Decision No. 8542

BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA

--oOo--

ORIGINAL

In the matter of the application of the CITY OF REDDING, a municipal corporation of the sixth class, to ascertain the value and to fix and determine just compensation to be paid the Northern California Power Company, Consolidated, a corporation, for the acquisition by said City of its system of distribution of electrical energy to the inhabitants and consumers thereof.	)	Application No. 3718.

W. D. Tillotson and E. A. Mason, for City of Redding.
Allan P. Mathew for Northern California Power Company, Consolidated.
Charles P. Cutten, for Pacific Gas & Electric Company.

BY THE COMMISSION:

OPINION AND ORDER ON REHEARING.

On July 3, 1919, the Commission rendered its decision in this application (Decision No. 6537) and thereafter the Northern California Power Company, Consolidated, petitioned for a rehearing. This application was granted (opinion and order on application for rehearing of November 6, 1919) for reasons stated in the opinion. Additional exhibits have been filed and additional testimony introduced and the matter is now submitted for final decision.

The Company sets forth twenty-one different

reasons why a rehearing should be granted, twenty of which rest upon the allegation that the Commission has failed regularly to pursue its authority under the Public Utilities Act and in particular under Section 47 of said act, and that the Commission's findings are confiscatory and in violation of the Fourteenth Amendment of the United States Constitution. The additional reason alleges that the Commission is without authority to fix the rates for the sale of electric power by the Company to the City of Redding after the acquisition by the City of the property in question.

In granting the application for rehearing, the Commission decided upon a virtual reopening of the case, stating that "it is our opinion that the importance of this proceeding requires that an opportunity be given both to the municipality and to the company to present complete evidence upon all of the issues involved....." In order, however, to meet the issues, the essential grounds of the Company's objections are listed below. It is alleged:

1. That erroneous valuation methods were employed in measuring the value of the physical property.
2. That valuation estimates and findings were made that were not supported by the evidence.
3. That insufficient overhead allowances were made.
4. That erroneous methods of measuring depreciation were employed.
5. That the Commission failed to determine and include the value of three franchises.
6. That the Commission failed to include in the compensation an amount sufficient to represent the development cost of the property and of the business.

7. That the Commission's presumption as to the existence of fair rates prior to the authority of the Railroad Commission was unjust and unreasonable.

8. That proof on the part of the Company as to actual unrequited losses, such proof being required by the Commission, is not essential in order to establish the present value of the property and the business.

9. That the Commission erred in its conclusions on going concern value.

10. That the Commission erred in finding and concluding that the rates for the sale of electric power by the Company to the City after the acquisition of the properties will be fixed by the Commission, the Commission being without authority to fix such rates.

11. That the Commission's findings with reference to the Company's entire generating system and all its transmission lines not sold were erroneous.

12. That the Commission's findings with reference to severance damages were erroneous.

13. That the Commissinn has no authority to require the Company to enter into an agreement with the City in order to avoid certain severance damages and that it has erred in failing to find the amount of severance damages covering this item.

14. That since the Commission through certain of its employees has produced and placed in evidence exhibits which were offered and presented in behalf of the City of Redding, the Company has been denied a fair hearing before an impartial tribunal as required by due processes of law.

I - Basis of Just Compensation

In Decision No. 6537 supra, the Commission set forth the bases of finding just compensation and the methods employed in considering and finding each element of value and of damage. Nothing has developed during the rehearing to change our conviction of the complete soundness and fairness in law and in equity of these bases. The questions remaining are questions of fact and of the proper interpretation of fact in relation to the matters of value and of damage.

After a careful consideration of the exhibits and the voluminous transcript in this proceeding and also of the extended and able briefs of Counsel for the City and for the Company, it

seems desirable to repeat what was pointed out in the former decision: that many of the contentions and arguments of both parties lose significance and disappear as soon as the confusion is done away with between the making of engineering appraisals and reports (giving necessarily different results according to the methods employed), on the one hand, and the finding of just compensation by the Commission after all of the different measures of value and of severance damage have been considered, on the other.

It must be admitted that while there can only be one final value, there is more than one consistent and honest method of measuring the present worth of the several elements and items of public utility property. The market value of a portion of an electric utility cannot, in the nature of things, be ascertained readily and automatically in the same sense that market conditions often determine accurately and automatically at a given time the market value of commodities or of securities. And since this condition is a fact and not a theory, it becomes necessary to measure value by other means.

It seems clear to us, for instance, that actual cost cannot be the one and sole measure of value; and yet it would not be well to ignore a consideration of that cost if value is to be ascertained with any reasonable degree of correctness. It will be found in practice that in many instances of special equipment and expenditures for labor and management, actual cost incurred during the time in question is indeed the best measure of value, since substitute estimates partake of the element of speculation and lack the certitude that pertains to actual facts, no matter how honestly or how carefully such estimates may be made. And yet abnormally high or abnormally low costs, or costs incurred during a time long since past or for things no longer efficient, cannot be the true measure of actual present day worth.

Nor are we on firm ground when we base reliance on reproduction cost estimates alone. It is well known that there are many methods (most of them legitimate as showing what the result will be, given certain assumptions) of making engineering estimates of reproduction cost.

There is the historical method of reproducing the property piecemeal in the period of time through which it has actually lived. This method means prices and costs for labor and material fluctuating between wide limits, and it means more expensive construction costs by reason of the actual piecemeal method of construction than if the job were done under more ideal construction conditions with a more or less perfect construction organization in a comparatively short time. Yet a good deal can be said for this method, for, in the absence of reliable bookkeeping costs, it will give the nearest approach to actual expenditures that can be devised. Yet this method cannot be considered the sole criterion of value.

Another method is that of reproduction cost new, with an assumed construction period and assumed construction conditions and organization and with estimated prices and overheads actually in effect during the assumed construction period. This method has the advantage of reflecting more accurately than the other two the present day conditions. But we should not ignore the truth that literally the method proceeds on an impossible hypothesis: the engineer who makes this estimate of a public utility in a given locality as of today has to take all things and conditions and men in the community as he actually finds them but has to eliminate in his imagination the utility plant theoretically to be reconstructed. This radical hypothesis is

bound to ignore and to do violence to such obvious considerations as the very utility which is assumed nonexistent has created and as affect the costs which the engineer has adopted. --- But it is easy to criticise these apparent inconsistencies and to discredit any such method of valuation. The difficulty comes in suggesting a less vulnerable and a fairer one.

It has been a source of confusion quite evident in this proceeding that the distinction was lost sight of between a rate base and a just compensation figure. We have no patience with the argument that in a reproduction cost estimate for rate making purposes a power line pole should stand at one figure and that in a reproduction cost estimate for condemnation purposes the same pole should stand at another figure. It seems clear to us beyond argument that a given property item valued according to a given method must have in its estimate of value new and in its estimate of value depreciated the same figures no matter for what purpose that estimate may be used. To conclude, however, that because of this statement the rate base and the just compensation of a public utility plant

must be the same, seems to us altogether erroneous.

The difference in the final result (depending on whether a given public utility property is to be valued for just compensation purposes or for rate making purposes) will be found to lie not in the value given to different property items under various methods of valuation but rather in the answer to the final question of whether in a rate case the basis for the fair return should be "value" or "investment" or "sacrifice". In a rate case the rate making authority is concerned with finding the sum on which a fair return should be allowed. The problem involves the determination of what property is reasonably used and useful in the public service, what capital expenditures have been made by the utility even though these expenditures may be on property not owned by the utility, and other similar questions. Also the matter of going concern, in so far as going concern is an element resulting from the actual or prospective ability to realize profits, cannot enter into the rate problem. If it were held otherwise there would follow the absurdity that the higher the rate, the greater the earning power; the greater the earning power, the larger the going concern; the larger the going concern, the higher the rate, ad infinitum.

An essentially different problem confronts the Commission when it has to find just compensation. Beyond a question it must, in that case, find the fair value of the property as of a given time with all of the elements making for increase or decrease and for loss or gain attached to it. And what property items are to be valued is settled by the description of the property desired to be taken, by which description the Commission is governed.

If, therefore, agreement can be had on the proposition that it is legitimate to consider various estimates of value on various theories (each with necessarily different results) and that in the last instance these various estimates, elements and measurements must be resolved by the Commission into "just compensation" and that "just compensation" can be found only if all factors (to the exclusion of none) having a bearing on present day value are given their proper weight, then it will be possible to discuss the problem on common ground and with an intelligent vocabulary.

A - Valuation of Physical Property plus Overheads

To reach a conclusion as to the value of the physical property (without regard in this place of the effect on such value of profits and losses) the Commission had available in Decision No. 6537 six engineering estimates, viz.,

1. The historical reproduction cost.
2. The reproduction cost new on the basis of average prices for the preceding five years.
3. The reproduction cost new on the basis of prices as of May 2, 1918, the date of the filing of this application.
4. The reproduction cost less depreciation based on the historical reproduction cost.
5. The reproduction cost less depreciation based on the five-year period reproduction cost.
6. The reproduction cost less depreciation based on the date of valuation reproduction cost.

We were convinced that the law required an engineering estimate of reproduction cost based on prices for material and labor during a fair construction period immediately preceding the date of application with a deduction from that estimate of such a sum as represented the accrued

depreciation. After weighing all of the evidence the Commission was of the opinion that one year (the year ending May 2, 1918, - the date of the filing of the application) was a reasonable reproduction construction period. No single one of the available engineering estimates for reproduction cost gave a figure in strict accordance with this definition. Since, however, for reasons indicated above, factors of large uncertainty must be inherent in any reproduction cost estimate, and since furthermore an engineering estimate figure is not the end in itself but merely the means to an end, the Commission was of the opinion that the law was fully complied with and that reasonable accuracy was obtained by making a 20 per cent addition to the Engineering Department's reproduction cost new estimate based on the 5 year period. The Commission was the more ready to adopt this method since the physical property is only one element in the total value of plant and business. This total value may be more or less than the reproduction less depreciation estimate. It may also be stated that from its considerable experience in valuation matters, the Commission's judgment may be assumed to carry some weight.

The Company alleges that this procedure was in error, in violation of Section 47 of the Public Utilities Act and resulted in confiscation of the Company's property within the meaning of the Fourteenth Amendment of the Constitution of the United States.

The Commission is not persuaded that this allegation is sound and that all exercise of judgment and discretion is taken from the Commission in a proceeding of this nature. We believe it to be the Commission's function and duty to reach its own conclusion from conflicting testimony or other conflicting data and are by

no means of the opinion that the Commission is bound to accept a certain figure testified to by its own or other witnesses to the exclusion of other considerations that in its judgment should be given weight.

In order to remove uncertainty in our own mind, however, we arranged for a joint report by engineers of the Company and of the Commission on the valuation of the physical properties of the Redding Distribution System. Instructions were issued by the Commission to the engineers as follows:

> "Submit a joint report showing the reproduction cost new of the physical properties of the Redding Distributing System based on market unit prices for the year from May 3, 1917 to May 2, 1918, inclusive. In determining market unit prices, fix, as far as possible, the average price for materials required based on actual sale prices referable to materials of the kinds, qualities and amounts necessary for a reconstruction of the Redding system. In case any material involved shows a wide fluctuation or variation of prices during the year, detailed figures should be given showing basis of average. Unit prices for labor shall be fixed in the same manner as that employed for materials. In all cases, prices are to be referred to materials and labor of the kind and in the amount required for the construction of the Redding plant as though purchased in the open market by an independent buyer."

This report is in evidence (Commission's Exhibit BB) and shows the figure agreed to by the Company's and the Commission's engineers for reproduction cost new, including organization and overheads (but without any deductions for accrued depreciation) of $64,243.44. The report also removes from controversy the subject of overheads and organization, Counsel for the City and Counsel for the Company having stipulated that 16 per cent on the proper base figure should be added as a fair allowance to cover the so-called overhead items, including "organization", "undistributed construction expenditures" and

"interest during construction".

The Commission is ready to accept this figure inclusive of overheads, for what it purports to be, viz., an estimate of reproduction cost on the basis indicated above. It is not to be inferred, however, that the Commission lays down the rule that this figure is the only correct measure of the value of the physical property or that it must, unmodified and to the exclusion of every other factor affecting fair value, be taken as the criterion of just compensation for any one portion or element of the toal property sought to be acquired. This saving clause is not intended as specious argument. Aside from the question of depreciation, there is not, and cannot be, reflected in an engineering estimate made by this particular method the efficiency of the plant as a whole or any abnormal conditions of construction or operation. A valuation by this method by and of itself can only be one step and is merely an inventory and reproduction cost new estimate of a large number of individual property items.

B - Accrued Physical Depreciation.

The Company alleges error and consequent violation of the Public Utilities Act and confiscation of property within the meaning of the Fourteenth Amendment of the United States Constitution because of the Commission's finding, in this respect alleging:

> ".....that the amount of accrued depreciation of petitioner's said properties should be determined by the "straight line method" and not by the "sinking fund method" of computing depreciation; that the Commission has heretofore in a proceeding conducted by it for the purpose of fixing rates to be charged by the petitioner in the sale of electric energy in the City of Redding, determined that the depreciation allowance properly to be included in the estimated expenses to be incurred by petitioner in the conduct of said business should be computed in accordance with the sinking fund method, and such rates were fixed by the Commission in accordance therewith;
>
> "That by virtue of the said finding herein the petitioner will be deprived of a portion of the value of its said properties measured by the difference between such depreciated value as determined by the application of the sinking fund method, and such depreciatdd value as determined by the application of the straight line method."

A great amount of testimony and argument was heard and read by the Commission on the question of depreciation in this proceeding. The matter was exhaustively discussed in briefs filed by the petitioner after the original hearings and is again gone into fully in the briefs filed on rehearing.

In Decision No. 6537, supra, an attempt was made to state definitely and at considerable length the Commission's views and conclusions on depreciation as it confronts us in this case. It now seems necessary to state more fully the facts as we see them and to make our position more definite, if possible.

Counsel for the Company sets forth with considerable completeness the decisions of the courts and the commissions on the principles governing the determination of just compensation. The basic rule of valuation in cases of this kind must be considered

as definitely established. It is the "present value," the "full and perfect equivalent," the "rule of giving to the owner the increment of value and subjecting him to the losses in value," "full compensation for everything or element of value taken."

And the Commission is in complete agreement with Counsel as to the intent and meaning of these terms. It is on the means of exact measurement and the relative significance of the various means that there appears to be disagreement.

Speaking of the physical property alone as it appears item by item in an engineering inventory and appraisal and not injecting at this point false quantities (such as service value, operating efficiency: these factors will receive consideration elsewhere), it is beyond question that a given property item will have attached to it a higher cost or value figure when taken into the estimate in its new condition than it will have after consideration has been given to the effect on this property item of wear and tear and the elements of decay appearing as inseparable accompaniments of use and passing time. This lessening of value from such causes is termed depreciation.

We believe that only actual depreciation, sometimes called accrued depreciation, should have consideration in a proceeding of this kind, and that possible or probable future obsolescence because of likely advances in the art or because of probable discoveries or inventions, should not be given weight. Such future depreciation -- while the past has shown that it is real and must be expected -- is too speculative an element to be estimated in terms of money and deducted from a value otherwise found. Only such depreciation as has actually accrued will in this case be considered by the Commission.

How is this accrued depreciation to be measured, or, in other words, what sum of money is to be subtracted from the estimate new in order to reach the estimate of cost of reproduction

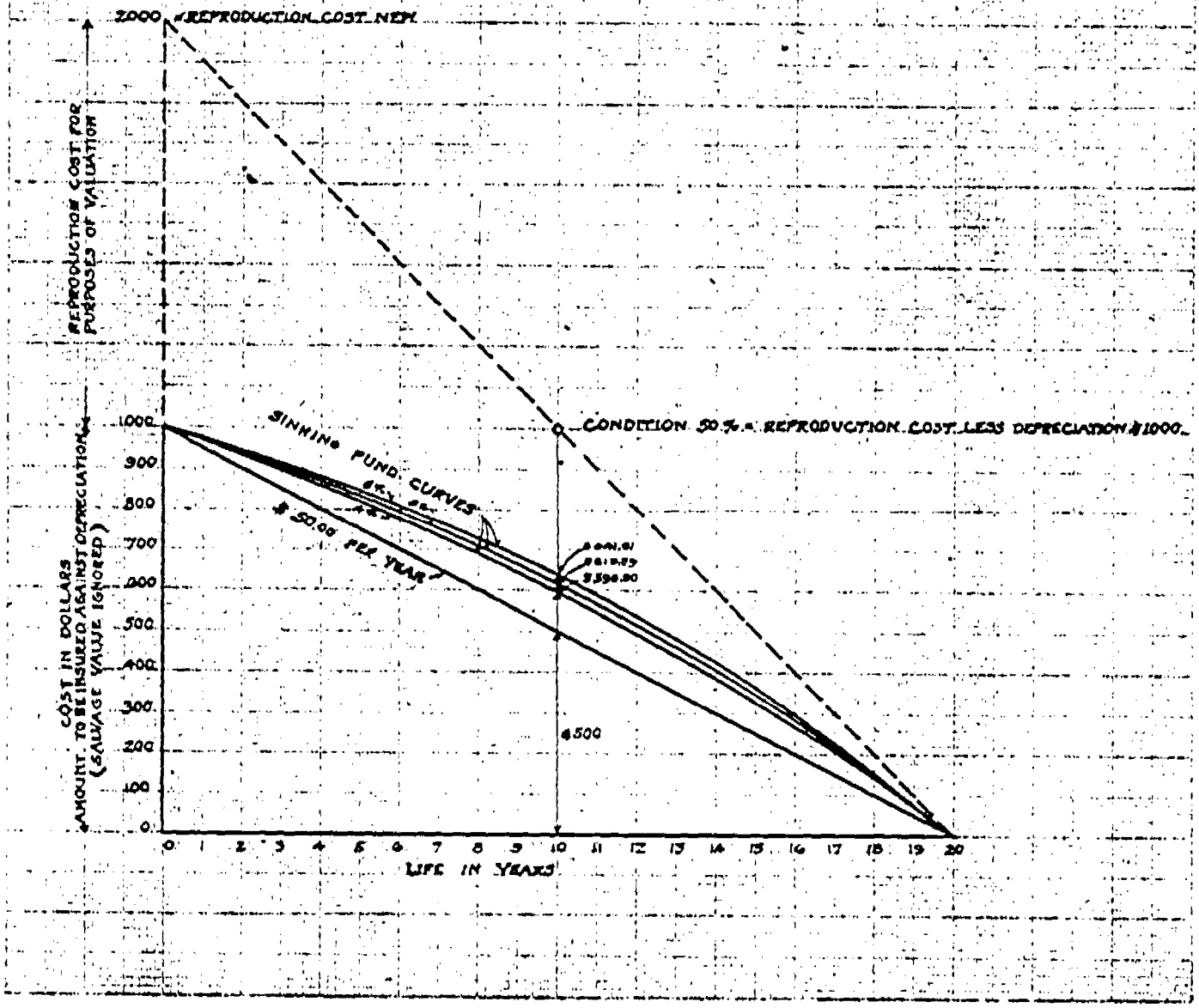
less depreciation? It is at this point that the argument on straight line method versus sinking fund method is injected. The Company argues that because in a past rate case the Commission authorized the Company to accumulate a depreciation fund on the sinking fund basis and because under the sinking fund method the annual payments into the fund are smaller than under the straight line method, a confiscation of property results if in this proceeding a larger amount of accrued depreciation is deducted from the reproduction cost estimate now than would be found in the sinking fund, if it had actually been set aside. We do not think it necessary to review the rate decision referred to in order to see whether or not the Company correctly interprets the Commission's opinion and order. Regardless of what the Commission did in the rate case, it will appear that the facts of the matter do not bear out the Company's contention of confiscation and there is not the least doubt that the Company's position is erroneous and probably rests on a misunderstanding of the problem. The problem can best be illustrated, perhaps, in the form of a diagram

CALIFORNIA RAILROAD COMMISSION
ENGINEERING DEPARTMENT
DIAGRAM SHOWING

DEPRECIATION FUND ACCUMULATIONS UNDER VARIOUS METHODS AND VALUATION CONDITION PERCENT

(ACCOMPANYING DECISION No. APPLICATION 3718)

AUGUST 1920



413-65

138

Let the diagram stand for a machine of an original cost of $1,000 and a life estimated at the time of purchase at 20 years. We have, then, two problems in depreciation:

Problem 1: What is to be done to accumulate $1,000 in 20 years to insure against the depreciation of the machine during the estimated life, that is to say, to have the investment intact when the machine is gone? It is obvious that the end sought can be accomplished in many ways. The diagram shows four methods:

(a) The straight line method.

(b) The sinking fund method on a 4 per cent basis.

(c) The sinking fund method on a 5 per cent basis.

(d) The sinking fund method on a 6 per cent basis.

Assuming that the machine was bought 10 years ago (one half of the estimated life having elapsed), the Company will now have in its depreciation fund under method (a) $500; under method (b) $403.10; under method (c) $380.41; and under method (d) $358.39. It is to be noted, however, that under each of the methods there will be in the fund at the end of the 20 years the sum of $1,000. And there are many other possible methods, each leading to the sum to be accumulated, viz: the $1,000 at the end of 20 years.

Problem 2: What is the difference, in money, between the machine new (cost being estimated at present prices) and the machine in the condition in which we actually find it after 10 years have elapsed of its life and use? Will, or must, the answer be the same as under any one of the methods used in problem (1) above? Certainly and obviously not, for these reasons:

First: We are not dealing with the investment, nor are we concerned with keeping the investment intact. We are concerned with present prices and present values.

Second: It is impossible, beforehand, by any theoretical method (straight-line or sinking fund) to determine the actual condition of the machine at a given time in the future. The machine should be inspected at the time its value is to be found or, if that cannot be done, the accrued depreciation must be determined in the light of all available facts, keeping in mind that the history of the machine will be available in whole or in part for the last 10 years. The machine might have depreciated 50 per cent and might still be worth more than the total original investment (in which case there would be no depreciation whatever in the curve for the first problem). Or the machine might be entirely worthless (in which case all curves in problem (1) would be in error and should have reached zero) and the Company would at best (under the straight-line method) have insurance only for one-half of the investment.

The two problems are entirely different and have nothing in common, and only by mere chance may the amount in the sinking fund and the difference between reproduction cost new and reproduction cost less depreciation be the same. This must be so because in the one case we deal with investment and in the other we deal with value.

In the estimates made by the Commission's engineers the methods used are explained. Applicant's Exhibit No. 1 (the report of the Commission's engineers) reads in part as follows:

> "The term 'reproduction cost less depreciation' is defined as the reproduction cost less the diminution in the value of the physical elements, due to use, age, obsolescence, inadequacy or other causes, this diminution being called depreciation, and plus the increase in the value of the physical elements of the property due to age or other causes, this increase being called appreciation."

And:

> "There are two kinds of depreciation as ordinarily considered: One is caused by the action of time and

"the elements and the wear to which property is subjected. The other is caused by the inadequacy or obsolescence of the facility due to developments which have made it incompetent to perform its function properly or economically even before its natural life has run.

"The first of these kinds of depreciation is generally called physical depreciation, and the second functional depreciation. Functional depreciation may or may not happen, while physical depreciation (or appreciation) always acts during the life of a facility.

"Both kinds of depreciation must be taken into account in this application.

"Having to some extent considered and defined what depreciation means, as used in this report, it is necessary to examine what method we have used to arrive at a depreciated value. The procedure has been this: From the cost of the property new there is deducted the scrap value at the point of usage. The remainder is called the wearing value. This wearing value is then divided by the estimated or probable life of the property, on a straight line basis, and the quotient is called the annual depreciation. The actual age of the item of property is then multiplied by this annual depreciation to find the total depreciation. This total depreciation subtracted from the cost or 'reproduction cost' gives what is called reproduction cost less depreciation, and the relationship which this quantity bears to the reproduction cost is called condition per cent. If, through maintenance, the life of a property item is lengthened or its normal condition is improved, this fact is also reflected and taken care of in the appraisal by the condition per cent determined from inspection."

After giving consideration to every available factor having a bearing on depreciation, a "condition per cent" was assigned to each given property item new. This condition per cent obviously can be, and in the engineering estimates is, expressed in terms of life for purposes of computation. To illustrate again by means of the diagram above:

Assume that the condition per cent of the machine is found to be 50: expressed in terms of life, this would equal one-half of whatever life the machine might be given. Assuming that the reproduction cost of the machine (under present prices) had become $2,000 (a reasonable assumption), then a 50 per cent condition would equal $1,000. The dotted line in the diagram shows the resulting depreciation curve on the straight-line method

and shows a life of 20 years with a 50 per cent condition and a reproduction cost less depreciation of $1,000.

There is, however, one other reason why the two problems can have nothing in common. Estimates of lives of existing property must, in the nature of things, be uncertain. It is a recognized fact that in most structures, tools and machines, the period between marked permanent impairment of function and complete uselessness or complete disappearance is very short as compared with the total life. Can it truly be said, however, that because a power line pole, taken out yesterday after a life of 15 years, still gave satisfactory service two weeks ago, the process of depreciation, nevertheless, did not surely (if unnoticeably) extend over the entire life of the pole ? If that pole were removed because of natural depreciation only and for no other reason (and it is actual and accrued depreciation only that we are taking into consideration in this proceeding), then this must be true. It seems to us beyond argument that a piece of property gets less valuable with age and use when the then value is compared with what that same property would be worth without the handicap of age and use. In other words, the owner of depreciated property carries a liability that the owner of new property does not.

Other aspects of the question of depreciation, we believe, have been set forth sufficiently fully in Decision No. 6537 Supra. In our opinion, the methods used by the Commission's engineering department in finding the accrued depreciation of this property are fair and as nearly accurate as reasonably can be expected. In this case, an unusually large amount of investigation was had to find the truth. Nothing in the proceeding on rehearing has lead us to change our conclusion to adopt a condition per cent of 73 for the aggregate of the individual property items as listed in

the inventory and without giving weight at this point to the general condition and efficiency of the plant as a whole as an operating unit.

The Company asks that special consideration be given to the treatment of depreciation for the particular account C-20 (line transformers and devices) for the reason that for the property appraised for that account weight was given by the Commission's engineers to both inspection and life tables. Inasmuch as we are adhering to the original condition per cent of 73 without a reconsideration in detail of any particular property item for which the percentage might possibly be slightly increased or decreased, we see no reason for changing this average percentage for the property as a whole.

A condition per cent of 73 applied to the reproduction cost estimate of $64,243.44 results in a reproduction cost less depreciation of $46,897.71, say $46,898.

C - General Operating Condition of Plant.

The Company insists that a deduction from the reproduction cost new figure as adopted by the Commission above cannot be made except for the item of accrued depreciation. A consideration of the general operating efficiency of the plant as an electrical distributing system separate and aside from the physical condition, as expressed by the condition per cent of the individual property items listed in the inventory, they insist results inevitably in a duplicate deduction for depreciation. Holding this view, they ask that we exclude from consideration the exhibit offered in evidence as Commission's Exhibit CC. On this theory, the Company deals with this matter under the heading of depreciation.

The City, on the other hand, has from the beginning held to the contention that the depreciation reflected by inspection of particular property items does not establish the plant's

value as an operating entity. Counsel for the City argues that even if the operating efficiency of the plant were treated as an additional item of depreciation, "this particular depreciation is the depreciation of the plant as a whole while the depreciation reflected by the field inspection in the first instance only applied to the depreciation of the component elements of the physical properties. In other words, Exhibit CC reflects depreciation of the sale value of the property instead of the depreciation of physical parts."

The City maintains the position that it took prior to the rehearing, viz., that the general operating condition of the plant pertains to the subject of going concern value.

We shall prefer to treat this matter separate both from the question of accrued physical depreciation and from the question of going concern value. If so treated, duplication and ambiguity will be less likely.

In Decision No. 6537, supra, we stated our conclusion on this matter as follows:

> "..... the condition per cent as determined in the engineering report does not touch the question of general operating efficiency of this plant as an electrical distributing system. It is conceivable that the individual property items may be in first-class physical condition, that the machinery and installations are all modern and adequate and that consequently there is no obsolescence but that nevertheless the general arrangement and operating conditions of the plant as a whole are such as to produce wasteful, inefficient and costly operation, resulting in operating costs that are above normal. Where such a condition exists.....it cannot be denied that a physical plant will be less valuable because of such condition than it otherwise would be.
>
> "The testimony on this point shows that the system at Redding is the result of the consolidation of two systems and that there is a certain amount of duplication in pole leads and that there are unnecessary poles. It is to be noted, however, that all of these duplications and superfluous items of property are included in the totals given above.

"It is also in the record that there is certain overhead construction on this system not in accordance with the laws and orders of this Commission governing such construction in this state. This observation is not intended as a criticism of the company but is made merely to establish the fact that considerable expenditures are necessary to remodel this plant in order to bring it into conformity with existing laws and to create safe working conditions. The city will have to incur this expense after the property is acquired. No estimate was made to show in dollars what it will cost to put this distributing system in what might be called first-class condition. It is evident to me, however, that whatever weight this factor of inferior operating condition may have, will act as a deduction from the depreciated plant value as it has been found above."

In the original decision in this case a deduction was not made for the inferior operating condition for the reason that a reliable estimate was not available to show what the deduction should be.

In view of the Company's strenuous objections to a taking into account of this factor by the Commission in any form, the Commission instructed the engineering department to prepare exhibit CC. This exhibit is entitled "Tabulation of Condemned Portions of Redding Electrical Distribution System showing Items Condemned, Inventory Value based on condition per cent, Reasons for Immediate Removal, Cost of Removal and Salvage Value." In the letter transmitting the Exhibit, assistant engineer L. B. Cramer, who introduced it, states that the report covers "the features of the Redding Electrical Distribution System in regard to the operating condition of the plant as a whole, which is not taken care of in the valuation report."

The exhibit takes up item by item, and account by account, property items not in use or of reduced value because of the impossibility of making efficient operating use of them; property items inadequate for efficient service although as individual and detatched items they may have a high condition per cent; items not

in compliance with the provisions of the law and requiring certain expenditures to bring them into such compliance; and unnecessary or duplicate property items that will reduce the efficiency of the plant and increase operating expenses. After taking into consideration the salvage value of those items, this Exhibit concludes that a total deduction of $1,347.27 should be made to allow for lessened value because of unsatisfactory operating conditions.

Counsel for the Company in his brief in the rehearing, puts a wrong significance on the withdrawal by the Commission of Exhibit Z, for which Exhibit CC was substituted. Exhibit Z was withdrawn because upon analysis the Commission found that there might be a possible duplication between the physical depreciation already covered and the items considered in Exhibit Z. It is exactly this duplication that the Commission wishes to avoid in this proceeding. No such criticism can be made against Exhibit CC. The Company bases its objections to Exhibit CC on definite grounds. We will attempt, without going into too much detail, to state clearly the Commission's position as to each objection:

> "(a) Elements of property to be taken by the city cannot validly be stricken from the inventory upon the ground that they are unnecessary."

We do not disagree with this proposition and are of the opinion that whatever property the City of Redding specifies and desires to take over must be paid for at its full value. The objection, however, goes not to the merits of Exhibit CC. That Exhibit does not purport to strike any property from the inventory. It purports merely to estimate the impairment or reduction in value of unused, unnecessary or inefficient property items insofar as the effect on the system as a whole is concerned.

"(b) It cannot competently be declared that any element of the existing properties is without use or value."

This would seem to be a question of fact and not of opinion or argument. There can be no doubt, however, that the value of a property may be affected adversely because there is unnecessary duplication resulting in increases in maintenance and operating costs.

"(c) The purchaser must pay for the plant to be acquired rather than for a substitutional plant."

The Commission is in agreement with this general statement and no deductions have been made anywhere and no estimates have been introduced to show cost or values of a substitutional plant.

"(d) The estimated cost of renewing or repairing portions of the plant represents a duplicate deduction for depreciation."

This point of view on which so much stress is laid by the Company throughout the proceeding has been fully dealt with, we believe, under the previous heading, "Accrued Physical Depreciation."

We are satisfied that the operating condition and efficiency of the plant as a whole must be considered and that without such consideration just compensation cannot be found. If, by reason of faulty construction or deferred maintenance, prospective operating expenses are abnormally high and reconstruction is necessary, these facts certainly vitally affect the value of the whole property, and the effect is the same upon the present owner as it is on the prospective owner; the same, in other words, upon the seller and the buyer. Such condition, if it exists, cannot possibly be

reflected in the condition per cent of the individual property items, for reasons explained above.

> "(e) The estimated cost of effecting renewals or repairs is indefensibly exaggerated."

There is nothing in Exhibit CC or in the evidence to warrant that contention. On the contrary, the Commission is persuaded that the inherent difficulty of making an estimate of this nature, after comparison of operating results of the plant under consideration with a plant of reasonably high operating efficiency (the substitutional method is to be avoided) tends toward a low rather than a high estimate of deductions.

We are persuaded that we are here dealing with one of those elements where engineering estimates necessarily cannot be exact and where the Commission must exercise discretion based upon the evidence and upon its judgment. We make a deduction of $1,000 from the reproduction cost estimate less accrued depreciation because of certain proved inadequacies and inefficiencies in the general arrangement and operating conditions of the plant as a whole tending to produce abnormally wasteful, inefficient and costly operation. This deduction, we believe, is reasonable and in no sense excessive.

The sum of $46,898. heretofore found, therefore, will be reduced to $45,898.

D - Cost of Franchises.

The cost of franchises will be allowed, as stated in Decision 6537, supra, undepreciated with $495. The sum of $45,898. reached in the previous subdivision becomes now $46,393.

E - Value of business, as distinguished from value of plant. (Development cost; franchise value; going concern value.

It is on this question--the value of the business, as distinguished from the value of the plant--that the most important issue is made by the Company. There is agreement between the parties and the Commission that the three items under this head (development cost, franchise value, and going concern value) deal with the same main subject (the value of the business as measured by the earning power) and that, therefore, they may best be considered together.

In Decision No. 6537, supra, the Commission reached certain conclusions and made certain findings on these items and, in the interest of a clearer understanding of the problem, it will be well to review these conclusions. The Commission concluded that-

(a) franchises are property and must be paid for in condemnation proceedings;

(b) such value as may inhere in the franchises may be properly comprehended within the element of going-concern value;

(c) going-concern value, being defined as value of the business, has been recognized by the law, the courts and the authorities, without exception, and must be considered as an element in condemnation cases.

(d) it is of the greatest importance to scrutinize closely the methods used in computing going-concern value, in order that there may be no duplication and in order that proper weight may be given to all factors;

(e) development costs, which have been included in operating expenses and actually returned to the owners of the plant in rates, cannot be considered in the computation of going-concern.

(f) the element of "good will," as the term is applied to a business not a public utility, is not to be considered in estimating the value of a public utility plant for the reason, among others referred to in Decision No. 6537, that the public utility enjoys a monopoly of a particular business in the community it serves and the public has no choice but to buy from the utility or to do without such service;

(g) the theory advanced by the company for measuring going-concern value by the capitalization of profits, or a portion of the profits, is to be rejected as unsound;

(h) the only remaining element left for consideration as entering into going-concern value must consist of losses sustained during the development period of the enterprize and which have not been returned to the Company in earnings during the later period of successful operation.

Based on these conclusions, the Commission held the opinion that no showing had been made by the Company tending to prove the existence of development costs not returned to the Company from earnings.

Consel for the Company in his concluding brief (page 9), and speaking of the Commission's opinion in Decision No. 6537 as regards the factors of franchise value, going concern value and development cost, says this:

> "It is clearly recognized in the initial report of the Commission in this case that just compensation cannot be found unless the factors of franchise value, going concern value and development cost are given their proper weight. The Commission's analysis of the problem is exact and complete. We are familiar with no opinion of court or commission which offers any clearer expression of correct principle."

In view of this language, we may assume that the Company is generally agreed with the conclusions summarized above. It is urged, however, that the award originally made by the Commission does not include an allowance for these several elements of value, and that if this result is to be ascribed in any measure to a deficiency of the record, the want has been fully supplied in the re-hearing. We agree that there is now suf-

ficient and sufficiently reliable data before the Commission pertaining to these matters to enable us to reach a decision based on fact. The essential facts and their bearing on the value of the business will be carefully considered.

(1) The Question of the Profitableness of the Redding Distributing System.

There was controversy during the original proceeding as to the profitableness of the business of the portion of the Northern California Power Company's property located in the City of Redding. The uncertainty arising from this controversy has now been done away with. The Commission instructed its own engineers and the engineers of the Company to make a joint report dealing with this matter, the instructions reading as follows:

> "Submit a joint report showing, as far as possible, proper segregation of income and operating expense between the Northern California Power Company's System as a whole and the Redding Distributing plant for the three years ending December 31, 1918. If, in the opinion of the engineers, agreed figures of proper segregation of the aforesaid items for the year ending December 31,1917, are not abnormal but fairly represent a basis of determination of net income for the Redding System for that year, then the figures for that year alone may be submitted.
>
> "In all cases ....where agreement is not possible, the fact of disagreement shall be stated and the reasons therefor shall be given."

Two of the Company's engineers and three engineers of the Commission reached a unanimous conclusion in their joint report, Commission's Exhibit BB. This Exhibit shows the result of a careful analysis of the revenue and expense, item by item and account by account, of the years 1917, 1918 and 1919. Abnormalities for the year 1917 were eliminated and the business for that year may therefore be considered normal and average. The results as found in Commission's Exhibit BB. were as follows:

Revenue & Expenses of Electric Service within Corporate Limits of City of Redding - Year 1917.

1. Revenue		$38,451.92
Expenses		
2. Operation	$3,691.36	
3. Maintenance	2,200.00	
4. Commercial Expense	893.00	
5. General Expense of Local Office	2,191.00	
6. Rent	177.12	
7. Taxes	2,340.40	
8. Cost of Energy Delivered into Redding System	13,982.28	
9. Pro rata of General Head Office Expense,	888.69	
10. Depreciation Annuity	1,393.49	
Total Expenses-		$27,757.35
Net Return-		$10,694.57

These figures, beyond a doubt, establish two facts:

First, that in the normal and typical year of 1917 there was a net profit from the Redding Distributing System, over and above operating expenses, depreciation and taxes, of $10,694.57.

Second, that the Redding plant, that is to say the plant the city seeks to acquire in this proceeding, is doing profitable business.

Company's Exhibit No. 4-A finds the development cost to be approximately $15,000.00. Company's Exhibit 5-A shows a development cost of approximately $11,000.00 Mr. Vincent, the Company's third witness on the subject concludes that the Redding business could not be developed for an expenditure of less than $15,000.00. It is not necessary for the Commission to express an opinion at this time as to the soundness of the basis and of the methods adopted by these witnesses in their calculation for development cost. It is clear that they use different methods and therefore reach different results. Neither is it necessary now to determine what expenses should be included and what should be excluded in order to come to a clear definition of the term "development cost." It is apparent that even the largest of the estimates (Company's Exhibit 4-A-$15,319.41) is less than two years' net return as established in Commission's Exhibit BB.

It will probably be conceded that a fair return for a utility business of the nature of this one, in a city like Redding, should be in the neighborhood of 8 per cent and should, in any event, not be less than 6 per cent. If the earnings were less, they would be below the cost of money and the business could hardly be called profitable. Applying this range of fair return, therefore, to the profits, as we find them in Commission's Exhibit BB., we have the following mathematical result:

Net earnings of $10,694.57 are equal to a fair return
At 8% on a rate base or a property value of $133,682.
At 7% " " " " " " " " " 152,780.
At 6% " " " " " " " " " 178,243.

The question now is: What is the exchange value, if any, of the condition whereby the company is at present enabled to make a profit, such as the profit indicated above, from the operation of a portion of its property, to wit: the Distributing System in Redding? And the further question: How much money, if any, should the City of Redding pay to the Company, in addition to the sum already indicated, because of the fact that in 1917, 1918, and 1919 a condition existed by virtue of which the Company was able to make such profits?

(2) The Question of the Capitalization of Profits.

The Company, on the principle that the full value of plant and business must be paid, and that such value depends primarily upon the productiveness, urges the following method and measure of going-concern value (quoting from Company's concluding brief, page 37; underscoring ours):

> "Following that principle and employing Mr. Sachse's assumed rate of risk (8%), the capitalized annual net earnings of the Redding Distributing System (shown in the joint report as evidence in Commission's Exhibit BB., to be $10,694.56) will yield a value of $133,682.12. These figures, of course, include the value of the physical properties. Assuming that the value of the physical properties alone is approximately $50,000.00, the value of the business considered separately, i.e., the

going-concern value will appear to be $83,000.00. There can be no escape from the conclusion that these figures fairly represent the value of the business which the City of Redding proposes to take over from the Northern California Power Company Consolidated."

It will be noted that this is capitalization of profits pure and simple. It will also be noted that if this simple method of finding value of plant and business in a "just compensation" proceeding were adopted, all effort and time spent in making and considering a valuation of the physical property, of a consideration of fair overheads, of the condition of the plant, of depreciation, of development cost and of other matters, is merely that much waste of time and effort. Under the Company's proposal, where the going-concern value is simply the remainder after the plant value has been deducted from the fixed total value, it is, of course, immaterial what the plant value comes to. To illustrate by the figures found in the present proceedings: If the value heretofore found in this opinion is correct ($46,393.00), then this figure would be deducted from the grand total of $133,682.00, and the remaining going-concern value will be $87,289.00. It is clear that it is immaterial what the constituent parts of the total amount to if we take the total for granted.

Capitalization of income, or of profits, is a problem in elementary arithmetic. In the solution of such a problem there must always enter three factors: The amount of earnings, the rate of interest, and time. In the matter before us the amount of the earnings is known, the rate of interest is not known, and the factor of time is equally unknown. The problem, therefore, cannot be solved unless assumptions are made for the last two factos. The Company assumes that 8 per cent. should

be taken as the interest rate. In the original hearing the Company urged that 6 per cent. should be taken as the rate of capitalization (if that were done the going-concern value as separated from the plant value would become $132,849.00 instead of the $87,289.00 shown above.)

The factor of time, in the Company's conclusion, is assumed to be perpetuity. That is to say, the Company expects the City of Redding to pay, in addition to the value of the plant, plus overheads, plus the cost of franchises, for all time an annual income of $10,694.57, being 8 per cent. $133,682.12.

The Company, of course, has no assurance of any such earnings for any continuous period in the future, yet it is apparently serious in its contention that the City, if it buys the property, must guarantee a profit of 23 per cent., or more, on the value of the physical property, plus overheads, for all time to come. The City is expected to guarantee this profit, relieving the Company from all responsibility and all risk.

If "value" means sales value, or exchange value, the question arises if it is possible to sell the abnormal profitableness of a public utility business. An objective view will establish the fact, we believe, that in the nature of things no such sale is possible, because in no sense can the continuity of such profits be guaranteed even for a short period of time. This is true because of the distinct characteristics of the public utility business, a character differing in essentials from competitive, non-regulated private business.

The Company urges that the relation of the element of risk to the earnings, and to the going-concern value, should not be considered. Referring to the testimony of the Commis-

sion's Chief Engineer, Mr. Sachse, counsel for the Company in his concluding brief (page 36) says:

> "His conception of the so-called rate of risk has no support upon authority, so far as we can determine, and we think it is erroneous in principle . . . . . "

We are unable to agree to the Company's view in this matter. It does not require an extended analysis to establish beyond doubt the fact that in all business undertakings the rate of return, and consequently the profit, bears a direct relation to the amount of risk involved in the business. This is true of regulated as well as of strictly private business. This relationship is recognized and well stated by the Supreme Court of the United States in the case of Willcox v. Consolidated Gas Company, 212 U. S. 19, 48 (underscoring ours):

> "Such compensation must depend greatly upon circumstances and locality: among other things, the amount of risk in the business is a most important factor, as well as the locality where the business is conducted, and the rate expected and usually realized there upon investments of a somewhat similar nature with regard to the risk attending them. There may be other matters which, in some cases, might also be properly taken into account in determining the rate which an investor might properly expect or hope to receive and which he would

be entitled to without legislative interference. The less risk, the less right to any unusual returns upon the investments. One who invests his money in a business of a somewhat hazardous character is very properly held to have the right to a larger return, without legislative interference, than can be obtained from an investment in government bonds or other perfectly safe security. The man that invested in gas stock in 1823 had a right to look for and obtain, if possible, a much greater rate upon his investment than he who invested in such property in the City of New York years after the risk and danger involved had been almost entirely eliminated.

"In an investment in a gas company, such as complainant's, the risk is reduced almost to a minimum. It is a corporation which, in fact, as the court below remarks, monopolizes the gas service of the largest city in America, and is secure against competition under the circumstances in which it is placed, because it is a proposition almost unthinkable that the city of New York would, for purposes of making competition, permit the streets of the city to be again torn up in order to allow the mains of another company to be laid all through them to supply gas which the present company can adequately supply. And, so far as it is given us to look into the future, it seems as certain as anything of such a nature can be, that the demand for gas will increase, and, at the reduced price, increase to a considerable extent. An interest in such a business is as near safe and secure investment as can be imagined with regard to any private manufacturing business, although it is recognized at the same time that there is a possible element of risk, even in such a business."

The utility business in the case before us is essentially of the same character as the utility business discussed by the Supreme Court in the quotation above. It is a business attended with a minimum of risk, and it is not to be contemplated that a business of such a character can carry with it a guarantee of over 20 per cent profits for the distant future. And yet it is clear that a capitalization of earnings, as suggested by the Company, would amount to such a guarantee.

In this connection attention should be called to the testimony of Chief Engineer Sachse, one of the Commission's witnesses, and who was also made by the City of Redding one of its witnesses. The Company cites his testimony in support of its argument for the capitalization of earnings as a measure of going-concern value. Although the Commission is certainly not bound to accept the findings or opinions of its engineers on questions

so indeterminate and uncertain as the subject of going-concern value (no matter how carefully and honestly presented) and although the Commission insists that, after a consideration of all evidence, the conclusion in such a matter must in the end represent its own best judgment, it seems well to point out that in our opinion the Company is mistaken in its interpretation of Mr. Sachse's testimony. He testified that all methods for measuring the value of a going business resolved themselves into a capitalization of profits. He pointed out that this method is the universally accepted method in estimating the value of strictly private and unregulated business, and he laid stress on the point that, in order to give a correct result, the rate of capitalizationof the net earnings must be equal to the rate of risk attached to the business. On this theory, he testified that a business with an 8 percent risk and net earnings less than 8 per cent has a negative going-concern value (is operating at a loss in other words), and instead of there being an addition to the value of the physical plant, there should be a deduction. If, however, according to his testimony, the present and future profits are in excess of the rate of risk, then this excess profit represents going-concern value to the extent that the continuity of the net earnings is assured for the future.

It appears to us that this view of the matter squares with the facts and might be accepted if other facts and other considerations do not change the problem. His views seem to us a correct statement of conditions for all business enterprises other than regulated public utilities. Public utilities, however, as business enterprises, are in a class by themselves with privileges and obligations differing essentially from other kinds of business: This is a fact so well established in practice and in law that it needs no further elaboration. What influence this

fact should have on the question of capitalization of profits this witness did not discuss and, inasmuch as this legal aspect is not in any sense an engineering question, and he was testifying as an engineer, it was proper that he should not discuss this phase of the problem. The Commission, however, is confronted with this aspect, and it seems to us the determining one.

The relation that should exist between a regulated public utility and the people is well established by this time. Public utilities should not belong in the category of highly speculative business enterprises. The people have seen fit to grant to such businesses certain privileges, to wit: The right of eminent domain, a large measure of monoply and security from the risk of ruinous competition, the surety of a fair return if the nature of the business permits the earning of such a return, and the many other advantages that spring from effective and enlightened regulation. In return, the utility is expected to forego the possibility of unusual or speculative profits and must be prepared to adjust itself to permament good service under reasonable rates. It is the legal right of the community to take over for ownership and operation public utility plants and business from private owners upon the payment of just compensation to be fixed by an impartial tribunal.

The effect of this relation between the utility and the public is fairly well understood when it comes to the fixing of rates. The consequences of this state of affairs, however, appear not to be as clear when the public avails itself of its right to purchase a utility and when the just compensation is to be found. There is no disagreement that the just compensation must

be the fair value to the owner. Can it fairly be said, however, that an award, in a lump sum, permitting in perpetuity and practically without risk a return in excess of 20 per cent on an investment in public utility represents "just compensation"? We think not. We think that the rule laid down by the United States Supreme Court in the Minnesota rate cases is applicable in a case of this nature, to the same extent that it should control in a rate case (230 U. S. p.434):

> "The ascertainment of that value is not controlled by artificial rules. It is not a matter of formulas, but there must be a reasonable judgment, having its basis in a proper consideration for all relevant facts."

And again it seems to us that the general criterion laid down by the United States Supreme Court in the same decision (230 U.S. pp.454,455) should hold true in this instance, although we do not overlook the fact that the decision of the Supreme Court deals with the question of land values in a railroad rate case (it must be remembered that it is the value supposedly created by the rates charged that we are now discussing):

> "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 of law. But still it is property employed in a public calling, subject to governmental regulation, and while, under the guise of such regulation, it may not be confiscated, it is equally true that there is attached to its use the condition that charges to the public shall not be unreasonable. And there the inquiry is as to the fair value of the property, in order to determine the reasonableness of the return allowed by the rate-making power, it is not admissable to attribute to the property owned by the carriers a speculative increment of value, over the amount invested in it and beyond the value of similar property owned by others, solely by reason of the fact that it is used in the public service. That would be to disregard the essential conditions of the public use, and to make the public use destructive of the public right.
>
> "The increase sought for 'railway value' in these cases is an increment over all outlays of the carrier and over the values of similar land in the vicinity. It is an increment which cannot be referred to any known criterion, but must rest on a mere expression of judgment which finds no proper test or standard in the transactions of the business world. It is an increment which, in the last analysis, must rest on an estimate of the

> value of the railroad use as compared with other business uses; it involves an appreciation of the returns from rates (when rates themselves are in dispute) and a sweeping generalization embracing substantially all the activities of the community. For an allowance of this character there is no warrant.
>
> "Assuming that the company is entitled to a reasonable share in the general prosperity of the communities which it serves, and thus to attribute to its property an increase in value, still the increase so allowed, apart from any improvements it may make, cannot properly extend beyond the fair average of the normal market value of land in the vicinity having a similar character. Otherwise we enter the realm of mere conjecture."

It seems to us that a theory under which it would be possible to multiply by three or four the reproduction cost less depreciation, plus overheads, plus cost of franchises, by the simple expedient of the capitalization of earnings is on all fours with the sweeping generalizations and the conjectures condemned by the Supreme Court in the last quotation. Our point of view was well stated by Judge Savage in Kennebeck Water District vs. Waterville, 97 Maine 185, 54 Atl. 6. In this case Judge Savage instructed the appraisers with reference to the capitalization of income:-

> "We cannot assent to the proposition that the capitalization of income even at reasonable rates can be adopted as a sufficient or satisfactory test of present value. Such a capitalization would fix at the present time a specific value which would continue for all time to come, as a fixed and unvarying source of income, no matter how conditions may be changed."

Continuing, Judge Savage said:

> "And what may be reasonable rates at any given time will depend upon conditions which not only may vary, but are likely to vary. Therefore, the basis for capitalization is too uncertain to afford a satisfactory test of value."

In National Water Works Company vs. Kansas City, 62 Fed. 853, a case frequently referred to, Judge Brewer, later a member of the Supreme Court of the United States, definitely discarded the capitalization of net earnings, as a proper method for

ascertaining the value of the property of National Water Works Company in a suit brought by National Water Works Company to enforce a contract by Kansas City to purchase plaintiff's water system.

The Company on re-hearing has completely changed its position both as to the method of measuring and the amount claimed for going-concern value. In the original proceeding the Company undertook:-

> "To determine the earning capacity of the Redding Distributing System as shown by its record, and the amountof such earnings in excess of what may be regarded as a minimum net return has been capitalized as an index of going-concern value. This method is supported by the authorities previously reviewed, and there can be no doubt that upon principle it constitutes a fair criterion of business value. The method is subject to criticism, as, indeed, must every other method, but until a superior alternative is devised it is entitled to receive recognition.
>
> "In making this computation the company endeavored to be extremely conservative in order to avoid the possible criticism that an undue earning power had been attributed to the Redding plant . . . . . .A 6% return, representing a minimum compensation, was then deducted, and the balance capitalized at 6%, affords an index of going-concern value, or value of the business."

The method of computation as outlined in the preceding quotation from the brief of Company's counsel, was adopted by the principal Company witness, Mr. Whaley. Upon further consideration the Company, itself, suggested a change of this method:

> "These considerations lead us to suggest that the Commission may well adopt, as a rough measure of going-concern value in condemnation cases, the capitalization of the margin of net earnings between what may be termed a minimum rate of return and a normal rate of return. It will be recalled that precisely this measure is urged by Whitten in his discussion of franchise valuation. Such a measure would not work injustice to either the public utility or the public authority. If earnings under rates fixed by the Commission have been less than a normal return the public utility is not therebymulcted of any portion of business value which properly should belong to it; if earnings on the other hand have for any reason been in excess of a normal return, the public authority is not required to pay for a business value measured by such excess earnings. We think

That the Commission will eventually adopt some such criterion. If applied in this case, a return of 6% may properly be taken as the minimum, and a return of 8% as the normal, and the difference of 2% between the two when related to the ascertained value of the physical properties and capitalized at an interest rate of 6% might fairly be accepted as a measure of going-concern value without doing apparent injustice to any interest."

Using its own methods the Company, in the original proceeding, came to a claim of development expense and going-concern value combined of $67,536.00. Upon re-hearing the Company abandons these methods. It adopts in part a theory with which it insisted to be in complete disagreement during the original hearing and which it assumes, erroneously we believe, is advocated by the Commission's chief engineer. This is the theory under which the entire value of plant and business can be ascertained at one stroke, and without any preliminaries, by merely capitalizing net earnings at a given rate per cent and letting the result equal the total just compensation. Deducting from the sum total whatever amount may be taken to represent the other elements of the property, the remainder will automatically become the measure of going value. Using this new method, but changing the rate of capitalization from 6 per cent used in the original proceeding to 8 per cent, a minimum for going-concern, according to the Company, of $83,000.00 remains. In addition, the Company claims, under the revised estimates, a cost of developing the business ranging from $15,000.00 to $35,000.00.

We must decline to follow the latter method as well as the former.

(3) Findings of Fact and Conclusions on the Value of the Business, (Development Cost, Franchise Value, Going-Concern).

We have in the first decision in this case (Decision No. 6537, Supra) in considerable detail stated our views

on these matters. Nothing has developed on re-hearing that would lead us to change, on principle, the conclusions reached in the decision referred to. We think it is evident in law, and in fact, that the intangible quantity called business value in a regulated public utility differs in very essential particulars from that same quantity in an unregulated competitive private business. This essential difference, and, indeed, a consideration of the relation between a public utility and the people, which should rest on a permanent fairness to both sides, compels the rejection of the theory of the capitalization of profits. We adhere to that decision.

In Decision No. 6537, supra, we said:

> "If we eliminate from consideration in going-concern value those elements of overhead costs above referred to and which already have been cared for by adding 10 per cent. to the reproduction cost new, together with an allowance of 3 per cent. to cover the interest on invested capital during the period of construction, and if further the element of "good will", as indicating that element of value which inhered in the fixed and favorable consideration of customers arising from an established and well-known and well conducted business is to be eliminated as indicated in the Des Moines Gas Company case (238 U. S. 164-165), then the only remaining element left for consideration as entering into going value must consist of losses sustained during the development period of the enterprise--losses which were incidental to the development period and of necessity incurred in bringing the plant into successful operation, and which have not been returned to the company inrates during the later period of successful operation.
>
> "All public utility enterprises go through three stages of development. First, there is the construction period. The second may be termed the development period and the third the period of profit of going concern.

"In the first or construction period all items of expense, including capital invested in the enterprise and all necessary overhead required to put the plant in condition and readiness to render service, are properly chargeable to capital account.

"The second or development period may be said to begin when construction is completed and the plant is in existence ready to operate and to produce the product to be sold.

"With most business enterprises, whether public utility or otherwise, a shorter or longer period will elapse between the beginning of operation and the time when the business will earn not only its operating expenses, its depreciation allowances, the taxes to be paid and other carrying charges, but also the return on the investment, which return will be available for the payment of interest, dividends and other surplus.

"During this period the investment for the original plant remains constant and all expenses incurred in the production and in the marketing of the commodity to be sold are charged to operating expenses. In order that customers may be rapidly found it frequently occurs that the company must

undertake additional and unusual expense to defray the costs of solicitation, advertising, etc. These and other costs may, and often do, so increase the operating expenses during the development period that the expenses are greater than the total receipts and an actual loss occurs during this period. These losses represent an actual outlay of money on the part of the company necessarily incurred in the establishment of a successful business and while generally and more acurately referred to as 'development costs' constitute a real and a tangible element of the 'going concern' value.

*

****

"If it is to be conceded that the actual amount of money expended by a company over and above the amount of its receipts during the development period, such expenditure being necessary to the establishment of a successful business, should be considered as an actual investment in the business, then in giving proper consideration to this item it will be necessary to fix a reasonable period of time for such development. Necessarily the development period will vary with the circumstances and conditions surrounding each separate plant; upon the extent of the demand for such service, the size of the communityto be served, the prosperity of the people and their desire and ability to buy. Roughly, this development period may well bear some definite relation to the time allowed for the construction of the plant. If, for example, as in this case, the time allowed for the construction of the plant is fixed at one year, it would, in my opinion, be reasonable to say that within two or three times the period allowed for construction, that is, two or three years, the company would have ample time to demonstrate whether the enterprise could or could not be made a successful going concern. If within a reasonable period of time the enterprise cannot be developed into a successful business, then the project is a financial failure and has no 'going concern' value, which attaches only to a successful business.

"In this case there is no question that the business is in successful operation. The plant has been operated successfully for a long period of years. Therefore, if in this case, we fix a period of three years for development of the business - the longest possible reasonable period that can be allowed in this case - it then remains for the company to show the extent of the actual losses necessarily incurred in the development of its business during this period, and also to show that the company after incurring such losses during the development period of its business has not later recouped itself from subsequent earnings for such losses."

The Commission is of the opinion that the rule laid down in the last sentence above quoted, insofar as it declares that the best evidence of development costs consist of showing what the costs actually amounted to during a reasonable development period, is sound and should be applied in all cases where it is possible to determine the nature and extent of actual losses, if any, during such development period.

To the contention that something over, above and in addition to the fair allowance for that amount of money expended for the purpose of bringing the non-earning physical properties to a point of earning a reasonable sum within a reasonable time should be allowed and designated as going concern value, we find answer in the fundamental difference between the regulated utility and the non-regulated enterprise. It is unquestionably true that there is a fundamental difference in the nature of investment of these different character of enterprises.

In the unregulated business, money may be invested under two separate and distinct theories, namely, fair and normal return on the money invested, and also because of a contemplated speculative value. At the outset, the investor may invest his money giving greater consideration to the staple investment character, or he may have greater hope of success through the speculative character of the investment, or, indeed, the two combined might be the attraction that induces the investment. These observations relate to such enterprises as are not public utilities nor can under our law be converted into regulated utilities.

The inducement for investment in the construction of a public utility property is, however, different, and this whether or not the investor is entirely conscious of this fact at the time of advancing his money.

Regulation not only imposes certain restrictions and limitations upon utility property, but also confers certain rights and privileges upon money invested in utilities beyond that conferred upon investments in non-utility and unregulated business and thereby affords a protection other and different and more beneficial to, in many respects, the money invested in a non-regulated business.

The owner of the non-utility, and therefore non-regulated business is, under our statutory as well as under our economic laws, privileged to reap speculative profits from investments. The regulated utility is accorded the right, and it is the duty of regulatory bodies to protect the right of a reasonable return upon investment. In addition to that, many other privileges accrue to the utility, one of especial and very substantial benefit being that of monoply and protection against destructive competition within the territory properly served. To such benefits enjoyed by public utilities should be added the legal obligation of regulatory bodies to allow a reasonable rate, benefits denied to unregulated business.

It seems unsound and illogical that the public utility should also enjoy that benefit which is enjoyed by the non-regulated utility, namely, the speculative value, and in the last analysis it would seem that speculative value may be the proper characterization of that sum over and above the reasonable development costs hereinbefore referred to and a value which the utility claims should be allowed by reason of the success of the venture.

In this particular case, unfortunately, it is impossible to determine the actual development costs incurred in the early period of the history of the enterprise. It is of record that the books of the company long have been destroyed, and actual records are not now available. Also it is of record that several companies competed with each other in the lighting business in the city of Redding and that the plant now in existence and the business

attached to it result from a merger or consolidation of these properties. In such circumstances it is clear that if the actual costs of developing the present business now could be ascertained from the books which have been destroyed, such showing would have but little value in this particular proceeding. Frankly, the Commission must declare that the rule above quoted, while perfectly sound in cases where it is possible to determine actual development costs, does not and should not apply in this proceeding.

The situation with which we are here confronted is this:

Allowances have elsewhere been made for all elements of value entering into "going concern" - the value of the business attached to the plant - except to the extent that the one single item of "development costs" enters into the computation of "going concern" value.

It has been established that the business now is, and for a long time has been, prosperous, and as such has a going concern value. Allowances have been made for part of that "going concern" value, but not for that portion of such value as may be reflected in "development costs," incurred after the construction of the plant and during the development period. "Just compensation" cannot be awarded unless all elements of value are considered and given proper weight. The extent of the actual development costs incurred during the development period cannot now be ascertained from the records of the company.

While it is in evidence that the company now is making a high rate of return on its Redding property, it cannot definitely be determined whether these later large profits have or have not wiped out all of the earlier development costs. It also must be borne in mind that the large profits which have been derived in later years from the business attached to the Redding plant have been due almost entirely to the fact that the rate which the company has been permitted to charge

in Redding is a rate that has been made applicable to similar business over the entire system operated by the company in a large territory in Northern California. The rate charged over the whole system yielded the company less than a normal return upon its actual investment. While under these uniform rates the City of Redding according to the testimony in this case, in the year 1917, contributed to the total earnings of the system a larger share in proportion to the value of the distributing plant located in Redding, than did some other communities, there can be no assurance that these conditions will continue to exist indefinitely. Obviously it is as impossible to fix a separate and different rate for every community served by a utility operating in an extensive territory as it is to fix a separate and different rate for every consumer located in a given city or town. There is a certain mutuality of interests between individual consumers, and between communities as well, and the most profitable business always has and in some degree probably always will help to carry the least profitable business. But it does not follow that "fat" territory always will remain "fat" or that the "lean" always will be "lean." Conditions ever are changing, and business that in the beginning was least profitable may develop so as materially to lighten the cost to others.

Consideration of the large profits earned in 1917 by the Redding plant and of all the circumstances surrounding such earnings, lead to these conclusions:

(a) Such earnings, in so far as they exceed normal earnings, do not constitute any element of "going concern" value that can be capitalized.

(b) Such earnings, on the other hand, do not establish in this case the contention that early "development costs" have been extinguished by later profits, for the reason that the record is clear that the business of the company on its system as a whole earned less than a normal "fair return," and if we concede that

> the owners of a utility are entitled to a fair return upon the value of the property actually devoted to the public service, it is not clear that there was available to the owners of the company any particular sum of money which could be applied to the extinguishing of early development costs incurred in establishing the Redding business.

If we look upon the Redding plant as wholly and entirely detached from all the other parts of the system so far as its earnings are concerned, it might be contended that the profits arising from the Redding business,-judging from the figures of 1917 presented in evidence - had in part or wholly wiped out these early development costs. But if we take this view, then to be consistent the same view should have been taken in fixing rates, and the City of Redding should have been given a lower rate, and other communities similarly served in the same district by the same company should have been compelled to pay a higher rate. Also, if we are to hold that any considerable sums earned by the Redding plant in the later years of its operation should apply to the extinguishment of earlier "development costs," to just the extent that such monies were so diverted, there would be a lessening of the return which the owners of the whole property would receive, which amount, as has already been stated, was below the fair return usually allowed.

This leads to the conclusion that there is in this case no showing that early development costs, if any, have been returned to the company; also that the amount of these early losses have not been definitely established, although it is probable from the nature of the business and the conditions existing at the time it was established

that such development costs actually were incurred. The best that can be done in such circumstances is to make an approximation of such development costs and allow a reasonable amount therefor.

While the method which herein is suggested for determining the amount of such allowance for "development costs" is not entirely free from objections, nevertheless it is the opinion of the Commission that it is as satisfactory as any other method that has been suggested or now can be devised, and that in the main it fairly represents an amount approximating the additional costs of attaching the business to the plant, to the extent that these costs are reflected in the item of development costs. The suggested method is to allow 2 per cent per annum, the difference between a normal return of 8 per cent and a minimum return of 6 per cent, during the assumed reasonable development period of the enterprise, which in this case has been fixed at three years.

The application of this rule would result in an increase of 6 per cent upon the figure already found of $46,393. This amount would be $2,784, and added to the previous amount would give a total of $49,177, as a final figure representing the fair value of the physical properties plus overheads and interest during construction, and including development costs, franchise value and all items entering into going concern value.

F - Severance Damage.

The Commission maintains its position as to severance damage as it is discussed in Decision No. 6537, supra, except as to the third item, representing the cost of construction necessary to make the connection of circuits for the purpose of economical operation of the Company's business after the Redding distributing system is taken over by the City. In the decision referred to, we suggested that the City and the Company enter into a written contract providing for satisfactory arrangements as regards telephone and power lines. This suggestion was made because it is apparent that any other course will lead to duplicate construction and to a waste of labor, material, and money, which seemed unjustifiable since other arrangements were possible. We said, in the decision referred to, that in the event of failure to come to an understanding on such a contract, the City should be asked to pay the actual costs of such construction. It is now apparent that the Company refuses to enter into any such arrangement under any circumstances.

The record before the Commission shows that a rearrangement of the power and telephone circuits after the sale of the Redding Distributing System, in order to create the same or better operating conditions for the Company's own requirements, can be effected at a cost of $623.00. This amount will be awarded as severance damage.

The other elements of severance claimed by the Company in the original proceeding, and reiterated upon re-hearing, are not present as a fact. The reasons for this finding are stated in Decision No. 6537 supra.

Q - Objections Going to the Commission's Procedure.

The Company, in the application for a re-hearing, avers that the Commission, through certain of its employees, produced and placed in evidence substantially all of the evidence and exhibits which were offered and presented on behalf of the applicant, the City of Redding, in this proceeding; that substantially no evidence was offered or produced on the part of the applicant; that because of this condition, the petitioner has been denied a fair hearing before a non-partisan tribunal in accordance with the requirements of due process of law. The Company claims that the Commission has failed, therefore, regularly to pursue its authority under The Public Utilities Act and in particular under Section 47 of said act, and that the Company's rights have been violated within the meaning of the constitution of the State of California and the constitution of the United States of America and in particular the rights secured by virtue of the Fourteenth Amendment to the constitution.

We do not believe that this objection merits an attempt at serious and detailed refutation by the Commission.

Section 47 of The Public Utilities Act prescribes in detail the exact procedure to be followed by the Commission in cases of this nature. The provisions of this section have been adhered to in this proceeding. Section 47, Subdivision (a) of The Public Utility Act reads as follows (underscoring ours):

> "The Commission shall have the power to ascertain, for each purpose specified in this Act, the value of the property of every public utility in this state and every fact and element of value which, in its judgment, may or does have any bearing on such value.."

Subdivision (b) of this section deals with the detailed procedure in just compensation cases, and Paragraph 4 of subdivision (b) of this section of the act provides that--

> "At such times and in such amounts, as may be directed by the commission, the political subdivision must pay to the commission all extra costs as determined by the commission, which extra costs the commission may incur to comply with the requirements of section 47 (b) of this act. . . ."

It is apparent, not only from the quotations given above but from the language of the entire section, that the act contemplates investigation by the Commission's own staff in all matters connected with such proceedings.

We have repeatedly made it clear that in all formal proceedings before the Commission the reports and the testimony of the Commission's employees are considered as evidence and are given whatever weight they may deserve in the Commission's opinion, in exactly the same manner as any other witnesses appearing before the Commission. It is for this reason that all reports introduced by Commission employees in formal proceedings are put in evidence and made available (wherever possible in ample time before a hearing) for all parties in a proceeding. This rule has not been departed from in this instance.

If any party to a proceeding sees fit to make a Commission's employee its own witness or to accept as a statement of its own position the report made by a Commission employee, we see no impropriety in such a procedure and can have no objection.

It may be pointed out in this connection that the Company itself, in this proceeding, has taken part in joint investigation with the Commission's staff and has accepted the reports made by the Commission's engineers jointly with Company employees.

We are satisfied that investigations conducted by our staff are not conducted in a partisan spirit and are more likely to

reach the facts and to get at the truth than other methods of procedure. But even if there were any doubt on that score, the utmost opportunity and latitude is given by the Commission to the parties in such proceedings to cross-examine Commission witnesses and establish the soundness or unsoundness of their contentions. How thoroughly the Company has made use of this right in this case the record bears evidence.

We are satisfied, therefore, that any contention questioning the fairness of the Commission's award of just compensation, on these grounds, is altogether unfounded.

H - Summary of Just Compensation.

The summary of just compensation may follow the outline used in the first decision in this proceeding and is made up of the following items:

(a) Fair value of physical properties, plus overheads, including development cost, franchise value, and going concern -- $49,177.00.

(b) Severance damages allowing for the cost of rearrangement of the power and telephone circuits used for the company's own requirements, to create the same, or better, operating conditions as now exist in the Redding Distributing System -- $623.00.

ELH

Order and Findings.

The City of Redding, a municipal corporation of the sixth class, having filed with the Railroad Commission a petition setting forth the intention of the city to acquire, under eminent domain proceedings or otherwise, certain specifically described property and rights and parts and portions thereof of the Northern California Power Company, Consolidated, a public utility, and praying that the Railroad Commission fix and determine the just compensation to be paid to the Northern California Power Company, Consolidated for said property and rights and the parts and portions thereof sought to be acquired, public hearings having been held, evidence received, and the matter having been submitted, and the Commission, after due consideration thereon, having rendered its decision No. 6537, and thereafter a petition for rehearing on behalf of said Northern California Power Company, Consolidated, having been sought and granted and further hearings having been held and additional evidence received, briefs filed and the proceeding submitted,--

NOW, THEREFORE, the Railroad Commission of the State of California, after a full consideration of all matters presented and being fully advised in the premises, hereby orders that that portion of its decision No. 6537 heretofore made herein, commencing at the top of page 43 of the original typewritten copy of said decision on file herein, and extending through and including all of said page 43 and down to and including the third line of page 44, containing certain specific findings as the just compensation of the property sought to be acquired, is hereby set aside and rescinded, and in lieu thereof the Commission now makes and files its written findings herein as follows, to-wit:

118

The Railroad Commission hereby finds the just compensation to be paid by the City of Redding for the property and rights and parts and portions thereof sought to be acquired by said city, and which are specifically set forth and described in the amendment filed on the 27th day of February, 1919, to paragraph 13 of the petition herein, to be the sum of $49,177.00, and said sum is hereby declared to be the just compensation as of the day on which the petition was filed herein by the City of Redding, to-wit, the 2d day of May, 1918.

The Commission further finds that the property and rights and parts and portions thereof which the City of Redding seeks to acquire, was, at the time of the filing of the petition herein, used by the Northern California Power Company, Consolidated, in connection with other property and rights not sought to be acquired by said city, and constitutes in connection therewith a larger system used by said Northern California Power Company, Consolidated, for the generation, distribution and sale of electricity; and that by reason of the taking of said property and rights and the parts and portions thereof sought to be acquired by said city, a severance damage will result to the property and rights of the Northern California Power Company, Consolidated, which are not sought to be acquired by said city; and the Commission hereby finds the amount of said severance damage to be the sum of $623.00.

The foregoing opinion and findings are hereby approved and ordered filed as the opinion and findings of the

Railroad Commission of the State of California.

Dated at San Francisco, California, this 14th day of January, 1921.

H. D. Loveland

Frank R. Willis

H. M. Rundlett

Irving Martin

Commissioners.