that the Bluefield and Hope decisions made a bold step forward in setting out the tests of fair returns in the “end result doctrine.” There is less than total agreement on this point. Justice Jackson remarked cryptically of the Hope Case, “All that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully.”

A. Cost of Capital

While treatment of the capital-attraction test is the subject of other papers, it is difficult to refrain from a few quick comments in passing. The first is that by implication this test embraces the other two, i.e., maintenance of credit and comparability of risk, for if you accept these tests, how can the first really be met without satisfying the other two? Second, implicit in the test is the assumption of a completely inelastic supply price, that is, at a 6 per cent rate of return, for example, all the capital needed would be attracted, while at a 5.5 per cent nothing at all would come in. Also a distinction should be made between enabling a public utility to attract capital and inducing them to do so, for it is a fact of utility finance that over the last half century there has been a pronounced shift from external to internal financing. Finally, as Bonbright argues, there may be no inherent relationship between reasonable rates to charge to consumers and specified rates of return to investors. The rate at issue in the capital-attraction test is a future return as estimated by the commission and not a realized past return, hence there may be a discrepancy between returns assumed by commissions and those expected by investors. In any event this standard by itself requires that the rates of charge and the rates of return be at the absolute minimum for the assumed purpose; “Otherwise,” Bonbright says, “the test is indeterminate. Anything yielding more does so on some other standard or consideration, e.g., incentives to efficiency.”

B. Maintenance of Credit

The credit maintenance test, like the capital-raising test under the Hope Case, has no really clear tie to property value—a tie which some people, from another era of regulation no doubt, would fondly recall. Rather it gives great emphasis to the amount and type of outstanding securities, for the standard is an ex post idea of holding old investors under the assumption that there is a public obligation to protect the value of their private holdings. Here again the point can be made that while the interests of the old and the new investor may be related, they are not the same thing and should not be treated as if they were. Consideration of average rates of return may be appropriate to past plant and investment values, but clearly additions to plant and investment should be tied to marginal rates of return.

Of relevance to maintaining the financial soundness of investments is of course the

8. Ibid., p. 469.
matter of price level adjustments over the business cycle. The commissions and the courts have been something less than unswerving on this score. It was held in Newton vs. Consolidated Gas Company that, "Mere past success could not support a demand that it continue to operate at a loss." Yet in the Oronogo Gas Company case the Missouri Commission argued that a fair return meant a return over a period of years, not every year by itself, and that while the rate granted might not be sufficient for the ensuing year, if taken with former years it would be reasonable. And in the Municipal Gas Company decision, it will seldom be important that rates have been inadequate for a day or a week or a month. Fleeting losses may be suffered, and yet the balance sheet may show a profit. Prolong the loss, however, for a year and you may reach and cross the danger line. It is by the average of the year that business commonly reckons its losses and its gains. On the other hand, there may be times when the average must be distributed over periods still longer.

And finally, Justice Stone's words in the Natural Gas Pipeline decision, "Regulation does not insure that the business shall produce net revenues, nor does the Constitution require that the losses of the business in one year shall be restored from future earnings. . . ." 12

My own thought is that while it would be difficult to argue against maintaining the financial soundness of a utility, that problem is seldom really at issue and the return it takes to meet it is generally overestimated. Utility revenues have historically been characterized by a strikingly regular upward trend. Cyclical fluctuations have been of only moderate intensity with the rising secular movement prevailing. We are, after all, dealing with a solid industry of long standing with a public accustomed to the use of its service and a management familiar in capital markets where funds are readily available for secure investment. Experience data are plentiful and good records are kept, making for pretty precise forecasting and control of operating revenues. The point is that far from assuming that maintaining the credit of a company inherently means upward pressure on the rate of return, the operation of such a seasoned company in such a solid industry should, like technical economies, occasion price reductions or at least a holding of the line.

C. Comparability of Risk

The standard of relating public utility returns to private returns in corporations "attended by corresponding risks and incentives" has been with us at least since the Consolidated Gas case of 1909. The helpfulness of the test would be greatly enhanced if there were any such corporations, though a good many utility writers have spent much time and effort trying to prove that there are. To argue that Coca Cola's or Eli Lilly's experiences have anything at all to say for the utility situation in the remotest way is more than I can understand and is surely an heroic undertaking. The only possible comparability is to be found with other utilities, and that of course gets you immediately into a circularity unbroken by any independent tie. Yet even this last simple point is not always honored, for utilities are not above parading out exhibits indicating how returns in another area of the utility industry are substantially higher than those currently allowed in its own case.

In the Wisconsin Telephone case the Wisconsin Commission—one of the few commissions with a history of public courage—properly ruled that "a business enterprise enjoying a complete monopoly, not harassed by competition and rendering a service which has become an absolute necessity ... should not be given the same rate of return that non-utility companies received."14 And again in the Bluefield case, "... it (a utility) has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.15

While it would overstate the case to argue that the utility industries are riskless, still they are well fortified against the usual risks of doing business, and even those they do experience are minimal. There is virtually no inventory risk, little bad debt risk, and the price and income inelasticity of demand for utility services provides a stability of rising revenues.16 Moreover, the telephone industry—unlike other utilities—has not historically been threatened with government competition or government-subsidized competition.

Among the elements of risk that are operative with utilities generally, for example advances in the arts, conditions affecting changes in supply, and changes in communities themselves, the telephone industry seems singularly insulated. The first is handled by owning the fountainhead of its own technology, the Bell Laboratories. The second is not applicable in that no depletions are experienced, as in the case of the natural gas industry. Finally, population

changes, labor problems, and industrial shifts are real aspects of community evolution, but almost invariably the trend is an increasing amount and intensity of demand.

Traditional standards of determining a fair rate of return are viewed, then, as riddled with defects and of doubtful helpfulness to the public welfare. At their most charitable best they provide a rough range of reasonableness characterized by an upward bias and erring on the side of the utility interest: at worst they suggest a certain quantitative precision in measurement—and hence halo of respectability—which is totally undeserved. It remains to treat explicitly the relationship between ethics and the rate of return.

IV. ETHICS AND FAIR RETURNS

It is all too fashionable nowadays to relegate the science of ethics either to some remote college classroom to be dealt with playfully as a collection of obscure abstractions or to a particular day of the week when fleeting homage may be dutifully and conspicuously rendered. To plead for its relevancy in day-to-day personal and professional activity is frequently to open oneself to derisive charges of preachment and piety. I have hesitatingly come to believe that in the private sector of the economy there is no such thing as "business ethics"—rather only "business practice." And maybe this is appropriate. But in the mixed private/public sector, in our case the public utility sector, there must be, and this must be reinforced by the commissions' concern for ethics in regulation. Writing to this latter point a member of the St. Louis Commission once expressed it, "The exercise of the power to fix rates or the exercise of any other power in the public regulation of the utilities is a governmental function, and being so, the very first element to be considered is the element of justice."17

16. Even in the grossest terms and admitting all the qualifications that must attend such statistics the following Selected Business Indexes based on 1947-1949 prices and drawn from the October 1962 Federal Reserve Bulletin do support the strength of utility demand: Industrial Production up 75% over 1948; Manufacturing up 74%; Consumer Prices up 26%; and Public Utilities up 230%.
Prevailing views to the contrary, old things sometimes are good things, and this homely principle has, I feel, something to say for the matter of rate-of-return. What I have in mind are the "just price" doctrines of the Scholastics and the Medievalists and the commitment to natural law of the 18th century rationalists; not, obviously, as technical tests for the measurement of fair rates of return, but rather as a useful and necessary way of looking at what ought to be the return in public utility industries.

Recall that regulation began during an era of economic and political liberalism philosophically rooted in a rational and orderly system of nature. The "laws" governing social behavior and processes were held to be as immutable and precise as those on the physical science side. I argue that what the commissioner should take from this is the assumption of absolutism regarding the—not a—fair rate of return, that is to say that there are such things as ethical absolutes and the return in each given case is one of these. The determination should be approached this way.

Lest we too easily part company on this first point, be aware that we readily make similar judgments of absolutism in many analogous instances. To drive through a 50 m.p.h. speed zone at 51 m.p.h. is to break the law as much as it would be broken at 70 m.p.h., yet there may be no significant physical difference, for example, in safety terms, between 50 and 51 m.p.h. Similarly the minimum voting age in most states is 21 years of age, but few would argue that something intestinal happens to voter responsibility, insight, and maturity in that last day of the twentieth year as opposed to the first day of the twenty-first. The point is, of course, that these absolutes provide working guidelines by which society best gets along.

This approach to rate determination, if followed, would preclude tragic commission announcements to the effect that "representatives of the utility, interested commercial operators and the commission came to terms" on a proposed rate increase—as if utility regulation were a collective bargaining adventure where the final solution shifted lower or higher depending on the relative power positions of the participants! The fair return ought not to be negotiable. It should provide ordinary and minimum profits and nothing more. This in no way implies a once-and-for-all judgment, but rather demands a certain precise direction for the commission's habit of mind for each given time, place, and circumstance.

Despite the time span from St. Thomas Aquinas and Aristotle before him to the present, the leap from the "just price" to the "fair rate of return" seems to me an exceedingly short one to take. In fact the concepts should be synonymous, for just values are social values.

Recall the elements involved in the just price. It was in part a cost-of-production theory with the hint of objective value lurking behind price. But it involved chiefly the subjective value of the service to the seller and not the value of the service to the buyer—that is, the just price could increase in accordance with external circumstances where the loss to the seller in parting with the service was high. The doctrine did not permit the contrary case where excessive urgency on the side of the buyer afforded a chance for advancing the price. What better characterization of the utility situation with its monopolistic market, its inelastic demand, and its price and returns issues?

Couple this just price notion with the natural law concept discussed previously and the commissioner assumes, I believe, a posture for thinking that will well serve the public interest in the determination of returns. Writing in another connection, but appropriate to our case here, the famous economist Frank Knight has put it,

There is a place, and a vital place, for an "absolute" science of ethics. Its dicta will not be readily absolute, for they never cut loose entirely from the real world and its possibilities of growth and transformation, and they will al-
ways grow and change. But at least they are not "merely" relative; they must be beyond the immediately attainable, and will often lie in the field of the actually impossible—patterns to be approached rather than objectives to be achieved. 18

Now I am aware that this plea provides no neat formula to rate of return determination, and I am also aware that utility usage of even the two concepts suggested would very likely result in differing conclusions. But I would far less reluctantly place my hand in that of the commissions' if they approached each rate case reeking of this philosophy. For conflicts are inherent in regulation and it is the task of the commissioner to make judgments about them. In the words of a noted commentator on the scene,

Regulation is not easy either for the regulated or those that regulate. Inevitably, it must always contemplate and frequently must require the subordination of individual judgments to the judgment of the agency charged by the public with the regulatory task. This is its very nature. 19

The demands are for wisdom and courage, with the latter the rarer ingredient here.

V. ON GATHERING ONE'S TENT

In the November 1961 issue of Land Economics a contributor decried the decline of academic attention to public utility economics. 20 It is reassuring to see that our sessions here give counterweight to any such trend—in vehemence and let's hope in substance. My own hunch is that future contributions to the literature will likely come from the welfare economists and other economists of mathematical bent. My own hope is that equal attention might be given to the non-quantitative and ethical aspects of public utility economics. It seems to me that here the larger contributions can be made. The last one I found directly devoted to the subject was in the Quarterly Journal of Economics and dated 1912. 21
