

ST. LOUIS LAW REVIEW

Vol. XX

DECEMBER, 1934

No. 1

STATE REGULATION OF CONTRACTS WITH PUBLIC UTILITY AFFILIATES

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The public utility holding company has been the scapegoat upon whose head the public has been all too ready to lay all the sins, real and imaginary, of the public utility situation. It has been charged that the growth of public utility holding companies has rendered state control of public utility rates a mere farce and has cost unwary "investors" the savings of a lifetime. It cannot be denied that there have been great abuses of the holding company device. It has in the past, and may still be, possible to sell so-called "securities" of holding companies which despite their form (whether bonds, notes, or preferred stock) were mere chips in a gamble far riskier than any played at Monte Carlo. Rates have been based upon operating expenses which have been inflated by the inclusion therein of large fees for services which were not rendered and excessive prices for goods sold to the local operating company. But there is another side to the picture. It has certainly been true in the past that a well managed holding company could supply funds to its local operating companies at a lower interest rate than these same local companies could have obtained such funds upon their individual credit. Management should be more efficient and service better. Surely none would desire to return to the jumble of small companies which existed before the American Telephone and Telegraph Company secured control of a nation-wide system. Centralized purchasing and even centralized manufacturing (e. g. the Western Electric Company for the Bell System) should and has resulted in large savings. It may be urged that the same

results could be obtained by unified nation-wide operating companies. This may, or may not, be true in theory, but historically local companies grew up first and it was all too often impractical to merge them because of the rights of minority stock and security holders, laws against foreign corporations owning real estate, restrictions in under-lying mortgages (particularly when they contained an after-acquired property clause), discriminatory tax legislation and restrictions upon the transferability of franchises.

The problem of controlling the public utility holding company, is essentially a dual one, involving the protection of two distinct classes of interests. The consuming public is primarily interested in getting service at the lowest possible rates. Except so far as service may be affected by financial catastrophes, the consuming public is not concerned with the safety of the financial structure of the operating utility or of the super-imposed holding company or group of holding companies. On the other hand, there are investors who have acquired the securities of either the operating or the holding company. They are concerned with the financial safety of their company rather than the service it can give. They wish the rates to be as high as possible. This paper is concerned with the ways by which the consumers can be protected from exploitation by unscrupulous operators of holding companies. It does not attempt to deal, except incidentally and by way of explanation, with the means which are necessary to protect prospective investors in the securities of holding companies.

It is necessary, however, to consider briefly certain basic principles concerning the financial structure of holding companies. A failure to understand these concepts has led to much ill-considered, but very vehement, criticism of the holding company for making allegedly excessive profits or for causing investors to suffer large and unexpected losses. Under the ordinary financial set-up in the public utility industry, the operating company will have outstanding an issue of closed first mortgage bonds, an issue of preferred stock and an issue of common stock. The holding company will probably own all the common stock. In turn most holding companies have outstanding either collateral mortgage bonds (based upon the deposit of the common stocks of the operating companies), debentures, or notes. There may, or may

not, be an issue of preferred stock. There is always an issue of common stock of some variety and perhaps more than one. The principle of financial leverage or of "trading upon a thin equity" is at once the hope and the terror of the managers of a holding company. The operation of this principle can best be understood by the study of a concrete case. Let us suppose that there is an operating company whose plant cost, and is now worth, \$1,000,000. It has outstanding an issue of \$500,000 first mortgage 5% gold bonds, but has no other debt, funded or unfunded. It likewise has issued 3,000 shares of 6% preferred stock and 2,000 shares of common stock. Both of these stocks have a par value of \$100 per share which was actually paid in in cash. The company is not particularly efficiently managed, but is able to make a net profit of \$60,000 per year. \$43,000 is required to pay the interest on the bonds and the dividends on the preferred stock. This leaves available for the common stock the sum of \$17,000 or \$8.50 per share. A holding company now considers purchasing all the common stock. Its officers are confident that they can cause the local company to be managed more efficiently and will be able to make a net profit of \$70,000 a year. This is the sum which the state public utility commission has stated is a fair return upon the value of the property of the local utility (a higher rate of return has been approved in many instances, but these figures are deliberately made overly conservative). If this return should be made, there would be available the sum of \$27,000 to pay dividends on the common stock which will now be held by the holding company. On the strength of these calculations, the officers of the holding company are willing to pay the sum of \$125 per share for the common stock of the local utility. This sum is in excess of the par value of the stock but is less than 10 times the prospective annual earnings which are \$13.50 per share. It is to be noted in all this that the holding company only plans to obtain what the state commission has already decided is a fair return upon the property actually used by the local utility. To finance this acquisition the holding company sells an issue of \$125,000 7% notes secured by a pledge of the stock to be acquired. Even the present earnings are slightly less than twice the required interest upon these notes, while if the holding company's predictions are correct the interest will be earned more than three times. The rest of the needed money

is secured by issuing \$125,000 par value of common stock, which is paid for in cash. This stock also appears attractive. Even at the current rate of profit for the subsidiary, there will be available profits of \$6.60 per share of the common stock of the holding company. If the predictions of the holding company's officers are correct, the earnings will jump to \$14.60 per share, which would enable the holding company to pay a very liberal dividend upon the money invested. Yet, in all this the holding company is not attempting to obtain anything more than a fair return upon the value of the underlying property. Unfortunately, an economic depression ensues. Despite operating economies, the underlying company's revenues decrease by \$10,000. There is now available only \$50,000 with which to pay the interest on the underlying bonds and preferred stock. These two items require \$48,000. The remaining \$7,000 is not sufficient to pay the interest on the holding company's notes. This default will force a receivership or bankruptcy of the holding company, wiping out the equity of the common stockholders of that company, for which they paid \$125,000 in cash. It will also result in severe losses to the purchasers of the notes. Thus do the managers of the destiny of the holding company discover what an all-destroying Frankenstein they have created.

It would not have been worth while to devote so much attention to these elemental principles of holding company finance if their action did not so vitally affect the regulation of charges between the affiliated members of the holding company structure. The terrific pressure of fixed charges of the more speculatively capitalized holding companies is thought by the commissions to exert a sinister influence upon the managers of these bodies, so as to cause them to divert money which properly belongs to the subsidiaries into the treasury of the holding company. As long as this is openly done, it is primarily the security holders of the operating company who are injured. But it may be done indirectly. The operating expenses of the subsidiary may be inflated by excessive payments to some other subsidiary and a rate increase demanded because of these operating expenses. The purpose of this paper is to consider how such tactics may be prevented.

Superficially, it would seem that the easiest and surest means by which a state commission could avoid all the difficulties of

holding company regulation would be by merely disregarding the corporate entities involved and treating the local company to be regulated as a mere part of the larger unity. Many commissions have seized upon this method. Unfortunately neither the courts nor the commissions have laid down any clear tests by which it may be ascertained whether the conditions are such that the corporate entities may be disregarded. It is therefore essential to examine each class of cases in which this has been done, ascertain the reasoning upon which such action is based, and determine the probable legality of such procedure.

The simplest situation is where the sole fact that the holding company owns all the stock (presumably except director's qualifying shares) is seized upon as a reason for disregarding the corporate entities. Such a view has been the favorite of many commissions which have based their decisions invoking it upon the principle that so long as the holding company gets the money it does not matter how it receives it.¹ Such reasoning begs the question by assuming the point at issue, i. e., that the holding company is not entitled to make any profit on the contractual relations it may have with the operating company. In rate cases it has been adopted by the Supreme Courts of Ohio and Montana.²

In the following footnotes an attempt has been made to cite all decisions by the commissions or courts (so far as these have been published in the standards sets of reports) in which there is any substantial discussion of the questions involved. Decisions cited from the Public Utilities Reports are decisions by the commission in the state shown in the parenthesis.

¹ United Paper Board Co. v. D. & H. Co. (1930) 168 I. C. C. 297; Traffic Bureau v. N. S. R. R. Co. (1926) 109 I. C. C. 52; United Paper Board Co. v. C. R. R. of N. J. (1925) 95 I. C. C. 608; Traffic Bureau v. A. C. L. R. R. Co. (1925) 107 I. C. C. 156; Arizona Packing Co. v. A. E. R. R. Co. (1923) 81 I. C. C. 115; Re Cumberland Tel. & Tel. Co. (La. P. S. C. 1922) P. U. R. 1922 E, 86; Public Service Commission v. Chesapeake & Potomac Tel. Co. (Md. 1924) P. U. R. 1925 B, 545; Re Michigan State Tel. Co. (Mich. 1921) P. U. R. 1921 C, 545; Re Michigan State Tel. Co. (Mich. 1922) P. U. R. 1923 A, 30; Fowler v. Billings Gas Co. (Mont. 1931) P. U. R. 1932 A, 456; Re Southern Bell Tel. & Tel. Co. (N. C. 1921) 1921 D, 447; *contra*: Re Peoria & Pekin Union Ry. Co. (1924) 93 I. C. C. 13. Commissions have occasionally applied the reverse of this principle so as to refuse to disregard corporate entities when the holding company did not own all the stock of the local company although it did own a legally controlling stock interest. Galveston Commercial Ass'n v. G., H. & S. A. Ry. Co. (1927) 128 I. C. C. 349; Re Carthage Gas Co. (1922) 12 Mo. P. S. C. 637.

² Ohio Mining Co. v. Public Utilities Commission (1922) 106 Oh. St. 138, 140 N. E. 143; Gallatin Natural Gas Co. v. Public Service Commission (1927) 79 Mont. 269, 256 Pac. 373. A similar position was assumed to uphold a transaction as not being contrary to the New York Anti-Trust Statutes in *Continental Securities Co. v. Interborough Rapid Transit Co.* (C. C. A. 2, 1915) 221 F. 44.

The Montana case primarily relies upon the earlier Ohio decision. The opinion of the Ohio court is far from satisfactory. It announces the doctrine but only after the court has admitted that the commission could reach the same result on another ground. It cites in support of its conclusion a group of cases in none of which was stock ownership considered the decisive or apparently even a very important factor. Aside from mere quotations, from some of these cases, of general statements which were not made with reference to fact situations in which mere stock ownership was the only factor to support disregard of the corporate fiction the present opinion makes no attempt to advance any reasons for its view. Alabama has a statute which specifically allows the public utilities commission to disregard corporate entities if it so desires in all cases in which the parent owns all the common stock of the subsidiary.³ In the absence of such a statute the great weight of authority is that the corporate entities must be respected if this is the only reason which can be advanced for their being cast aside. Such a view has been upheld by the Supreme Court of the United States in a series of cases involving the Associated companies of the Bell system in which the American Telephone and Telegraph Company held all the common stock, which alone had the right to vote. In the first of these cases, *City of Houston v. Southwestern Bell Telephone Co.*,⁴ the point does not seem to have been seriously contested by the counsel for the city of Houston. However, in the famous cases of *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*⁵ (involving rates in the City of St. Louis) and *Smith v. Illinois Telephone Co.*,⁶ (involving rates in the City of Chicago) the point was fully and ably discussed by counsel on both sides. Although the tendency of the courts to treat all cases involving the possible disregard of the corporate entity as sui generis weakens the force of precedents which do not involve the question of rate regulation, it is interesting to observe that the Supreme Court has steadily refused to disregard the corpor-

³ R. S. Ala. (1923) sec. 9792. It was applied in *Public Service Commission v. Souther Natural Gas Co.* (Ala. 1930) P. U. R. 1930 C, 31; *Home-wood v. Birmingham Electric Co.* (Ala. 1930) P. U. R. 1930 D, 463.

⁴ (1921) 259 U. S. 518.

⁵ (1923) 262 U. S. 276.

⁶ (1930) 282 U. S. 133.

ate entity when the only ground was complete stock ownership.⁷ It would seem that the view of the United States Supreme Court is the more consistent with the accepted principles of legal theory, although perhaps not with those of popular belief. The subsidiary will almost always have creditors who are interested in the continued existence as a distinct unit of the property on which they rely. More fundamentally important is the legal principle which denies to stockholders the right to remove directors during their term of office except for good cause shown.⁸ If the parent is thus to be deprived of legally effective control over the child, it is hardly just to say that they form one unity.

However, if the holding company uses its stock ownership and the factual power that this gives over the directors, there is apt to be created a situation under which the courts will sanction the disregarding of the corporate entity. If the situation becomes such that the parent company absolutely dominates the action of the local company, this result will follow. Unfortunately the cases have not laid down a concrete and readily applicable test by which to determine with objective precision whether this required domination exists. The cases representing the majority rule when dealing with complete stock ownership concede that the holding company may use the voting power of its stock to elect directors which will represent its interests. It is possible to set forth certain factors which will probably lead the courts

⁷ Pullman's Palace Car Co. v. M. P. R. R. Co. (1885) 115 U. S. 587 (liability on a contract); Humphreys v. McKissock (1891) 140 U. S. 304 (liability on a mortgage); Peterson v. C., R. I. & P. R. R. Co. (1907) 205 U. S. 362 (service of process); Interstate Commerce Commission v. Stickney (1909) 215 U. S. 98 (reasonableness of combination rates as determined by value of the service); U. S. v. D. & H. Co. (1909) 213 U. S. 366 (Commodities Clause of the Interstate Commerce Commission Act); Philadelphia & Reading Co. v. McKibbin (1917) 243 U. S. 264 (service of process); Cannon Mfg. Co. v. Cudahy Packing Co. (1924) 267 U. S. 330 (same). In accord: Bronx Gas & Electric Co. v. Prendergast (D. C. S. D. N. Y. 1924) 1 F. (2d) 323 (where the attempt was to force the companies to operate as a unit to produce savings expected by the New York Public Service Commission). The cases on the whole subject of the disregard of the corporate entity have been collected in Anderson, Disregard of the Corporate Entity, and Powell, Parent and Subsidiary Corporations. These only treat public utilities incidentally. The various law review articles which attempt to treat public utilities specifically are practically worthless. They are either a mere statement of two or three of the outstanding cases coupled with the propagandistic opinions of the author or if they attempt to deduce legal principles their conclusions are vitiated because of the failure to refer to important cases decided by the Supreme Court of the United States.

⁸ Cook on Corporations (8th ed.) sec. 624.

to decide that this domination exists. The most important and most easily recognized is the failure to provide the subsidiary with a board of directors which contains any but the tools or officers of the parent company.⁹ This was apparently the decisive factor in the decision of the Michigan Supreme Court in the leading case of *People ex rel. Potter v. Michigan Bell Telephone Company*.¹⁰ This test was approved by the United States Supreme Court in *United States v. Reading Company*.¹¹ The opinion in *Smith v. Illinois Bell Telephone Company* clearly shows that the court considered this test as still valid, although it did not apply there because only three of the nine directors were connected with the holding company or were officers of the subsidiary and hence likely to obey implicitly the wishes of the holding company so as to retain their jobs. The cavalier manner in which the Federal district court treated the action of the Michigan commission which had followed the decision in the *Potter* case cannot be too bitterly condemned.¹² These judges ruled on the basis of a mere citation of the *Houston*, and *Southwestern Bell* cases that this disregard of the corporate entity could not be applied in a Federal court. The decision shows an utter failure to understand the principle upon which the *Potter* case was based, since neither of the allegedly controlling decisions of the United States Supreme Court was based upon fact situations in which there was this failure to provide independent directors. The only points of similarity between the cases were that both companies were subsidiaries of the American Telephone and Telegraph Company and both companies had management contracts with the parent organization.

⁹ *C. M. & St. P. Ry. Co. v. Minneapolis Civic Ass'n* (1918) 247 U. S. 409; *People ex rel. Woodhaven Gaslight Co. v. Public Service Commission* (1923) 203 App. Div. 369, 196 N. Y. S. 623, aff'd (1924) 236 N. Y. 530, 142 N. E. 271 (Memo); aff'd (1925) 266 U. S. 244 (discussion on another point). Cf. also cases cited in notes 10 and 11. A study of the directorates of the Associated Companies of the Bell system shows that the American Telephone and Telegraph Co. has ordinarily been careful to avoid trouble on this score. The same care has not been exercised by such holding companies as Cities Service Co. and Associated Gas and Electric Co. (The directors are given for each company in Moody's Manual of Public Utilities). If the subsidiary is to be used as a means of borrowing money it would seem advantageous to place local bankers and financiers upon its board.

¹⁰ (1929) 246 Mich. 198, 224 N. W. 438.

¹¹ (1920) 253 U. S. 26.

¹² *Michigan Bell Telephone Co. v. Odell* (D. C. E. D. Mich. 1930) 45 E (2) 180.

The other factor which is very weighty in persuading the courts to disregard the corporate entities is that the parent company attempts to give orders directly to the officers of the subsidiary or to dictate who shall be such officials.¹³ Under such circumstances it, would seem only fair to disregard the corporate entity which is not to be respected by the very persons who are now demanding that it be recognized. Where there are management contracts between the subsidiary and the parent holding company or some other subsidiary of the parent company, it is very easy to maintain that there is this improper direction.¹⁴ To guard against such results, the more carefully drawn management contracts now provide that the holding company or its affiliate shall only furnish advice which may, or may not, be accepted by the officers of the subsidiary. Even in such cases, it would seem very easy to show that there was this improper giving of direct orders unless the persons concerned were very careful to observe the correct formalities. The only way that the holding company can guard against this danger is to confine its

¹³ U. S. v. D. & H. Co. (1909) 213 U. S. 366; U. S. v. Lehigh Valley R. R. Co. (1911) 220 U. S. 257; U. S. v. D., L. & W. Co. (1915) 238 U. S. 516 (all three cases involving the Commodities Clause). The principle as applied in the following rate cases: Richmond Chamber of Commerce v. S. A. L. Ry. Co. (1917) 44 I. C. 455; Re Blackshear Mfg. Co. (1924) 87 I. C. C. 654; Re Livestock Rates in the Southwest (1924) 91 I. C. C. 292; Re Transit Privileges and Intermediate Rule on Lumber (1925) 95 I. C. C. 154; Re Livestock to and from Points in the Southeast (1925) 101 I. C. C. 105; Bragg & Millsaps Co. v. A. & W. P. R. R. Co. (1927) 128 I. C. C. 238; Re Routing on Cotton (1927) 129 I. C. C. 387; Re Routing from Points on S. C. D. & P. Ry. Co. (1928) 142 I. C. C. 230; A. T. & N. R. R. Co. v. So. Ry. Co. (1928) 148 I. C. C. 708; Hohenberg & Co. v. A. & W. R. R. Co. (1929) 151 I. C. C. 574; Longhart Supply Co. v. C., R. I. & P. Ry. Co. (1929) 153 I. C. C. 118; Big Lake Box Co. v. S. P. Co. (1929) 155 I. C. C. 240; Humbard Construction Co. v. So. Ry. Co. (1930) 161 I. C. C. 38; Russ Market Co. v. N. W. P. R. R. Co. (1930) 171 I. C. C. 117; Re Alabama Power Co. (Fed. Power Comm. 1932) P. U. R. 1932 D, 345; Re Citizens Tel. Co. (Ind. 1924) P. U. R. 1924 E, 835; Re Cities Service Gas Co. (Mo. 1931) P. U. R. 1931 E, 11; City of Fulton v. Panhandle Eastern Pipe-Line Co. (Mo. 1932) P. U. R. 1933 A, 256; Casanave v. Overbrook Steamheat Co. (Pa. 1925) P. U. R. 1926 A, 600; Re Tennessee Electric Power Co. (Tenn. 1930) P. U. R. 1930 E, 312; Re Chesapeake & Potomac Tel. Co. (Va. 1926) P. U. R. 1926 E, 481.

¹⁴ Re Houghton County Traction Co. (Mich. 1919) P. U. R. 1919 D, 350; Re Houghton County Traction Co. (Mich. 1920) P. U. R. 1920 D, 350 Cf. Federal Trade Commission v. Smith (D. C. S. D. N. Y. 1932) 1 F. Supp. 185 (where the purpose of disregarding the corporate entity was to show that the Electric Bond and Share Co. was engaged in interstate commerce and hence subject to the inquisitorial jurisdiction of the Federal Trade Commission).

advice to matters of general policy which are subsequently acted upon by the board of directors of the subsidiary.

Closely allied to this type of situation are those in which the holding company has made no apparent effort in good faith to put the local company on a profitable basis. Under such circumstances, the subsidiary cannot use its failure to make a fair rate of return as a reason for abandoning service.¹⁵ The only cases in which such policies have been adopted have been cases in which holding companies primarily engaged into the sale of electricity have found themselves under the necessity of taking over local street railway lines because of the corporate connection between them and an electrical utility which they desire to control. The long continued decline in the credit and earning capacity of such traction properties has made it desirable that they get out of this business as rapidly as possible even at a loss, for investors have a prejudice against securities where the prospectus reveals that they are based, even in part, upon earnings derived from such sources.¹⁶ Unfortunately, from the holding company's point of view, traction companies are public utilities and cannot simply abandon service. However, if it can be shown that there is no prospect of making a fair return on a fair value abandonment will be sanctioned,¹⁷ and the holding company can salvage what it can by liquidating the traction company. Under the pressure of such impelling economic and financial motives, certain holding companies adopted these practices. A case involving such practices was carried to the Supreme Court of the United States, which granted mandamus to compel the continuation of service. It is true that the opinion on the first hearing of *State ex rel. Daniel v. Broad River Power Co.*¹⁸ did not rely upon this abuse, but rather upon the fact that the holding company had not respected the corporate entity of its subsidiary because it had intervened directly in the management of the traction company. On a rehearing, the element of abuse was strongly stressed. This proved fortunate, since the

¹⁵ *Re Hudson Valley Ry. Co.* (N. Y. 1927) P. U. R. 1927 C, 326; *Re Columbia Ry., G. & E. Co.* (S. C. 1927) P. U. R. 1927) D, 684.

¹⁶ Dewing, *Financial Policy of Corporations* p. 1227.

¹⁷ *Railroad Commission v. Eastern Texas R. R. Co.* (1924) 264 U. S. 79; *Fort Smith Light & Traction Co. v. Bourland* (1925) 267 U. S. 330.

¹⁸ (1930) 281 U. S. 537, rehearing (1930) 282 U. S. 187, followed *Coney v. Broad River Power Co.* (1933) 172 S. E. 437.

point was considered by all the justices and was the sole ground for upholding the former decision in the opinion of Justices Van Deventer, Butler, Sutherland, and McReynolds, who changed their minds as to what was shown by the evidence as to the existence of the alleged direct intervention.¹⁹

Similar considerations have led to the disregarding of the corporate entity when the subsidiary was created solely to evade the statutes regulating public utilities.²⁰ Clearly, the same considerations apply here as caused the corporate entities to be disregarded in the historic *Northern Securities Company* case.²¹ Under such circumstances it does not matter whether the holding company owns all the stock of the subsidiary or not.²²

The weakest of all cases for the disregarding of the corporate entities involved are those in which there is merely a showing that one company manages another without any showing as to the ownership of the stock of the company under such management. There is no case involving action by a state commission which has proceeded on this basis.²³ The Interstate Commerce Commission has acted upon such evidence in a variety of cases.²⁴

¹⁹ Both points were stressed in the briefs of counsel in this case.

²⁰ *Pearsall v. G. N. Ry. Co.* (1896) 161 U. S. 646; *Re West Missouri Power Co.* (Mo. 1928) P. U. R. 1929 A, 61. The same result has been reached where the only reason for the division of the companies was a desire to escape from the shackles of a mortgage covering after acquired property. *Re Independence Water Co.* (1919) 7 Mo. P. S. C. 532; *Re B. & Q. Service Co. Inc.* (N. Y. 1930) P. U. R. 1931 A, 392 (dicta in approving the arrangement).

²¹ *Northern Securities Co. v. U. S.* (1904) 193 U. S. 197; *U. S. v. U. P. R. R. Co.* (1912) 226 U. S. 61 (where there was never any intent to acquire more than voting control of the competing railroad).

²² Less than complete stock ownership was involved in the cases of *Pearsall v. G. N. Ry. Co.*; *Northern Securities Co. v. U. S.*; and *U. S. v. U. P. R. R. Co.* cited in notes 20 and 21.

²³ The nearest precedent is the action of the Texas Commission in the case of *Re Fort Worth Gas Co.* (1928) P. U. R. 1929 A, 136 in which the commission considered it unnecessary to make any finding as to the extent of affiliation. Actually all the stock of both companies was owned by the same holding company. In the more recent case of *Re Northwestern Electric Co.* (Ore. 1932) P. U. R. 1933 B, 41 all the stock of the local company was owned by the American Power & Light Co., nineteen percent of whose stock was owned by the Electric Bond & Share Co. which had a management contract with the local company. The commission felt justified in disregarding the corporate entities involved, but there was also a very considerable interlocking of the directorates of the three companies.

²⁴ *Commercial Club v. G. N. Ry. Co.* (1912) 24 I. C. C. 96; *Shrevesport Chamber of Commerce v. K. C. S. Ry. Co.* (1916) 39 I. C. C. 296; *North Vernon Lumber Co. v. I. C. R. R. Co.* (1921) 61 I. C. C. 355; *U. S. War Dept. v. A. & S. Ry. Co.* (1923) 83 I. C. C. 742; *Re Brick and Drain tile from St. Louis* (1923) 85 I. C. C. 353; *Nebraska Livestock Case* (1924)

As far as the Interstate Commerce Commission is concerned there is considerable excuse for such holdings, since Congress has expressly directed that this course be followed in fixing the location of joint routes.²⁵ It occasionally happens that a firm of engineers will be hired to supply expert managerial service for a group of independently owned utilities. Under such circumstances it would seem highly unjust to disregard the corporate entities involved since beneficial ownership might be in wholly distinct persons. Such a situation still exists with reference to the properties belonging to Eastern Utilities Associates which is under the management supervision of Stone & Webster Inc., although its managers do not hold any interest in the stock of the Associates.²⁶ The Electric Bond and Share Company has consistently followed the practice of only acquiring a minority of the stock of its principal subsidiary holding companies.²⁷

Although the theory of disregarding the corporate entity has many attractive features so far as simplicity and directness of regulation are concerned, it also possesses many great disadvantages. The most obvious, but least serious, of these is the fact that such a ruling would normally result in forcing the commission to undertake to value all the property of the parent company which is used and useful in supplying the service to the particular locality whose rates are under investigation. This might force a commission in California to attempt to value office buildings in New York or a commission in Illinois gas fields in Texas. This danger is more chimerical than real since it can be avoided under the recent ruling of the Supreme Court of the United States that the municipality concerned may be made the unit and calculated values substituted for a precise determina-

89 I. C. C. 444; *Restrictions of Routing* (1930) 165 I. C. C. 3; *Acme Brick Co. v. A., T. & S. F. Ry. Co.* (1930) 168 I. C. C. 583; *Egyptian Tile & Timber Co. v. M. I. R. R. Co.* (1931) 176 I. C. C. 354.

²⁵ 36 Stat. 552 (1910), 49 U. S. C. 15 (4).

²⁶ *Moody's Manual of Public Utilities 1932*. In their annual report for 1932 to their stockholders Stone & Webster Inc. announces that they have made such contracts with several other independent companies during the year and that the majority of their service as supervisory engineers is to wholly independent companies. 136 *Commercial and Financial Chronicle* (March 11, 1933) p. 1708.

²⁷ Recently they have departed from that policy in that they hold 52 per cent of the voting stock of the American and Foreign Power Co. At the time securities of this company were originally sold to the public it was stated that Electric Bond and Share Co. planned to retain only a minority interest. (Prospectus issued for sale of \$7.00 preferred stock.)

tion of the values of assets lying outside its boundaries.²⁸ In certain instances it may prove highly disadvantageous to the consumers to disregard the corporate entity. This will be true in cases in which the contract between the two companies is based upon the price which certain property cost while the property would have a higher present value because of the general increase in the price level, causing it to have a higher "fair value" on account of the weight given the factor of reproduction costs.²⁹ In communities whose population is expanding similar results might occur because of the tendency of land prices to rise.

State commissions are jealous of their jurisdiction and loathe to surrender it to national authorities. Yet, the doctrine of disregarding the corporate entity may lead to just this result. In the case of *Pennsylvania Gas Company v. Public Service Commission*³⁰ it was held that a company which brought natural gas into a state and distributed it to local consumers was engaged in interstate commerce while so doing, although the state could regulate the rates charged for local distribution of gas where Congress has not acted. But if Congress should act, its regulations would prevail.³¹ The complete control that the Interstate Commerce Commission possesses over intrastate rates charged by railroads engaged in interstate commerce³² would indicate that if it once were held that the combined company was engaged in interstate commerce, the Interstate Commerce Commission could be given complete control over its intrastate rates. With the growing use of natural gas (often mixed with manufactured

²⁸ *Wabash Valley Electric Company v. Young* (1933) 53 S. Ct. 234.

²⁹ The concurring opinion of Mr. Justice Brandeis (concurring in by Mr. Justice Holmes) in *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission*, supra, shows how widely these figures may differ even if general prices remain stationary. If the general price level has changed, the difference will be very great. Under the present theory involving the use of cost, in certain cases, as a measure of reasonableness, no price can be reasonable if it is above competitive prices (no matter what the costs may be). *Re Southern Power Co.* (N. C. 1924) P. U. R. 1924 B, 821.

³⁰ (1920) 252 U. S. 23; *Public Utility Com. v. Landon* (1919) 249 U. S. 236; *Missouri v. Kansas Gas Co.* (1923) 265 U. S. 298.

³¹ This was admitted in *Pennsylvania Gas Co. v. Public Service Commission*. It has been recognized law as to interstate commerce ever since the decision in *Cooley v. Board of Wardens of the Port of Philadelphia* (1851) 12 How. 299.

³² *Railroad Commission of Wisconsin v. C., B. & Q. R. R. Co.* (1922) 257 U. S. 563.

gas) and the spreading network of high tension electric lines, it is inevitable that most of the great holding companies will be partially engaged in interstate commerce. This situation has already arisen in the telephone industry.

THE EARLY PERIOD

If we decide to discard the theory of the disregard of the corporate entity, as being either inapplicable under the fact situation or undesirable as a question of general policy, we are not reduced to the mere impotent acquiescence and acceptance of whatever charges the holding company may see fit to make and include in the operating expenses of the local company. The commissions and the courts still have great power to scrutinize and reduce such charges if they be excessive. Unfortunately, the commissions have not always realized that they possessed such powers and the courts have been misled into making statements in language well calculated to cause even greater confusion among the commissions. In treating this question it is vitally necessary to use a historical approach. The commissions are naturely prone to look to the Supreme Court of the United States as a final arbiter to determine how far they can go without violating the due process clause of the Fourteenth Amendment. Thus, the cases naturally fall into four great classes whose divisions are marked by the opinions in *City of Houston v. Southwestern Bell Telephone Company*,³³ *Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission*,³⁴ and *Smith v. Illinois Bell Telephone Company*.³⁵ Such an examination is not a mere vain display of historical erudition. It is impossible to understand the difficulties of interpreting and rationalizing the most recent decisions without a background of the earlier decisions which have never been overruled or clearly repudiated. Moreover, it is the custom of commissions to determine cases largely on the basis of the earlier cases involving the same company, rather than remembering what they have decided a week before in a case involving an exactly similar situation but different parties.

The opinions of the courts during the early period paid little

³³ (1921) 259 U. S. 518.

³⁴ (1923) 262 U. S. 276.

³⁵ (1930) 282 U. S. 133.

attention to the question of what charges might be allowed as operating expenses and what power the commissions had over the amount of these charges. The reason for this situation was the fact that the earlier rate regulations were by legislative fiat without previous investigation and mostly concerned railroads wherein the operating expenses covered such a multitude of different items that the really important question was the issue of how much of these costs should be assigned to the commodity whose rate is being fixed rather than what should be included in the total of costs. Another factor, which is still operative, is that in many utilities the operating expenses are relatively a small proportion of the total revenue collected. Most of the income is required to pay for the large capital investment. This is particularly true of water-works, natural gas pipelines, and hydro-electric power developments. Under such circumstances the great conflict will be over the value of these assets since this is the factor which will affect most directly the rates which will have to be paid by the consumer.

However, court decisions are not entirely lacking. In the case of *Chicago & Grand Trunk Railway Co. v. Wellman*³⁶ the United States Supreme Court dismissed a case in which it was sought to have a Michigan rate statute held unconstitutional on the basis of a stipulation setting forth what the Railway Company had actually paid out as expenses during the past years. Mr. Justice Brewer, speaking for a unanimous court, used these significant words:

A single suggestion in this direction: It is agreed that the defendant's operating expenses for the year 1888 were \$2,404,516.54. Of what do these operating expenses consist? Are they made up partially of extravagant salaries—fifty to one hundred thousand dollars to the president and in like proportion to the subordinate officers? Surely, before the courts are called upon to adjudge an act of the legislature fixing the maximum passenger rates for railroads to be unconstitutional on the ground that its enforcement would prevent the stockholders from receiving any dividends on their investments, or the bondholders any interest on their loans, they should be fully advised as to what is done with the receipts and earnings of the company; for, if so advised, it might clearly appear that a *prudent and honest manage-*

* (1892) 143 U. S. 339.

ment would, within the rates prescribed, secure to the bondholders their interest and to the stockholders reasonable dividends. While the protection of vested rights of property is a supreme duty of the courts, it has not come to this: that the legislative power rests subservient to the discretion of any railroad corporation which may, by *exorbitant and unreasonable salaries, or in some other improper way, transfer its earnings into what it is pleased to call "operating expenses."*

This language is very forceful. Under it the good faith or lack of it of the railroad officials is apparently immaterial. What are proper operating expenses are not subject to their "discretion". The test is an objective one: what are reasonable expenses which would be incurred in operation by an honest and prudent management. If the courts and commissions had only remembered these wise words, there would never have been serious trouble in controlling holding companies and their affiliates. Six years later (1898) the leading case of *Smyth v. Ames*³⁷ announced what has ever since been considered the test of "fair value." Under it "operating expenses" were one of the factors to be considered in determining the final figure. The case of *Darnell v. Edwards*³⁸ again denied that the owner of property had discretion as to what he might consider as operating expenses. In 1921 the Supreme Court of the United States was called to pass upon the sum charged by the Galveston Electric Company for maintainence. A unanimous court, speaking through Mr. Justice Brandeis, ruled that it was correct to use the "amount normally required for that purpose during the period" rather than the "amount actually expended within the year."³⁹ Perhaps the situation has been most pithily stated by a lower federal court, "Efficiency of plant is a prerequisite to reasonable rates."⁴⁰ The Transportation Act of 1920 directs the Interstate Commerce Commission to fix rates so that each group of carriers shall be able to earn a fair return "under honest, efficient, and economical management and reasonable expenditures

³⁷ (1898) 169 U. S. 468.

³⁸ (1917) 244 U. S. 564.

³⁹ Galveston Electric Co. v. City of Galveston (1921) 258 U. S. 388.

⁴⁰ Landon v. Court of Industrial Relations (D. C. D. Kan. 1920) 269 F. 433.

for maintenance.”⁴¹ Even without this legislative direction, this basis was being followed by the Commission.⁴²

The state commission generally followed similar views. Charges were frequently disallowed because the commission felt that the utility could have secured the same service or commodity from others at lower prices.⁴³ In other instances the charges were eliminated on the ground that they were unnecessary for so small a utility.⁴⁴ Although the Missouri Public Service Commission had frequently acted on such views, there is one case in which it considered that it was bound by the contract price even though it appears “excessive”.⁴⁵ Probably this may be considered as a mere oversight by an over-worked commission. Moreover, the increase granted in this case was only temporary and the commission recommended that the utility attempt to obtain a more favorable contract. In certain cases, the commissions have gone to great lengths under this power to fix rea-

⁴¹ 41 Stat. 488 (1920), 49 U. S. C. 15a. In prescribing just division in cases in which the Commission has established through routes and joint rates, the Commission is directed to consider the “efficiency” with which the carriers concerned are operated. 41 Stat. 486 (1920), 49 U. S. C. 15 (6).

⁴² Re Advance in Rates—Eastern Case (1911) 20 I. C. C. 243; Re Advance in Rates—Western Case (1911) 20 I. C. C. 307; Re Express Rates (1912) 24 I. C. C. 380; L. & N. R. R. Co. Coal and Coke Rates (1913) 26 I. C. C. 20; Re Express Rates (1913) 28 I. C. C. 131; Re Western Passenger Fares (1915) 37 I. C. C. 1; New Orleans Terminal Allowances (1917) 42 I. C. C. 748.

⁴³ In Re Etna Development Co. (Cal. 1915) P. U. R. 1916 A, 134; In Re Farmers Co-Operative Union (Cal. 1915) P. U. R. 1916 A, 271; In Re William B. Ross (Ill. 1915) P. U. R. 1915 D, 646; Re Indiana Fuel & Light Co. (Ind. 1921) P. U. R. 1921 E, 381; In Re Marshfield Electric Co. (1918) 7 Mo. P. S. C. 134; In Re LaFayette Tel. Co. (1919) 8 Mo. P. S. C. 346; In Re Hanamo Tel. Co. (1920) 9 Mo. P. S. C. 521; Re Pawnee Tel. Co. (Neb. 1920) P. U. R. 1920 D, 501; Re Public Service Gas Co. (N. J. 1919) P. U. R. 1920 A, 233; Re Nashville Ry. & Light Co. (Tenn. C. 1920) P. U. R. 1920 C, 1; Charlesworth v. Omro Electric Light Co. (Wis. 1915) P. U. R. 1915 B, 1.

⁴⁴ Re Arizona Electric-Tel. Co. (Ariz. 1920) P. U. R. 1920 E, 695; Re Marin Water Co. (Cal. 1916) P. U. R. 1916 F, 782; Re Madera Canal & Irrigation Co. (Cal. 1917) P. U. R. 1917 F, 642; City of Pekin v. Pekin Waterworks Co. (Ill. 1917) P. U. R. 1917 C, 838; Re Central Indiana Tel. Co. (Ind. 1918) P. U. R. 1918 E, 859; In Re Hume Tel. Co. (1914) 1 Mo. P. S. C. 405; In Re City Power Co. of Sedalia (1916) 4 Mo. P. S. C. 140; In Re Bunceton Ice, Light, & Fuel Co. (1918) 6 Mo. P. S. C. 408; In Re Missouri Public Utilities Co. (1918) 7 Mo. P. S. C. 569; In Re Clarence Tel. Co. (1920) 9 Mo. P. S. C. 498; Re Wessell Tel. Exchange (1921) 11 Mo. P. S. C. 182; Re Clifton Forge Mutual Tel. Co. (Va. 1920) P. U. R. 1920 C, 252; Re Charlestown Water Co. (W. Va. 1916) P. U. R. 1916 D, 725.

⁴⁵ In Re Edgerton Electric Light & Power Co. (1918) 6 Mo. P. S. C. 259.

sonable operating expenses. They have drawn up detailed lists of the types of employees required by the company and the salary which should be paid to each.⁴⁶ In one case this entailed a most peculiar result. Two brothers were the sole stockholders of a Missouri utility and were paying themselves salaries at the rate of \$50 per month for all the work that needed to be done. The Commission decided that the company was efficiently managed and would require the services of two persons who should be paid \$100 a month apiece. This happened although the brothers had made no claim that they were paying themselves too low salaries.⁴⁷

Holding these views, it is not surprising that the commissions have applied the same test of reasonableness in passing upon cases in which persons holding large or controlling blocks of the stock of the utility are also receiving salaries from the utility. In some of these cases, the question is easily settled. The commission finds that the stockholder was doing absolutely nothing in return for his salary.⁴⁸ In such case the salary is merely a form of dividend. More frequently, the officer does something in return for his pay. In such instances, the commission will only allow the amount for which some one else could be hired to perform the same duties.⁴⁹ As far as the operating utility is

⁴⁶ In *Re Clarence Tel. Co.* (1920) 9 Mo. P. S. C. 498; *Re Charlestown Water Co.* (W. Va. 1916) P. U. R. 1916 D, 725.

⁴⁷ *Re Moore Brothers Electric Light & Power Co.* (1918) 7 Mo. P. S. C. 210. *Re Central Indiana Tel. Co.* (Ind. 1918) P. U. R. 1918 E, 859 is somewhat similar in that the commission undertook to provide funds for an increase in salaries and wages to all employees although the company had announced that it had no present intention of making such an increase.

⁴⁸ *Re Leadville Water Co.* (Col. 1921) P. U. R. 1921 D, 172; *Re W. B. Hagar* (Idaho 1918) P. U. R. 1918 E, 451; *Re United Public Service Company* (Ind. 1918) P. U. R. 1918 F, 316; *Re Indianapolis Water Co.* (Ind. 1918) P. U. R. 1919 A, 448; *In Re Capital City Water Co.* (1918) 5 Mo. P. S. C. 619; *Re Salem Light & Power Co.* (1920) 10 Mo. P. S. C. 26; *Re Western Electric Co.* (N. D. 1921) P. U. R. 1921 E, 569.

⁴⁹ *In Re Westside Gas Co.* (Cal. 1915) P. U. R. 1916 A, 276; *Re San Francisco, Napa & Calistoga Ry. Co.* (Cal. 1917) P. U. R. 1917 E, 546; *Sandpoint v. Sandpoint Water & Light Co.* (Idaho 1915) P. U. R. 1915 F, 445; *Re Cairo Water Co.* (Ill. 1920) P. U. R. 1921 A, 764; *Re Sterling Water Co.* (Ill. 1920) P. U. R. 1921 A, 801; *Fort Wayne v. Home Tel. & Tel. Co.* (Ind. 1920) P. U. R. 1920 D, 83; *Simms v. Columbia Tel. Co.* (1915) 2 Mo. P. S. C. 256; *City of Columbia v. Watts Engineering Co.* (1918) 7 Mo. P. S. C. 78; *Re LaFayette Tel. Co.* (Mo. 1919) P. U. R. 1920 A, 169; *In Re Seneca Tel. Co.* (1920) 9 Mo. P. S. C. 563; *Springfield City Water Co. v. Springfield* (1920) 10 Mo. P. S. C. 42; *Re Poughkeepsie & Wappingern Falls R. R. Co.* (N. Y. 1920) P. U. R. 1920 C, 995; *Rose v. Mercersberg, Lehmasters & Marks Electric Co.* (Pa. 1919) P. U. R. 1919 F,

concerned, these officers and stockholders occupy exactly the same position as a holding company, since the influence of both is due to the voting right of the stock they hold. Unfortunately, this analogy was rarely realized by the commissions, who were blinded by the complexities of the corporate financial structure of the holding companies.

We are now prepared to examine how the courts and commissions treated contracts between subsidiary public utilities and their parent holding companies or other companies controlled by the same holding company. The great holding company of this period was the American Telephone and Telegraph Company and the commissions of virtually every state were called upon to determine how the contracts of this system were to be treated. These contracts were of two classes. By one the American Company guaranteed to furnish the subsidiary all the instruments for installation with the customer that were required (and a reserve stock equal to 3% of those in use); managerial advice upon any and all problems, whether concerned with public relations, engineering, research, construction, accounting, or the law; licenses under all patents issued or to be issued to the American Company or its subsidiaries; protection against all claims for infringement of patents; representation in all suits before public utilities commissions, or federal commissions or taxing bodies; and finally financial assistance by loans to any extent that might be required by the subsidiary. All this was in return for 4½% of the gross income of the subsidiary.⁵⁰ Distinct from this contract but only enjoyable by companies which had agreed to this contract was a special contract with the Western Electric Company (practically wholly owned by the American Company). Under this contract the local companies were privileged to buy what supplies they desired at special prices below those charged to outsiders. There was no contractual compulsion to buy if more advantageous prices could be obtained elsewhere. Most of

714; Fox v. Pine Grove Electric Light, Heat & Power Co. (Pa. 1919) P. U. R. 1920 B, 380; Re West Virginia Central Gas Co. (W. Va. 1918) P. U. R. 1918 C, 453; State Journal Printing Co. v. Madison Gas & Electric Co. (1910) 4 Wis. R. R. C. R. 501, 1. c. 640.

⁵⁰ This was the percentage in force at this time. On January 1, 1926, it was reduced to 4%. On January 1, 1928 the American Company sold the telephones to the Associated Companies, ceased to furnish any instruments, and reduced the charge to 2% of the gross. On January 1, 1929 this was still further reduced to 1½%.

the commissions at this period were not seriously concerned over the contracts which fixed the division of toll revenues between the American Company, which owned the long lines between cities, and the subsidiaries which furnished the local connections. It must not be imagined, however, that there were not other holding companies whose contracts were investigated. But even these contracts primarily concerned managerial services. The situation in which the subsidiary was merely the local distributor of gas or electricity bought from an affiliated company did not develop until later when it was produced by the spread of network of natural gas pipe-lines and superpower transmission lines.

Court decisions with reference to holding companies did not come until late in the period and did not then attempt to treat the subject systematically; therefore consideration of them is best postponed until after the commission decisions have been studied. Since the commissions asserted the doctrine that they could disallow ordinary operating expenses unless they were reasonable, it is but natural that the vast majority treated these holding company contracts on the same basis.

It is necessary to examine the various tests by which the commissions undertook to determine if a given contract basis was reasonable. Some commissions have allowed management fees on the mere showing that the service was of greater "value" to the local company than its cost in fees.⁵¹ This test is highly unsatisfactory in its application since the term "value" is so uncertain. In a few decisions which apply this principle the situation is made even worse by the fact that "value to the people" served by the utility is also considered.⁵² In such decisions we find the payment of the 4½% contract charge to the American

⁵¹ *City of Birmingham v. Southern Bell Tel. & Tel. Co.* (Ala. 1918) P. U. R. 1919 B, 791; *Re Southwestern Bell Tel. Co.* (Ark. 1920) P. U. R. 1921 B, 516; *Re Rates and Charges of Tel. Companies* (Ariz. 1919) P. U. R. 1920 B, 411; *Re Mountain States Tel. & Tel. Co.* (Col. 1917) P. U. R. 1917 B, 198; *Re Mountain States Tel. Co.* (Idaho 1921) P. U. R. 1921 B, 739; *Re Cumberland Tel. & Tel. Co.* (La. 1921) P. U. R. 1921 C, 363; *Re Chesapeake & Potomac Tel. Co.* (Md. 1920) P. U. R. 1920 F, 417; *In Re Missouri Public Utilities Co.* (Mo. 1915) P. U. R. 1915 C, 1017; *Commercial Club v. Missouri Public Utilities Co.* (1915) 2 Mo. P. S. C. 311; *Re Chesapeake & Potomac Tel. Co.* (Va. 1920) P. U. R. 1920 F, 49.

⁵² *Re Rates and Charges of Telephone Companies* (Ariz. 1919) P. U. R. 1920 B, 411; *Re Chesapeake & Potomac Tel. Co.* (Md. 1916) P. U. R. 1916 C, 925.

Telephone and Telegraph Company upheld on the basis that the service in the United States is better than that in France.⁵³ This is true, but the same reasoning would uphold any charge no matter how outrageous. In one of the rare cases in which the Missouri Public Service Company adopted the "value" criterion, it so limited it as to create a workable test. The services could have no "value" to the utility unless they saved it more than they cost.⁵⁴ The trouble with the whole attempt to use value as a criterion to determine what sum should actually be allowed is that the services may have value to the utility higher than their cost and still be obtainable elsewhere at a lower price.

Far better are those cases which seek to determine reasonableness by reference to the sum that it would cost the utility to perform the service for itself.⁵⁵ Certainly, the allowed contract price should not be more than this sum. Unfortunately this also is not an accurate test of how much should actually be allowed, since the service may be of such a nature that it can only be done effectively by large organizations serving many individual utilities. This is particularly true of expert engineering advice for which there will only be occasional need when broad questions of policy must be decided.

⁵³ This basis was used in both cases cited in note 50.

⁵⁴ *Commercial Club v. Missouri Public Utilities Co.* (1915) 2 Mo. P. S. C. 311. When the value test is used negatively, it gives a just result, i. e. the local utility should not be forced to pay for services which have no value to it. In *Re Application of the Southern Sierras Power Co.* (Cal. 1915) P. U. R. 1915 B, 27; In *Re Central California Gas Co.* (Cal. 1915) P. U. R. 1915 D, 607; *Sherman v. California-Michigan Land & Water Co.* (Cal. 1918) P. U. R. 1918 D, 93; *Re Missouri & Kansas Tel. Co.* (Kan. 1918) P. U. R. 1918 C, 55; *City of Springfield v. Springfield Gas & Electric Co.* (Ill. 1916) P. U. R. 1916 C, 281; *Re Spring Valley Utilities Co.* (Ill. 1920) P. U. R. 1920 F, 139; *Arlington Petition* (Mass. 1915) P. U. R. 1916 B, 363; *Re Lansing Fuel & Gas Co.* (Mich. 1921) P. U. R. 1921 C, 465; *Re Helena Light & Ry. Co.* (Mont. 1920) P. U. R. 1920 D, 668; *Buck v. New York Tel. Co.* (N. Y. 1921) P. U. R. 1921 E, 798; *Re Wisconsin-Minnesota Light & Power Co.* (Wis. 1920) P. U. R. 1920 D, 428; The Missouri cases which reached this same result are treated below at page ??.

⁵⁵ *Re Belvedere Water Co.* (Cal. 1916) P. U. R. 1917 D, 210; *City of Lincoln v. Lincoln Water Co.* (Ill. 1916) P. U. R. 1917 B, 1; *City of Bluefield v. Bluefield Waterworks & Improvement Co.* (W. Va. 1917) P. U. R. 1917 E, 22; *Re West Virginia Central Gas Co.* (W. Va. 1918) P. U. R. 1918 C, 453; *Bogart v. Wisconsin Tel. Co.* (Wis. 1916) P. U. R. 1916 C, 1020; *Birmingham v. Southern Bell Tel. & Tel. Co.* (Ala. 1918) P. U. R. 1919 B, 791; *Re Southwestern Bell Tel. Co.* (Ark. 1920) P. U. R. 1921 B, 516; In *Re Telephone Rates, Rules, and Practices in the city of Milwaukee* (1916) 17 Wis. R. C. R. 524; *Croty v. Tomah Electric & Tel. Co.* (Wis. 1916) P. U. R. 1917 A, 439.

These considerations caused many commissions to supplement the last test by inquiring whether the utility could obtain the same service elsewhere at a lower price.⁵⁶ Such a view was sanctioned by the Supreme Court of Illinois in *State Public Utility Commission ex rel. City of Springfield v. Springfield Gas & Electric Co.*⁵⁷ It was also relied upon by the federal court for the southern district of Texas which held the initial hearing in the *Houston* case.⁵⁸ It was applied by Judge Learned Hand with reference to contracts between the Consolidated Gas Company of New York and the Standard Oil Company of New Jersey made when a director of the latter was a member of the executive committee of the former company.⁵⁹ In this case the judge's opinion shows that he was fully conscious of the difficulty of applying such a test in cases in which there is virtually no competitive market. Three commissions adopted for a time a slight variant of this test by which the total sum paid for management was considered; and, if this was found to be no more than that paid by other utilities of similar size, this lump sum was allowed.⁶⁰ So long as only small utilities are considered such a test would work well, but it would prove extremely uncertain if the number of other units of comparable size was limited, for

⁵⁶ Re Southern Bell Tel. & Tel. Co. (Ga. 1921) P. U. R. 1921 C, 833; Re City of Peoria and Receivers of the Central Union Tel. Co. (Ill. 1918) P. U. R. 1918 E 74; Re Michigan State Tel. Co. (Mich. 1918) P. U. R. 1918 C, 81; In Re Kirskville Light, Power & Ice Co. (Mo. 1915) P. U. R. 1915 C, 114; In Re Kansas City Light & Power Co. (1919) 8 Mo. P. S. C. 223; Stone v. New York Tel. Co. (N. Y. 1921) P. U. R. 1921 D, 736; Moore v. Valley Railways Co. (Pa. 1919) P. U. R. 1919 F, 493; Re Southern Bell Tel. & Tel. Co. (S. C. 1921) P. U. R. 1921 D, 530; Re Ramier & Elgin, Receivers of the Memphis Gas & Electric Co. (Tenn. 1921) P. U. R. 1921 C, 121; Re Mountain States Tel. & Tel. Co. (Utah 1921) P. U. R. 1921 E, 117; Re Chesapeake & Potomac Tel. Co. (W. Va. 1920) P. U. R. 1921 B, 97.

⁵⁷ (1920) 291 Ill. 209, 125 N. E. 891. This case has been very frequently misconstrued because of its references to the view that the commission is not the financial manager of the utility. It says this but upholds the action of the Illinois commission in disallowing charges when they were higher than the competitive price. The commission had proceeded on the view that the services were of no value whatsoever.

⁵⁸ *Southwestern Tel. & Tel. Co. v. City of Houston* (D. C. S. D. Tex. 1920) 268 F, 878.

⁵⁹ *Consolidated Gas Co. of New York v. Newton* (D. C. S. D. N. Y. 1920) 267 F. 231, aff'd *Newton v. Consolidated Gas Co.* (1921) 258 U. S. 651 (the opinion of the Supreme Court does not mention this point).

⁶⁰ Re Colorado Springs Light, Heat & Power Co. (Col. 1916) P. U. R. 1916 C, 464; Re Concord, Maynard & Hudson St. Ry. Co. (Mass. 1917) P. U. R. 1917 E, 59; Re Tri-State Tel. & Tel. Co. (Minn. 1921) P. U. R. 1921 C, 733.

many of these might actually be mismanaged. If the commission must first investigate the reasonableness of the figures which are being used as a control, the task will be endless.

To meet these objections some commissions based the allowed figure upon the cost of rendering the services.⁶¹ Such a cost is figured upon the invested capital and a fair rate of return on it and hence is different from the fair return upon a fair value which would be allowed in cases in which the corporate entity was disregarded. Economically it has considerable justification since the operation of the laws of supply and demand in a free market would tend to make the selling price at least approximate the cost. With reference to managerial services there is not ordinarily a free and open competitive market and hence there seems to be little injustice in basing allowed operating expenses upon this criterion. Such a view was followed by the Supreme Court of Nebraska in *Re Lincoln Traction Company*,⁶² but was expressly disapproved by the Federal district court in the *Houston* case.⁶³ Although we shall see that this was the view finally adopted by the Supreme Court of the United States in the case of *Smith v. Illinois Bell Telephone Company*, it did not then enjoy much favor with the commissions. The difficulties of cost accounting where the service rendered involved many intangible factors, as under the American Telephone and Telegraph Company 4½% contract, would naturally tempt the commissions to try other and simpler tests first, while the companies were maintaining that the commissions had no power whatsoever over these contracts.

Where the attempt was made to regulate operating expenses as represented by contracts with affiliates upon any of the above

⁶¹ In *Re United Light & Power Co.* (Cal. 1915) P. U. R. 1915 C, 622; *Re Potomac Electric Power Co.* (D. C. 1917) P. U. R. 1917 F, 70; In *Re Washington Ry. & Electric Co.* (D. C. 1915) P. U. R. 1915 F, 34; In *Re Macon Ry. & Light Co.* (Ga. 1915) P. U. R. 1915 E, 648; *Newton and Watertown Petition* (Mass. 1915) P. U. R. 1915 D, 787; *Re Boston Consolidated Gas Co.* (Mass. 1919) P. U. R. 1919 E, 583; *Re Omaha & Southern Interurban Ry. Co.* (Neb. 1920) P. U. R. 1920 C, 897; *Re Massachusetts Northeastern St. Ry. Co.* (Mass. 1920) P. U. R. 1920 D, 1053; *Re Pacific Tel. & Tel. Co.* (Ore. 1919) P. U. R. 1919 D, 345; *Re Pacific Tel. & Tel. Co.* (Ore. 1921) P. U. R. 1921 D, 530; *Re Bluefields Waterworks & Improvement Co.* (W. Va. 1921) P. U. R. 1921 E, 665.

⁶² (1919) 103 Neb. 229, 171 N. W. 192.

⁶³ *Southwestern Tel. & Tel. Co. v. Houston* (D. C. S. D. Tex. 1920) 268 F. 878.

principles, the burden of proof was on the local company to show that its operating expenses should be allowed.⁶⁴ It is clearly most convenient, if operating expenses are to be rigorously controlled that the burden of proof should rest upon the utility. Under such a principle self-interest will force the holding company to reveal all necessary data, while the complainants' seeking a rate reduction would have great difficulty in obtaining the same information by the examination of hostile witnesses or the examination of the books of the holding company which are naturally more easily understood by the persons who keep them than by outsiders.

From the point of view of the utility it would be advisable to know in advance whether or not a contract price would be allowed, particularly if the company was considering asking for an increase in rates. Such motives have caused companies to submit contracts to the commission for approval before they are signed.⁶⁵ The commissions have ordinarily approved these contracts in blanket terms. Such blanket approval of contracts which have any considerable duration would seem dangerous. Subsequent events may change what should be allowed as operating expenses. In such a case the consumers should not be forced to pay for the mistakes of the management in making contracts covering too long a term. Yet, if the commission has approved the contract in advance, the commission would be likely to feel itself bound to allow it in all subsequent rate controversies.

⁶⁴ *Kings County Lighting Co. v. Lewis* (1920 180 N. Y. S. 570; *Jamaica Gas Light Co. v. Nixon* (1920) 110 Misc. 500, 181 N. Y. S. 623; *Re Chesapeake & Potomac Tel. Co.* (D. C. 1920) P. U. R. 1920 D, 614; *Belleville v. St. Clair County Gas & Electric Co.* (Ill. 1915) P. U. R. 1915 F, 235; *Belleville v. St. Clair County Gas & Electric Co.* (Ill. 1915) P. U. R. 1916 B, 24; *Re City of Peoria and Receivers of the Central Union Tel. Co.* (Ill. 1918) P. U. R. 1918 E, 74; *City of Belleville v. East St. Louis & Suburban Ry. Co.* (Ill. 1919) P. U. R. 1919 E, 916; *Re Freeport Gas Co.* (Ill. 1920) P. U. R. 1920 B, 726; *In Re Northampton Petition* (Mass. 1915) P. U. R. 1915 A, 618; *Natick Petitions* (Mass. 1915) P. U. R. 1915 D, 655; *City of Columbia v. Watts Engineering Co.* (Mo. 1918) P. U. R. 1918 D, 157; *Mayor of Olean v. Keystone Gas Co.* (N. Y. 1919) P. U. R. 1920 A, 307; *Re Wisconsin-Minnesota Light & Power Co.* (Wis. 1920) P. U. R. 1920 D, 428. Similar views are implicit in almost every case cited in notes 51 to 63, the cases cited in this note merely considering the problem more thoroughly.

⁶⁵ *Express Contract 1920* (1920) 59 I. C. C. 518; *Commercial Club v. Citizens Gas & Fuel Co.* (Ind. 1916) P. U. R. 1916 E, 1; *In Re Kansas City Gas Co.* (1920) 9 Mo. P. S. C. 448; *Dobson v. Kensington Ry. Co.* (Md. 1917) P. U. R. 1917 F, 102; *In Re Norfolk & Bristol St. Ry. Co.* (Mass. 1915) P. U. R. 1915 E, 411.

By a general order in 1917 the Massachusetts Board of Gas and Electric Commissions applying to all companies which had interlocking directorates or officials required that all contracts should either be let at auction to the highest bidder or be subject to the approval of the commission.⁶⁶

In a few instances the commissions have felt themselves bound by the terms of the contract unless they could show that the contract was the result of an abuse of discretion by the directors of the local company.⁶⁷ The commission cases upon this point are not particularly enlightening as they do not deign to supply any reasons for the conclusions and cite no authority.⁶⁸ From a reading of these opinions one would never suspect that the commissions have, as we have seen, power to disallow ordinary operating expenses if they do not consider them to be reasonable.

This view was also enunciated by certain courts. The first of these cases in point of time was *Havre de Grace & Perryville Bridge Co. v. Towers*⁶⁹ decided by the Maryland Court of Appeals in 1918. In this case the commission had disallowed the salary paid the President who owned the controlling stock. The commission had based its decision on the ground that this gentleman actually did no work for the company. The Court considered this an interference with the constitutional right of the company to manage itself. It stated that the decided cases hold that the commission is not the financial manager of the utility and cannot do this. No reason is given for this statement other than the bare citation of the names of four cases which are claimed to be authority for this view.⁷⁰ It is true that all four

⁶⁶Re Awarding of Contracts (Mass. 1917) P. U. R. 1917 B, 397.

⁶⁷Re San Diego Electric Ry Co. (Cal. 1919) P. U. R. 1920 B, 86; Re Central Illinois Light Co. (Ill. 1920) P. U. R. 1921 A, 688; *City of Bluefields v. Bluefields Waterworks & Improvement Co.* (W. Va. 1918) P. U. R. 1919 A, 790. These are all isolated cases as cases before the same commissions, both before and after these decisions, do not follow these views. Cf. cases cited in notes 51 to 64.

⁶⁸None of these cases even mention the commissions power over ordinary operating expenses or undertake to say why it should make operating expenses sacrosanct for them to be enshrined in a contract with an affiliate when they would not possess this immunity if the contract was with an independent company.

⁶⁹(1918) 132 Md. 16, 103 Atl. 319.

⁷⁰These cases are: *Laird v. Baltimore & Ohio R. R. Co.* (1913) 121 Md. 179, 88 Atl. 348; *People ex rel. Binghampton Light, Heat & Power Co. v. Stevens* (1911) 203 N. Y. 7, 96 N. E. 114; *People ex rel. Delaware & Hudson Co. v. Stevens* (1909) 197 N. Y. 1, 90 N. E. 60; *Towers v. United Ry. & Electric Co.* (1915) 126 Md. 478, 95 N. E. 170.

cases make the statement that the commission is not the financial manager of the utility. Unfortunately, none of them even mentions the question of operating expenses. Three of the cases deny the power of the commission to pass upon the expediency of issuing bonds or stock, while the fourth concerns the expediency of building an extension. A similar statement was made by the Federal District Court for the Western District of Missouri in *St. Joseph Railway, Light, Heat & Power Co. v. Public Service Commission*,⁷¹ but here the statement primarily concerned questions of general business policy as to the nature of means by which gas should be manufactured rather than the costs involved in the proper operation of either method. In one case involving the much litigated 4½% contract of the American Telephone and Telegraph Company, the majority of the Michigan Supreme Court said that the contract must be upheld provided the management is "fairly economical" and "the contract was made in good faith."⁷² This is an apparent attempt to straddle the issue. However, the case actually was dismissed for failure of the City of Detroit to sustain its burden of showing by the weight of evidence that the commission was in error in refusing to reduce the rates being charged. Since the City had not introduced any new evidence at all to attack the commission's finding, it was not necessary to decide whether or not the contract was valid. The most frequently cited case on this subject is the decision of the Illinois Supreme Court in *State Public Utilities Commission ex rel. Springfield v. Springfield Gas and Electric Co.*⁷³ This contained a passage which reads:

The commission is not the financial manager of the corporation and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by the corporate officers.

At first glance this would seem a sweeping repudiation of the doctrine that the commission can disallow operating expenses if it does not consider them reasonable. A careful examination of

⁷¹ (D. C. W. D. Mo. 1920) 268 F. 267.

⁷² *City of Detroit v. Michigan Railroad Commission* (1920) 209 Mich. 395, 177 N. W. 306.

⁷³ (1920) 291 Ill. 209, 125 N. E. 891.

the whole opinion will show that the court must have meant much less than it seems to say. The commission had disallowed a large part of the management fee charged by an affiliate on the ground that the price charged was excessive compared to the cost of hiring executives who would be capable of actively managing the corporation. This was specifically held by the Court to have been a proper exercise of the commission's power; yet there was not the slightest showing of abuse of discretion by the corporate officers who made the contract. Such a conclusion cannot be reconciled with the language used unless the language is to be interpreted very narrowly so as to mean that the commission cannot ignore, without assigning a reason founded upon a full investigation, items charged as operating expenses. The quoted words were used with reference to the rejection of the commission's views that the company might save money and earn a fair return at the allowed rates if it would radically alter its whole method of manufacturing gas, involving the investment of a large amount of new capital. It was admitted that the plant was an efficient representative of its type.

There are certain expedients by which a commission may avoid passing upon the general question of its power to disallow contractual charges between affiliates. If the contract is for the rental of equipment, the commission may include the value of the equipment in the value of the property upon which the utility is to be allowed to earn a fair return.⁷⁴ Theoretically it would seem that this is correct, since the case of *Smyth v. Ames* said that the attempt was to determine the fair value of the property "used and useful" in rendering the public service. Ownership is not apparently important. In the Valuation Act of 1913 Congress directed the Interstate Commerce Commission to include both owned and leased property.⁷⁵ Any other holding would

⁷⁴ Re Missouri Kansas Tel. Co. (Kan. 1918) P. U. R. 1918 C, 55; Re Indianapolis Traction & Terminal Co. (Ind. 1918) P. U. R. 1919 A, 278; Re Central Union Tel. Co. (Ind. 1920) P. U. R. 1920 B, 813; Re Laclede Gaslight Co. (1914) 1 Mo. P. S. C. 258; In Re Kansas City, Clay County & St. Joseph Ry Co. (1914) 2 Mo. P. S. C. 51; City of Kansas City v. Kansas City Tel. Co. (1921) 11 Mo. P. S. C. 731; Re Pacific Tel. & Tel. Co. (Ore. 1919) P. U. R. 1919 D, 345; Public Service Commission v. Grays' Harbor Ry. & Light Co. (Wash. 1915) P. U. R. 1915 C, 518; Milwaukee Electric Ry. & Light Co. v. Milwaukee (Wis. 1918) P. U. R. 1918 E, 1; Milwaukee Electric Ry. & Light Co. v. Milwaukee (Wis. 1919) P. U. R. 1919 D, 504.

⁷⁵ 37 Stat. 701 (1913), 49 U. S. C. 19a.

allow a company to avoid all possibility of fluctuation in its value by adopting the simple expedient of owning none of the property it used.

If the affiliate concerned is also a utility within the state, the commission may summon the affiliate before it and proceed to fix the rates which it may charge on the basis that it has power to regulate all contracts made by utilities for the sale of their services.⁷⁶ Under such a procedure the commission can make binding orders fixing the price for the future rather than merely settling what will be allowed as operating expenses and leaving the company free to pay whatever it desired provided it adjusted its books properly. This plan will not work if the affiliate sells the gas, water, or electric current to the company in another state, for commissions have no power over utilities in other states. In such instances the only remedy based on this method would be to request the commission in the other state to act, which it probably would do as a matter of comity.

The final method of securing relief and yet evading the necessity of passing on whether the contract price should be allowed or not is to assume that it is allowable but hold that it should not all be allocated to operating expenses as a matter of proper accounting practice.⁷⁷ When dealing with the 4½% contract of the American Telephone and Telegraph Company such a result is certainly correct as a matter of strict accounting. The Associated companies are constantly expanding their plant and much of the engineering service provided is connected with this change. Therefore it should be allocated to the construction account rather than to current operating expenses. With reference to other holding companies this result would not be so easy to justify, as they mostly follow the practice of separating their charges for current management from their charges for engineering supervision during construction.

⁷⁶ *Oklahoma Natural Gas Co. v. Corporation Commission of Oklahoma* (Okla. Supreme Court 1918) P. U. R. 1918 D, 515 (not reported elsewhere); *Re East St. Louis Light & Power Co.* (Ill. 1919) P. U. R. 1919 E, 379; *Muskegon Traction & Lighting Co. v. Grand Rapids, Grand Haven, & Muskegon Ry. Co.* (Mich. 1921) P. U. R. 1921 C, 583; *Intermountain Tel. & Electric Co. v. Mountain States Tel. & Tel. Co.* (Mont. 1917) P. U. R. 1918 C, 120; *Lehigh Valley Transit Co. v. New Street Bridge Co.* (Pa. 1919) P. U. R. 1919 C, 696.

⁷⁷ *Re San Diego Consolidated Gas & Electric Co.* (Cal. 1916) P. U. R. 1917 A, 930; *Re Mountain States Tel. & Tel. Co.* (Col. 1917) P. U. R. 1917 B, 198.

It is interesting to examine with somewhat greater detail the views of the Missouri Public Service Commission upon the treatment of contracts with affiliates in so far as they were reflected in its opinions during this period. During the first year of its existence the case of *McGregor-Noe Hardware Co. v. Springfield Gas & Electric Co.*⁷⁸ came before it. In this case a percentage of the gross income was paid to the holding company in return for managerial services. The commission announced that it could refuse to allow operating expenses even though they had actually been incurred if they were "excessive or unreasonable." As a test of reasonableness the commission investigated to determine whether the company could perform the services more cheaply for itself. Here the fee was completely disallowed on the ground that the managerial services were absolutely valueless to the local company since it already had a large and capable executive force. In a decision in the next year the commission actually used a test based on the saving to the local company (joint purchases, etc.); but stated that ordinarily the test should be the amount for which the local company could do the work itself or buy it in the open market.⁷⁹ The views of the commission were most fully expressed in the case involving the telephone rates charged in St. Louis by the Southwestern Telephone and Telegraph Company, an Associated Company of the Bell system now known as the Southwestern Bell Telephone Company. The commission refused to allow the 4½% contract. The value of the instruments furnished was determined and included in the rate base. The commission decided that the other services supplied by the American Company were absolutely valueless in view of the large, highly-paid, and efficient staff possessed by the local company.⁸⁰ In so far as the merits of this particular contract were concerned, the commission long regarded this decision as being "not final" but rather temporary until the commission should have time to investigate the nature of the services

⁷⁸(1914) 1 Mo. P. S. C. 468. No attempt is here made to cite every Missouri decision. They are treated largely under their proper heads.

⁷⁹*Commercial Club v. Missouri Public Utilities Co.* (1915) 2 Mo. P. S. C. 311. In a slightly earlier case where the utility bought coal from an affiliate, the commission allowed the charge but recommended economy. There was no showing of the relation between the price charged and the competitive price. *Weaver v. Kirksville Light, Power & Ice Co.* (1915) 2 Mo. P. S. C. 225.

⁸⁰In *Re Southwestern Tel. & Tel. Co.* (1915) 8 Mo. P. S. C. 43.

more fully.⁸¹ After a time the commission actually returned to the percentage method of figuring the proper charge. Somebody noticed that the formula used in the St. Louis case resulted in allowing 45% of the sum charged by the American company. It was easier to use this percentage than to value the instruments and calculate the sums necessary for depreciation, maintenance, and return. Hence by 1920 the commission had adopted this practice.⁸² This is thoroughly illogical, for the amount of gross revenue may vary considerably even though the same number of instruments are in use. Of course, increased use would increase maintenance, but it would not increase either depreciation or return. The St. Louis case was eventually carried before the Supreme Court of Missouri which approved the action of the commission.⁸³

Such was the state of the law in 1921 when the case of the *City of Houston v. Southwestern Bell Telephone Company*⁸⁴ was decided by the Supreme Court of the United States. The majority of commissions and courts considered the issue to be whether or not the contract price was reasonable, although they varied as to the means by which this issue was to be decided. A few decisions championed the view that the commission could not intervene unless an abuse of discretion was shown. Many commissions found ways to dodge the decision of the general question as to the power of the commission and still limit the allowance of particular charges. The burden of proof was upon the utility to justify sums claimed by it to have been expended as operating expenses. The Missouri commission was squarely in line with the great weight of authority and because of the time relation of some of its decisions might well be called a pioneer in this development.

THE PERIOD 1921-1923

It is now necessary to trace the development of the law during the period between the decision of the *Houston* case late in 1921 and the *Southwestern Bell* case late in 1923. The language used

⁸¹ Public Service Commission v. Southwestern Bell Tel. Co. (1919) 8 Mo. P. S. C. 487.

⁸² Re Kansas City Tel. Co. (1920) 10 Mo. P. S. C. 156.

⁸³ State ex rel. Southwestern Bell Tel. Co. v. Public Service Commission (Mo. 1921) 233 S. W. 425, reversed (1923) 262 U. S. 276, *infra* page ??.

⁸⁴ (1921) 259 U. S. 318.

by the Supreme Court in deciding the *Houston* case deserves to be quoted in full (in so far as it affects this point) :

It is contended by the City that no fair disclosure was made by the furnishing companies of their profits on the instruments and on the materials and supplies so furnished and that for this unique reason the company should not be heard in a court of equity and the case dismissed. It is true that the Company did not introduce proof to show what the profits of the two companies were, either upon the business done with it or upon their entire business, but it did introduce much evidence tending to show that the charges made and allowed for the services rendered and the supplies furnished by them was (sic) *reasonable and less than the same could be obtained from other sources*. Under the circumstances disclosed in the evidence, the fact that the American Telephone and Telegraph Company controlled the Company and the Western Electric Company by stock ownership is not important beyond requiring close scrutiny of their dealings to prevent imposition upon the community served by the Company, but the court recognized and applied this rule. Here again, the evidence introduced by the City was meager and indefinite, while that of the Company was exceptionally full and complete, and both contentions must be denied.

This language is highly significant. It clearly recognizes the right of the commission to disallow such contractual charges if they are not reasonable. It considers competitive cost as a sufficient test of reasonableness. Complete stock ownership is not a ground for disregarding the corporate entities, but only for closely scrutinizing the contracts. The case does not decide upon whom rests the burden of proof.

As might be expected after such a case the commissions and the courts which had long been asserting that the charges must be reasonable to be allowed continued to do so, using competitive cost as the proper test.⁸⁵ A few commissions considered that

⁸⁵ New England Divisions (1922) 66 I. C. C. 196; N. M. C. Ry. Co. v. A. T. & S. F. Ry. Co. (1923) 81 I. C. C. 718; Re Southern California Tel. Co. (Cal. 1921) P. U. R. 1922 C, 97; Re Pacific Electric Ry. Co. (Cal. 1921) P. U. R. 1922 C, 134; Re Great Western Power Co. (Cal. 1923) P. U. R. 1923 C, 545; City of Great Bend v. Southwestern Bell Tel. Co. (Kan. 1921) P. U. R. 1921 A, 321; Re Indiana Bell Tel. Co. (Ind. 1922) P. U. R. 1922 C, 348; Re Indiana Bell Tel. Co. (Ind. 1922) P. U. R. 1922 C, 758; In Re Carthage Gas Co. (1922) 12 Mo. P. S. C. 361; In Re Webb City & Carterville Gas Co. (1922) 12 Mo. P. S. C. 361; Re Northwestern Bell Tel. Co. (Neb. 1922) P. U. R. 1923 B, 112; Re Mountain States Tel. Co. (N. Mex. 1923) P. U. R. 1923 B, 352; Pavillion Natural Gas Co. v. Tri-County

cost to the affiliate performing the services was the proper test, at least where there was not an open competitive market from which a competitive price could be obtained.⁸⁶ In so doing they were probably going contrary to the implications of the *Houston* case, but an examination of the brief of the City of Houston in that case shows that they argued the case on the claim of the propriety of disregarding the corporate entity and did not consider the possibilities of attaining the result they desired by other means. Under such conditions the court may not have realized that no other organization was in a position to offer the services, particularly in research and engineering, which were supplied by the American Company under this contract. Moreover, the 4½% contract and the Western Electric Company contract were considered together and as to many items under the latter contract there was clearly a competitive market. Perhaps the most unusual reason for disallowing management contracts was advanced by the Oregon commission. It considered that they were conspiracies in restraint of trade and in violation of

Natural Gas Co. (N. Y. 1923) P. U. R. 1923 D, 630 City of Reading v. Reading Transit & Light Co. (Pa. 1921) P. U. R. 1922 A, 346; Re Knoxville Gas Co. (Tenn. 1922) P. U. R. 1922 E, 524; Dunn v. Rutland Ry., Light & Power Co. (Vt. 1923) P. U. R. 1923 C, 316; Virginia ex rel. City of Newport News v. Newport News Light & Water Co. (Va. 1923) P. U. R. 1923 D, 91; Re Crandon Tel. Co. (Wis. 1921) P. U. R. 1922 A, 164; Tomahawk v. Tomahawk Light, Tel. & Improvement Co. (Wis. 1921) P. U. R. 1922 A, 259. During this period the Interstate Commerce Commission made a series of investigations into the contracts certain roads had made for the repair of equipment. These contracts were criticized as being higher than competitive prices. Pennsylvania Railroad Co. (1922) 66 I. C. C. 694; Atlantic Coast Line Railroad Co. (1922) 66 I. C. C. 727; New York Central Railroad Co. (1922) 66 I. C. C. 732; Seaboard Airline Co. (1922) 69 I. C. C. 151; Erie Railroad Co. (1924) 93 I. C. C. 646. In the first of these cases Commissioner Potter dissented on the ground that the contracts could not be attacked as no bad faith was shown.

Several courts adopted the same test. New Jersey Central Traction Co. v. Board of Public Utility Commissioners (1921) 96 N. J. L. 90, 113 Atl. 692; Hardin-Wyandot Lighting Co. v. Public Utilities Commission (1923) 108 Oh. St. 207, 140 N. E. 779; State ex rel. Capital City Water Co. v. Public Service Commission (1923) 298 Mo. 524, 252 S. W. 446; State ex rel. Spokane v. Kuykendall (1922) 119 Wash. 107, 205 Pac. 3; cf. in accord: City of Cleveland v. Public Utilities Commission (1921) 102 Oh. St. 341, 131 N. E. 714; Ohio Mining Co. v. Public Utilities Commission (1922) 106 Oh. St. 138, 140 N. E. 103.

⁸⁶ Re Tucson Gas, Electric Light & Power Co. (Ariz. 1922) P. U. R. 1922 C, 658; Re Michigan State Tel. Co. (Mich. 1922) P. U. R. 1923 A, 30; Re New York Tel. Co. (N. Y. 1923) P. U. R. 1923 B, 545; Re Pacific Tel. & Tel. Co. (Ore. 1922) P. U. R. 1922 C, 248; Re Indiana Bell Tel. Co. (Ind. 1923) P. U. R. 1924 A, 1.

the Sherman and Clayton Anti-Trust Acts.⁸⁷ The present writer is unable to understand this view as he can see in these contracts no intent to restrain trade whether interstate or not. At worst they were mere attempts to secure secret profits at the expense of higher rates to the consumer.

There is one court decision which is generally cited as upholding the view that the commission cannot disallow operating expenses even though they be unreasonable. It says that the rates must be high enough to pay "all operating expenses" citing as authority the page of the *Springfield* case on which is found the passage that the commission is not the financial manager of the utility and cannot ignore operating expenses actually incurred unless an abuse of discretion is shown.⁸⁸ The point does not seem to have been seriously argued to the court and this was a mere passing reference.

There was considerable development in the law with respect to the question on whom rested the burden of proof. Without any thorough consideration several courts ruled that the burden of proof was on the commission to show that the charge was excessive and that the commission retained this burden even when the company affected sought to enjoin the enforcement of the commission's ruling.⁸⁹ The effect of this view was shown by the rulings of certain commissions which stated that they considered the charges as unreasonable, but that they could not obtain the books of the holding company and hence could not produce evidence that this was true.⁹⁰ Other commissions continued to follow the earlier rule that the burden was on the company throughout.⁹¹ Despite extensive litigation before the commissions beginning before 1915, it was not until 1923 that the American Telephone and Telegraph Company conceded temporarily that it was defeated and voluntarily offered evidence before a state commis-

⁸⁷ Re Pacific Tel. & Tel. Co. (Ore. 1922) P. U. R. 1923 A, 531.

⁸⁸ Petersburg Gas Co. v. City of Petersburg (1922) 132 Va. 82; 110 S. E. 533.

⁸⁹ Swan v. Public Utilities Commission (D. C. D. Kan. 1922) 298 F. 114; Home Tel. & Tel. Co. v. Public Service Commission (D. C. D. Ind. 1922) P. U. R. 1922 B, 478 (not official reported); City of Lima v. Public Utilities Commission (1922) 106 Oh. St. 379, 140 N. E. 147.

⁹⁰ Re Northwestern Bell Tel. Co. (Neb. 1922) P. U. R. 1923 B, 112; Re Tonapah Sewer & Drainage Co. (Nev. 1922) P. U. R. 1922 C, 434.

⁹¹ Re Indiana Bell Tel. Co. (Ind. 1922) P. U. R. 1922 E, 46; Department of Public Works v. Pacific Tel. & Tel. Co. (Wash. 1923) P. U. R. 1923 D, 113; Re West Union Gas Co. (W. Va. 1921) P. U. R. 1922 A, 657.

sion showing the cost of the services it performed for the associated companies. Even in this case, they contended that the cost was an irrelevant factor and that the value to the local company was all that mattered.⁹² The zeal of one Federal District Judge to follow what he believed was the ruling of the *Houston* case that the cost to the affiliate of rendering the services was immaterial led to one remarkable decision. Under it the commission could subpoena what witnesses it desired and force them to testify what would be a reasonable cost for rendering such services, cross-examining them as to the costs shown by the experience of the companies with which they were connected; but the commission could not subpoena the books of the American Telephone and Telegraph Company.⁹³ If the commission wished to find out the contents of these books, all it would have to do is subpoena the gentlemen who kept them.

THE PERIOD 1923-1930

Such was the law when the Supreme Court of the United States in 1923 decided the case of *Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission*.⁹⁴ This was a writ of error to the Supreme Court of Missouri which had upheld the ruling of the Missouri commission in the "St. Louis" case involving the disallowance as an operating expense of a large part of the 4½% contract charge on the ground that the services, if any, rendered under it were valueless to the local company. The case involved many other issues, but the majority opinion clearly indicated its disapproval of the action of the Missouri commission:

There is nothing to indicate bad faith. So far as appears plaintiff in error's board of directors has exercised a proper discretion about this matter requiring business judgment. It must never be forgotten that while the State may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the properties of the public utility companies and is not clothed with the general power of management incident to ownership. The applicable general rule is well expressed in *State Public Utility Commission*

⁹² Re Indiana Bell Tel. Co. (Ind. P. S. C. 1923) P. U. R. 1924 A, 1.

⁹³ Southern Bell Tel. & Tel. Co. v. Railroad Commission (D. C. E. D. S. C. 1923) 299 F. 615.

⁹⁴ (1923) 262 U. S. 276.

ex rel. Springfield v. Springfield Gas and Electric Co. 291 Ill. 209, 234:

"The commission is not the financial manager of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by the corporate officers."

This opinion written by Mr. Justice McReynolds represented the views of seven members of the Court. Justices Brandeis and Holmes concurred specially in the decision without mentioning this issue. This majority opinion is startling to say the least. We have seen that the Supreme Court of Illinois actually used the quoted words, but nevertheless upheld commission action exactly similar to that which the Supreme Court of the United States considers to be forbidden by these words. The whole doctrine upon which the earlier decisions of the Supreme Court itself in the *Wellman*,⁹⁵ *Galveston*,⁹⁶ and *Houston*⁹⁷ cases was based is overturned without even a passing reference to these cases. As we have seen there are cases which are actually precedents for this view but they are not cited.⁹⁸ Under this good faith test it would seem not to matter how excessive the prices paid were compared to the competitive cost of the services or supplies, provided only the board of directors were sufficiently stupid or inattentive not to realize that this was a fraud upon their own corporation. It gives incompetence full privilege to mismanage the property as it will and charge the cost of the folly to the consumer.⁹⁹

However, it is possible to understand, although not to approve, the reasons for the selection of these words. The counsel for the Southwestern Bell Telephone Company argued the case on the basis that the corporate entities involved could not be disregarded unless fraud was shown, using the same arguments which they had urged in vain before the commission and the Missouri

⁹⁵ (1892) 143 U. S. 339.

⁹⁶ (1921) 258 U. S. 388.

⁹⁷ (1921) 259 U. S. 518.

⁹⁸ They are discussed on page ?? and the following pages.

⁹⁹ The treatment of this case in Bonbright and Means recent book *The Holding Company* is very unsatisfactory. The authors think that this case follows the *Houston* case in applying the competitive cost test and that Justices Holmes and Brandeis strongly dissented on this subject. As a matter of fact the concurring opinion of Justice Brandeis (adopted also by Justice Holmes) did not mention this point, being solely concerned with the question of what is a fair value.

Supreme Court. The counsel for the City of St. Louis were primarily concerned with the question of the rate base. In their treatment of operating costs they too argued the case on the ground of disregarding the corporate entity, claiming that this was possible even where there was no fraud. Under such circumstances it is natural for the opinion to talk in terms of fraud. Furthermore the attention of all the justices seems largely to have centered upon the conflict between the majority and Justices Brandeis and Holmes on whether the rule of *Smyth v. Ames* should be abandoned in favor of the prudent investment theory of valuation. It was sufficient to authorize a reversal that the Court found that the valuation was too low under either theory.

The result of this decision was great confusion and uncertainty. Many commissions accepted the new order of things as imposed by a superior power,¹⁰⁰ although some grumbled much over this result.¹⁰¹ Other commissions accepted it without any seeming reluctance but took the precaution to investigate and hold that the charges involved could have been supported on the basis that they were no higher than competitive prices¹⁰² or were based upon the cost to the holding company.¹⁰³ Innumerable cases were before the lower federal courts during this period or were litigated in state courts. As might be expected in the inferior federal courts there was a tendency to blindly follow the

¹⁰⁰Re Indiana Bell Tel. Co. (Ind. 1926) P. U. R. 1926 C, 785; Re New England Tel. & Tel. Co. (Me. 1925) P. U. R. 1926 B, 247; Re Michigan Bell Tel. Co. (Mich. 1926) P. U. R. 1926 C, 607; Re New York Tel. Co. (N. Y. 1926) P. U. R. 1926 E, 1; Re New York Tel. Co. (N. Y. 1930) P. U. R. 1930 C, 325.

¹⁰¹Citizens' Association v. Chesapeake & Potomac Tel. Co. (D. C. 1924) P. U. R. 1924 D, 154; Re New England Tel. & Tel. Co. (Mass. 1925) P. U. R. 1925 E, 739; Public Service Commission v. Mountain States Tel. & Tel. Co. (Mont. 1924) P. U. R. 1924 C, 545; Re Northwestern Bell Tel. Co. (Minn. 1926) P. U. R. 1926 C, 624; In Re Southwestern Bell Tel. Co. (1924) 15 Mo. P. S. C. 58; Re Lincoln Tel. & Tel. Co. (Neb. 1929) P. U. R. 1929 E, 512; Re Lincoln Tel. & Tel. Co. (Neb. 1930) P. U. R. 1930 E, 438; Re New England Tel. & Tel. Co. (N. H. 1926) P. U. R. 1926 E, 186; Borough of Wyoming v. Luzerne Gas & Electric Co. (Pa. 1923) P. U. R. 1923 D, 80; City of Erie v. Mutual Tel. Co. (Pa. 1930) P. U. R. 1931 A, 169; Re New England Tel. Co. (Vt. 1926) P. U. R. 1927 B, 348; Re Chesapeake & Potomac Tel. Co. of West Virginia (W. Va. 1924) P. U. R. 1925 C, 570.

¹⁰²Re New England Tel. & Tel. Co. (Me. 1925) P. U. R. 1926 B, 247; Public Service Commission v. Mountain States Tel. & Tel. Co. (Mont. 1924) P. U. R. 1924 C, 545; New England Tel. & Tel. Co. (Vt. 1927) P. U. R. 1927 C, 348.

¹⁰³Re New England Tel. & Tel. Co. (Mass. 1925) P. U. R. 1925 E, 739; Re New York Tel. Co. (N. Y. 1923) P. U. R. 1923 B, 545; Public Utilities Co. v. New England Tel. & Tel. Co. (R. I. 1925) P. U. R. 1926 C, 207.

decision in the *Southwestern Bell* case,¹⁰⁴ but even in these bodies some reluctance was shown.¹⁰⁵ Some special masters in taking evidence made findings that the contracts were reasonable and also were made in good faith.¹⁰⁶ The state supreme courts tended to consider the problem more thoroughly, but even there the mere citation of the quoted passage from the *Southwestern Bell* case was normally considered as conclusive.¹⁰⁷ A result of the use of the good faith test was a sharp decline in cases in which those commissions even mentioned operating expenses. Practically, it was difficult or impossible to show an abuse of discretion; therefore there was no use wasting time in even discussing operating expenses.

A few commissions used various expedients to annoy holding companies whose charges the commission considered extortionate, although the commission stated that they could not directly interfere with these items. Thus, the California Railroad Commission refused to allow one of the Associated Companies of the Bell system to plead lack of money as a ground for failure to provide proper service in the Los Angeles district, then undergoing a boom expansion, pointing to the contractual obligation of the American Telephone and Telegraph Company to supply

¹⁰⁴ *Indiana Bell Tel. Co. v. Public Service Commission* (D. C. D. Ind. 1924) 300 F. 190; *Chesapeake & Potomac Tel. Co. v. Whitman* (D. C. D. Md. 1925) 3 F. (2d) 938; *Southern Bell Tel. & Tel. Co. v. Railroad Commission* (D. C. E. D. S. C. 1925) 5 F. (2d) 77; *Citizens Gas Co. v. Public Service Commission* (D. C. W. D. Mo. 1925) 8 F. (2d) 632; *New York & Richmond Gas Co. v. Prendergast* (D. C. E. D. N. Y. 1925) 10 F. (2d) 167; *Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission* (D. C. E. D. Mich. 1926) 11 F. (2d) 319; *Pacific Tel. & Tel. Co. v. Whitcomb* (D. C. W. D. Wash. 1926) 12 F. (2d) 279; *Brooklyn Borough Gas Co. v. Prendergast* (D. C. E. D. N. Y. 1926) 16 F. (2d) 651; *New York Tel. Co. v. Prendergast* (D. C. S. D. N. Y. 1929) 36 F. (2d) 54; *Michigan Bell Tel. Co. v. Odell* (D. C. E. D. Mich. 1930) 45 F. (2d) 180.

¹⁰⁵ *Chesapeake & Potomac Tel. Co. v. Whitman* (D. C. D. Md. 1925) 3 F. (2d) 938. Some Federal courts did not follow the *Southwestern Bell* case. They are cited in note 113.

¹⁰⁶ *New York & Richmond Gas Co. v. Prendergast* (D. C. E. D. N. Y. 1925) 10 F. (2d) 167; *Pacific Tel. & Tel. Co. v. Whitcomb* (D. C. D. Wash. 1926) 12 F. (2d) 279.

¹⁰⁷ *Columbus Gaslight Co. v. Public Service Commission* (1923) 193 Ind. 399, 140 N. E. 538; *State ex rel. Hopkins v. Southwestern Bell Tel. Co.* (1924) 115 Kan. 236, 223 Pac. 771; *Wichita Gas Co. v. Public Service Co.* (1928) 126 Kan. 220, 268 Pac. 111; *Michigan Public Utility Commission v. Michigan State Tel. Co.* (1924) 228 Mich. 658, 200 N. W. 749; *City of Cincinnati v. Public Utilities Commission* (1925) 113 Oh. St. 259, 148 N. E. 817; *City of Huntingdon v. Public Service Commission* (1926) 101 W. Va. 378, 133 S. E. 144.

all necessary funds.¹⁰⁸ Another device was sanctioned by the Virginia Court of Appeals. This involved the reduction of the allowance for going concern value on the ground that the holding company could easily reconstitute the local subsidiary.¹⁰⁹ A few commissions took the stand that payment of unreasonable sums was sufficient evidence of abuse of discretion.¹¹⁰ The Missouri Public Service Commission adopted the view that it would allow any other company that desired to do so to enter into competition with a public utility that bought gas from an affiliate. This decision said that the requirement of a certificate of convenience and necessity was designed to protect regulated monopolies, while such a company was essentially an unregulated monopoly.¹¹¹ Even in these times some local companies neglected to claim as operating expenses sums paid affiliated companies. Thus, in an application for a rate increase made in 1929 by the Laclede Gaslight Company no claim was made for the allowance of a management fee amounting to \$212,000.00 annually, although it was shown as paid on exhibits filed in the case.¹¹²

Many commissions and courts more or less boldly championed their former views that the commission might disallow operating expenses if they were shown to be unreasonable. In so doing the opinions do not explicitly state that they consider the *Southwestern Bell* case unsound; they merely do not apply its doctrine (even when they cite it as authority for what they are doing). In six cases inferior federal courts considered that the issue was whether or not the sums charged were reasonable, as tested by competitive costs, actually applying the test of the *Houston* case.¹¹³ The Missouri Supreme Court arrived at a similar conclusion by the use of some very interesting language:¹¹⁴

¹⁰⁸ Re Southern California Tel. Co. (Cal. 1923) P. U. R. 1924 C, 506.

¹⁰⁹ Chesapeake & Potomac Tel. Co. of Virginia v. Commonwealth (1927) 147 W. Va. 43, 136 S. E. 575. It was of course also possible to achieve a similar result by disregarding the corporate entities involved.

¹¹⁰ Re Indiana Bell Tel. Co. (Ind. P. S. C. 1923) P. U. R. 1924 A, 1; Re Citizens' Independent Tel. Co. (Ind. P. S. C. 1929) P. U. R. 1930 A, 431; Rexford Volunteer Fire Dept. v. Rexford Water Co. (Mont. P. S. C. 1929) P. U. R. 1929 E, 456.

¹¹¹ Re Industrial Gas Co. (Mo. 1928) P. U. R. 1929 A, 516.

¹¹² In Re Laclede Gaslight Co. (1929) 17 Mo. P. S. C. 206.

¹¹³ United Fuel Gas Co. v. Railroad Commission (D. C. E. D. Ky. 1925) 13 F. (2d) 511; United Fuel Gas Co. v. Public Service Commission (D. C. S. D. W. Va. 1926) 14 F. (2d) 209; Idaho Power Co. v. J. M. Thompson (D. C. D. Idaho 1927) 19 F. (2d) 547; New York Tel. Co. v. Prendergast (D. C. S. D. N. Y. 1929) 36 F. (2d) 54; Illinois Bell Tel. Co. v. Moynihan

But it must be kept in mind that the Commission's authority to regulate does not include the right to dictate the manner in which the company shall conduct its business. The company has a lawful right to manage its affairs and conduct its business in any manner it may choose, provided that in so doing it does not injuriously affect the public. The customers of a public utility have a right to demand efficient service at a reasonable rate, but they have no right to dictate the methods which the utility must employ in the rendition of that service. It is no concern of either the customers of the utility or the Commission if the water company obtains necessary material, labor, supplies, etc., for the holding company so long as the quality and price of the service rendered by the water company are what the law says they should be. . . . We cannot say that the holding company did not render valuable services to the water company, or that the 3% charged therefor was not a reasonable charge.

This language is a statement of the older orthodox view and yet the Court cites the *Southwestern Bell* case as authority.¹¹⁵

There are two decisions of the United States Supreme Court during this period which lent some comfort to the view that after all the correct test was the reasonableness of the charge. In *Bluefields Water Works & Improvement Co. v. West Virginia Public Service Commission*¹¹⁶ the rate of return was fixed upon the assumption that there must be "efficient and economical management." This case was decided the same year as the *Southwestern Bell* case and refers to the latter with reference to the proper method by which to determine a fair value. In 1929 the Supreme Court was called upon to decide a case in which the affiliate had been set up apparently to divert profits from the regulated public utility. Natural gas contains gasoline which may profitably be extracted therefrom before the gas is sold. The West Virginia commission had ruled that the utility business of the company must be credited with 50% of the profit

(D. C. N. D. Ill. 1930) 38 F. (2d) 77 (it was the appeal of this sub nom. *Smith v. Illinois Bell Tel. Co.* which finally settled the law); *West Ohio Gas Co. v. Public Utilities Commission* (D. C. N. D. Ohio 1930) 42 F. (2d) 899.

¹¹⁴ *State ex rel. City of St. Joseph v. Public Service Commission* (1930) 325 Mo. 209, 30 S. W. (2d) 8.

¹¹⁵ The only other authority cited was *Citizens Gas Co. v. Public Service Commission* (D. C. W. D. Mo. 1925) 8 F. (2d) 632 which merely quoted from the *Southwestern Bell* case.

¹¹⁶ (1923) 262 U. S. 679.

derived by the company from its own operations in extracting the gasoline. After this decision the holding company set up a separate affiliate which made a contract with the utility by which the affiliate was to extract the gasoline and give the utility only 12½% of the net profit. This arrangement was disallowed by the commission. A writ of error to the Court of Appeals of West Virginia was sued out after it had made a decision upholding the action of the commission. The Supreme Court upheld the action of the commission:¹¹⁷

We need not labor the point that a public service corporation may not make a rate confiscatory by reducing its net earnings by the device of a corporation unduly favoring a subsidiary or corporation owned by its stockholders. *Chicago & Grand Trunk Railway Co. v. Wellman* 143 U. S. 339. . . . We recognize that a Public Service Commission, under the guise of establishing a fair rate, may not usurp the functions of the company's directors and in every case substitute its judgment for theirs as to the propriety of the contracts entered into by the utility; and common ownership is not of itself sufficient ground for disregarding such intercorporate agreements when it appears that, *although an affiliated corporation may be receiving the larger share of the profits, the regulated company is still receiving substantial benefits from the contract and probably could not have secured better terms elsewhere.* *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission* 262 U. S. 276; *Houston v. Southwestern Bell Telephone Co.* 259 U. S. 319.

But this case is not of that class. It is not without significance that the West Virginia Court in considering this question had before it the previous findings of its Commission, based upon actual contracts for gasoline extraction, where the parties, dealing at arm's length, had agreed upon a 50% division. . . . Making allowance for the fluctuation in the market price and other common business hazards, we do not think it would be difficult to induce capital to seek investment upon the basis of this division of net earnings. In such circumstances we think no adequate reason is shown for not including in appellant's earnings 50% of the net proceeds from the gasoline extraction.

This language of Mr. Justice Stone is gratifying in that it at

¹¹⁷ This case also disposed of an appeal from a federal district court in the case of *United Fuel Gas Co. v. Railroad Commission*, cited above in note 113. It is generally styled *United Fuel Gas Co. v. Railroad Commission* (1929) 278 U. S. 300.

last recognizes the bearing of the *Wellman* case upon the point under discussion even though it cites that case for a point that it did not hold, since there was no reference to contracts unduly favoring other corporations in that case. It is somewhat startling to find the *Houston* and *Southwestern Bell* cases cited as affirming the same point when their language was so different. The case follows the competitive cost theory for determining reasonableness, but it does hint, particularly in the second of the quoted paragraphs at the application of a more objective test, based in part at least upon probable cost to the affiliate. The importance of this case was not recognized at the time.

The commissions which during this period refused to follow the good faith test of the *Southwestern Bell* case, representing by far the greater number, if we merely count the number of their decisions, did not reach any unanimous agreement with reference to the criteria by which reasonableness of the charge was to be determined. Many commissions found it sufficient to decide the case before them to hold that no valuable services whatsoever were rendered in return for the sums paid out. This conclusion could be drawn in either of two fact situations. In the first and simplest the affiliate merely did nothing at all which was for the benefit of the local company, although its existence might be beneficial to the holding company for its aid in supervizing the investment position of the holding company's stock interest in the local company.¹¹⁸ More frequently, the commission considered that the utility already had sufficient executives to perform the services if they would only work instead of leaving it all to the affiliate.¹¹⁹

¹¹⁸ Re Los Angeles Gas & Electric Co. (Cal. 1930) P. U. R. 1931 A, 132; Re Minier Tel. Co. (Ill. 1929) P. U. R. 1929 E, 235; Re Salomon Tel. Co. (Ind. 1930) P. U. R. 1930 E, 39; Re Johnson County Tel. Co. (Ind. 1930) P. U. R. 1931 A, 446; Re LaFontaine Tel. Co. (Ind. 1930) P. U. R. 1931 A, 94; Capital City Water Co. (Mo. 1928) P. U. R. 1928 C, 436; Re Cambridge Home Tel. Co. (Ohio 1930) P. U. R. 1930 E, 65; School Directors v. Highspire Water Supply Co. (Pa. 1926) P. U. R. 1926 D, 80.

¹¹⁹ Re Western States Gas & Electric Co. (Cal. 1924) P. U. R. 1924 D, 681; Re Rodeo-Vallejo Ferry Co. (Cal. 1925) P. U. R. 1925 E, 508; Home Tel. Co. (Ind. 1930) P. U. R. 1930 D, 481; Public Utilities Commission v. Gould El. Co. (Me. 1930) P. U. R. 1930 D, 289; Re Inter-County Tel. Co. (Mo. 1930) P. U. R. 1931 B, 5; Re Springfield City Water Co. (Mo. 1930) P. U. R. 1931 B, 80; Buck v. International Ry. Co. (N. Y. 1925) P. U. R. 1925 C, 782; Re International Ry. Co. (N. Y. 1927) P. U. R. 1927 D, 630; Knoxville v. South Pittsburg Water Co. (Pa. 1927) P. U. R. 1928 B, 206; Re West Virginia Central Gas Co. (W. Va. 1924) 1924 E, 24; Re Cumberland & Allegheny Gas Co. (W. Va. 1927) P. U. R. 1928 B, 20.

When such conclusions were not possible, most of the commissions followed the *Houston* case and adopted the competitive cost test.¹²⁰ Yet, many commissions recognized that this was impossible of practical application unless there was an open market for the services or supplies involved. Very frequently this did not exist. Under such conditions, these commissions based the sum allowed upon the cost to the affiliate plus a reasonable profit.¹²¹

With the commissions and the courts expressing such varied views as to the test by which to determine whether or not the charges should be allowed, it is not surprising that there was

¹²⁰ *Wayne Public Safety Ass'n v. Public Service Commission* (Pa. Super. Ct. 1928) P. U. R. 1929 A, 158; *Re River Falls Power Co.* (Ala. 1930) P. U. R. 1930 E, 97; *Re Mountain States Tel. & Tel. Co.* (Ariz. 1929) P. U. R. 1929 D, 414; *Re Public Service Co.* (Col. 1930) P. U. R. 1930 D, 21; *East St. Louis & Interurban Water Co.* (Ill. 1927) P. U. R. 1928 A, 57; *Re Home Tel. Co.* (1923) 14 Mo. P. S. C. 41; *Re Laclede Gaslight Co.* (Mo. 1929) P. U. R. 1929 A, 561; *Rexford Volunteer Fire Department v. Rexford Water Co.* (Mont. 1929) P. U. R. 1929 E, 456; *Ginocchio Brothers v. Board of County Commissioners* (Nev. 1923) P. U. R. 1924 A, 302; *Re Tonapah Sewer & Drainage Co.* (Nev. 1923) P. U. R. 1924 A, 837; *Re Logan Gas Co.* (Ohio 1928) P. U. R. 1929 A, 232; *Re Purcell-Lexington Toll Bridge Co.* (Okla. 1924) P. U. R. 1925 A, 253; *Re Coos & Curry Tel. Co.* (Ore. 1924) P. U. R. 1924 E, 344; *Herring v. Clark's Ferry Bridge Co.* (Pa. 1926) P. U. R. 1926 D, 514; *Nace v. McConnellsborg Water Co.* (Pa. 1926) P. U. R. 1926 E, 248; *Sharp v. Newville Water Co.* (Pa. 1928) P. U. R. 1929 B, 320; *Dept. of Public Works v. Pacific Power & Light Co.* (Wash. 1929) P. U. R. 1929 D, 55; *Re United Fuel Gas Co.* (W. Va. 1925) P. U. R. 1925 B, 705; *Re Ashland Water Co.* (Wis. 1924) P. U. R. 1925 A, 705; *Re Madison Ry. Co.* (Wis. 1928) P. U. R. 1928 C, 842; *Re Cheyenne Light, Fuel & Power Co.* (Wyo. 1930) P. U. R. 1930 E, 114.

In a few cases this comparison has taken the form of comparing the total expenses of supervision and allowing a lump sum for these items. *Re Houghton County Electric Light Co.* (Mich. 1923) P. U. R. 1924 B, 32; *In Re Capital City Water Co.* (1927) 16 Mo. P. S. C. 637; *Wood v. Elmira Water, Light & R. R. Co.* (N. Y. 1926) P. U. R. 1927 B, 400; *Minersville v. Minersville Water Co.* (Pa. 1926) P. U. R. 1926 E, 147.

¹²¹ *Re Southern California Tel. Co.* (Cal. 1924) P. U. R. 1925 C, 827; *Re Los Angeles Gas Co.* (Cal. 1927) P. U. R. 1927 C, 545; *Re Pacific Tel. & Tel. Co.* (Cal. 1930) P. U. R. 1930 C, 481; *Re Selectmen of the Town of Amesbury* (Mass. 1928) P. U. R. 1928 B, 581; *Re West St. Louis Water Co.* (1929) 17 Mo. P. S. C. 563; *City of Polson v. Public Utilities Consolidated Corp.* (Mont. 1929) P. U. R. 1929 E, 577; *Re New York Tel. Co.* (N. J. 1924) P. U. R. 1925 C, 767; *Re Logan Gas Co.* (Ohio 1928) P. U. R. 1929 A, 232; *Re Pacific Tel. & Tel. Co.* (Ore. 1924) P. U. R. 1924 D, 39; *Re New England Tel. & Tel. Co.* (R. I.) P. U. R. 1926 C, 207; *Re Chesapeake & Potomac Tel. Co.* (Va. 1926) P. U. R. 1926 E, 481; *Department of Public Works v. Pacific Power & Light Co.* (Wash. 1929) P. U. R. 1929 D, 54; *Re Wisconsin Tel. Co.* (Wis. 1925) P. U. R. 1925 D, 611; *Re Wisconsin Tel. Co.* (Wis. 1925) P. U. R. 1926 B, 628; *Re Wisconsin Tel. Co.* (Wis. 1926) P. U. R. 1927 A, 581; *Re City Water Co. of Marinette* (Wis. 1928) P. U. R. 1929 A, 243; *Re St. Croix Valley Tel. Co.* (Wis. 1929) P. U. R. 1929 B, 597.

hopeless conflict as to the issue of who must bear the burden of proof as to the necessary facts. When the *Southwestern Bell* case was followed and good faith made the determining factor, the decisions are unanimous in placing the burden upon the commission.¹²² Such a result is natural inasmuch as there is ordinarily a presumption that all persons act honestly. Moreover, it is implied from the very wording of the opinion of the Court in the *Southwestern Bell* case which says in the absence of specific evidence "There is nothing to indicate bad faith." Where the inquiry is whether or not the charge is reasonable, almost all commissions continued to hold that the burden was on the company to sustain its charges by proof meeting whatever criteria of reasonableness might be fixed by the commission.¹²³ Where the contract had been filed with the commission and no action taken on it, there was a tendency to allow the contract price until it was attacked in a direct proceeding.¹²⁴ By the weight of authority, the commission need not make the other contracting party a party to the proceedings before the commission.¹²⁵ If the burden of proof be placed upon the commission, it may desire to subpoena the books of the holding company. If it can secure valid service within the state upon the holding company, it can force the production of these books, provided they

¹²² *Northwestern Bell Tel. Co. v. Spillman* (D. C. D. Neb. 1925) 6 F. (2d) 663; *New York & Richmond Gas Co. v. Prendergast* (D. C. E. D. N. Y. 1925) 10 F. (2d) 167; *Re New England Tel. & Tel. Co.* (Me. 1925) P. U. R. 1926 B, 247; *Billings v. Billings Gas Co.* (Mont. 1924) P. U. R. 1924 C, 217; *Board of Railroad Commissioners v. Hughes Electric Co.* (N. D. 1924) P. U. R. 1925 A, 18; *Re New England Tel. & Tel. Co.* (N. H. 1926) P. U. R. 1926 E, 186. Such a view is implicit in the cases cited in notes 101-107.

¹²³ *Re Home Tel. Co.* (Ind. 1930) P. U. R. 1930 D, 481; *Public Utilities Commission v. Gould Electric Co.* (Me. 1930) P. U. R. 1930 D, 289; *Re Red River Power Co.* (N. D. 1923) P. U. R. 1923 E, 534; *Re Northern States Power Co.* (N. D. 1923) P. U. R. 1924 A, 325; *Re New York Tel. Co.* (N. J. 1925) P. U. R. 1925 C, 767; *Re Delaware & Atlantic Tel. Co.* (N. J. 1924) P. U. R. 1925 D, 60; *Re Dayton Power & Light Co.* (Ohio 1930) P. U. R. 1931 A, 332; *Alpha Portland Cement Co. v. Lehigh Navigation Electric Co.* (Pa. 1924) P. U. R. 1924 E, 737; *Re Point Pleasant Natural Gas Co.* (W. Va. 1927) P. U. R. 1927 B, 804; *Re Wisconsin Tel. Co.* (Wis. 1925) P. U. R. 1925 D, 660; *Re St. Croix Valley Tel. Co.* (Wis. 1929) P. U. R. 1929 B, 597.

¹²⁴ *New York & Queens Gas Co. v. Prendergast* (D. C. S. D. N. Y. 1924) 1 F. (2d) 351; *Public Service Commission v. Great Northern Utilities Co.* (Mont. P. S. C. 1929) P. U. R. 1929 B, 176.

¹²⁵ *Williams v. Southern Bell Tel. & Tel. Co.* (1932) 164 Tenn. 313, 47 S. W. (2d) 358; *Gunn v. Pacific Gas & Electric Co.* (Cal. 1926) P. U. R. 1927 B, 658; *Re Utility Gas Co.* (W. Va. 1925) P. U. R. 1926 A, 57; *contra: Municipal Gas Co. v. City of Wichita Falls* (Tex. 1923) P. U. R. 1924 B, 410.

are relevant to the inquiry being made by the commission.¹²⁶ However, if the holding company is not doing business within the state, the holding company is not subject to the jurisdiction of the state and cannot be validly served with process.¹²⁷ It is not enough that the holding company owns all the stock of a company which is doing business within the state.¹²⁸

THE PERIOD AFTER 1930

Such was the confused and uncertain state of the law, when the subject was at last clarified by another pronouncement of the Supreme Court of the United States. In December 1930 Chief Justice Hughes handed down the decision in *Smith v. Illinois Bell Telephone Co.*¹²⁹ The Court first ruled that mere complete stock ownership was not sufficient to authorize the disregarding of the corporate entity. The lower federal court had expressly found that the contract was made in good faith and that the services and supplies could not be obtained more cheaply elsewhere. Nevertheless the case was remanded for further findings with these words:

That fact (that the Western Electric Company's average annual profits had ranged between 7% and 10%) had evidentiary value but the finding does not go far enough. The Western Electric Company not only manufactured apparatus for the licensees of the Bell system, but engaged in other large operations and it cannot be merely assumed or conjectured that the net earnings on the entire business represent the net earnings from the sale to the Bell licensees generally or from those to the Illinois Company. Nor is the argument of the appellants answered by a mere comparison of the prices charged by the Western Electric Company to the Illinois Company with the higher prices charged by other manufacturers for comparable materials or by the Western Electric Company to independent telephone companies. The point of appellant's contention is that the Western Electric Company, through the organization and

¹²⁶ *Gilchrist v. Dahl* (1927) 130 Misc. 456, 224 N. Y. S. 210; *Marinette v. Menominee & Marinette Light & Traction Co.* (Wis. 1927) P. U. R. 1927 E, 708.

¹²⁷ *New Hampshire Gas & Electric Co. v. Morse* (D. C. D. N. H. 1930) 42 F. (2d) 490.

¹²⁸ *New Hampshire Gas & Electric Co. v. Morse*, above; *Philadelphia & Reading Co. v. McKibbin* (1917) 243 U. S. 264; *Cannon Mfg. Co. v. Cudahy Packing Co.* (1924) 267 U. S. 330. Of course, it may be possible to find conduct which will justify disregard of the corporate entity.

¹²⁹ (1930) 282 U. S. 133.

control of the American Company, occupied a special position with particular advantage in relation to the manufacture and sale of equipment to the licensees of the Bell system, including the Illinois Company, that is, that it was virtually the manufacturing department for that system, and the question is as to the net earnings of the Western Electric Company realized in that department and the extent to which, if at all, such profit figures in the estimate upon which the charge of confiscation is predicated. We think there should be findings upon this point. . . .

In view of the findings both of the State Commission and of the Court we see no reason to doubt that valuable services were rendered by the American Company, but there should be specific findings by the statutory court with regard to the costs of those services to the American Company and the reasonable amount which should be allocated in this respect to the operating expenses of the Illinois Company.

This decision is noteworthy. It rejects the doctrine of the *Southwestern Bell* case that good faith was the test. It also rejects under the special circumstances here alleged the doctrine of the *Houston* case that comparative costs were a sufficient criterion to determine reasonableness. Where there is no competitive market in which all sellers have equal opportunities, it demands a finding as to the costs of the affiliated seller and would apparently allow the sum fixed as reasonable to be based on these (at least if below the competitive price). In fixing this cost, the Court would apparently allow a reasonable profit to the affiliate. Since there must be a finding in order to obtain a permanent injunction, it practically places the burden of proof on the utility to show these costs, for if they are not shown the permanent injunction must be denied and the temporary injunction will fall when the case is finally dismissed. However, it is erroneous to consider this decision as revolutionary or a radical innovation as some have done.¹³⁰ We have seen that it is a mere return to the sound principles which prevailed before the springs of judicial wisdom were muddled by the *Houston* and *Southwestern Bell* opinions.

¹³⁰ Both Professor Bonbright and Mr. Lillienthal (then chairman of the Wisconsin commission, now a member of the Tennessee Valley Authority) fell into this error. Lillienthal, *Recent Developments in the Law of Public Utility Holding Companies*, (1931) 31 Col. L. R. 189, and Bonbright, *Comment thereon*, at 208.

The burden of proof of the reasonableness of the charges involved is on the local company. This is the clear intimation of *Smith v. Illinois Bell Telephone Company* where a finding on the subject of cost is made a condition precedent to a valid permanent injunction. Obviously there can be no finding if there is no evidence; therefore it becomes the duty of the local company to produce the evidence upon which a finding can be based or it will not get the permanent injunction it is seeking. The commissions have adopted this view to cases before them by requiring similar proof by the local utility.¹³¹ This is, of course, the mere reaffirmance of what we have seen to be the doctrine which prevailed in almost all states in which the test of reasonableness was used prior to the *Smith* case. Whatever doubts may have once existed on this subject ought to have been forever set at rest by the language used by the Supreme Court of the United States in February 1932 in deciding the case of *Western Distributing Co. v. Public Service Commission of Kansas*.¹³²

Having in mind the affiliation of buyer and seller and the unity of control thus engendered, we think the position of the appellees (the commission) and that the court below was right in holding that if the appellant (the local company) desired an increase of rates it was bound to offer satisfactory evidence with respect to all the costs which entered into the ascertainment of a reasonable rate. Those in control of the situation have combined the interstate carriage of the commodity with its local distribution into what is in practical effect one organization. There is an absence of arms' length bargaining between the two corporate entities involved and of all the elements which ordinarily go to fix market value. The opportunity exists for one member of the combination to charge the other an unreasonable rate for the gas furnished and thus to make such unfair charge in part the basis of the retail rate. The state authority

¹³¹ *California Farm Bureau Federation v. San Joaquin Light & Power Co.* (Cal. 1932) P. U. R. 1932 D, 310; *Re Atlanta Gaslight Co.* (Ga. 1931) P. U. R. 1931 E, 461; *Re Cayuga Omnibus Corp.* (N. Y. 1931) P. U. R. 1931 C, 238; *Re Columbus Gas & Fuel Co.* (Ohio 1932) P. U. R. 1933 A 337, and confer cases cited in notes 133 to 143 below, where similar views are implied.

¹³² (1932) 285 U. S. 119. A similar result was reached in a decision handed down a few days latter by a federal district court. *International Railway Co. v. Prendergast* (D. C. W. D. N. Y. 1932) 1 F. Supp. 623.

whose powers are invoked to fix a reasonable rate are certainly entitled to be informed whether advantage has been taken of the situation to put an unreasonable burden upon the distributing company, and the mere fact that the charge is made for an interstate service does not constrain the Commission to desist from all inquiry as to its fairness. Any other rule would make possible the gravest injustice, and would tie the hands of the state authority in such fashion that it could not effectively regulate the intrastate service which unquestionably lies within its jurisdiction. . . .

The argument is made that the proofs demanded by the Commission will involve an extensive and unnecessary valuation of the pipe line company's property and an analysis of its business, and that this burden should not be thrown upon the appellant. Whether this so, we need not now decide. It is enough to say that in view of the relation of the parties and the power implicit therein arbitrarily to fix and maintain costs as respects the distributing company which do not represent the true value of the service rendered, the state authority is entitled to a fair showing of the reasonableness of such costs, although this may involve a presentation of evidence which would not be required in the case of parties dealing at arms' length and in the general and open market, subject to the usual safeguards of bargaining and competition.

It will of course be observed that the language used in this case does not hold that the allowable price to be charged by the affiliate must not be more than a fair return upon a fair value. Instead, the word "cost" is used which would ordinarily signify a definite bookkeeping figure based either on the historical cost of the particular property involved, or upon the amount of capital that would be required to reproduce a plant capable of furnishing the same service or commodity under present conditions. The controversy between the Cities Service Company and the Kansas Public Utilities Commission over the so-called city gate rates at which the pipe-line companies sold gas to the local distributing companies continued even after this decision. The Commission proceeded to value the property of the affiliated natural gas-producing companies in the same manner as it would value any ordinary public utility property and issued an order restraining the local distributing companies from setting up on their books any payments to these companies in excess of what the Commission found to be a fair price for the natural

gas supplied.¹³³ The Federal District Court granted an injunction,¹³⁴ but this action was reversed by the Supreme Court on the ground that there was no irreparable injury since order did not fix new rates based upon this new and reduced statement of operating expenses but was only a step towards such an order which had not yet been made.¹³⁵

Meanwhile the legal principles involved in such cases were settled by two cases involving appeals from the Supreme Court of Ohio. In the case of *Dayton Power & Light Company v. Public Utilities Commission* (decided on April 30, 1934)¹³⁶ the Ohio Commission had valued the property of the affiliated producing and transportation companies as though they were part of the local public utility whose rates were subject to commission control. The Ohio Supreme Court had sustained this action of the Commission but had reversed the decision on the ground that the commission had improperly allowed the deduction of an amortization charge as to natural gas leases. The decision of the Supreme Court of the United States affirmed the action of the Commission. The company contended that the rates charged in the contract between the affiliated companies were binding, but Justice Cardozo stated: "They were not dealing at arm's length and the prices they fixed in their inter-company transactions were of no concern to the consumers unless kept within the bounds of reason." It must be confessed that this language, standing alone, would not have been a great aid in reaching a proper determination, but when explained by the course of action sanctioned by the Court, it is clear that the highest allowable price to be charged by the affiliate cannot exceed a fair return upon a fair value of the affiliate's property. In a factually connected case decided slightly later in the same term, this was expressly stated to be the law.¹³⁷

The commissions had in general been following this doctrine even before these decisions.¹³⁸ In some cases the opinions still

¹³³ Re *Cities Service Co.* (Kan. 1932) P. U. R. 1933 A, 113.

¹³⁴ *Wichita Gas Co. v. Public Service Commission* (D. C. D. Kan. 1933) 3 F. Supp. 722.

¹³⁵ *State Corporation Commission v. Wichita Gas Co.* (1934) 54 S. Ct. 321.

¹³⁶ (1934) 54 S. Ct. 647.

¹³⁷ *Columbus Gas & Fuel Co. v. Public Utilities Commission* (1934) 54 S. Ct. 764.

¹³⁸ *Montana Public Service Commission v. Billings Gas Co.* (Mont. 1933) P. U. R. 1933 D, 337; Re *Illinois Power Co.* (Ill. 1931) P. U. R. 1932 A, 122;

speak of "cost," but a reading of these opinions clearly shows that the affiliate either bought the electric current or natural gas supplied from other non-affiliated companies or produced the electric current under such circumstances that the fuel and labor costs were almost the sole elements to be considered.¹³⁹ There seems to have been no realization that the affiliate which produces the electric current or natural gas is not a public utility, has not dedicated its property to public use and hence could not be compelled to continue to supply electric current or natural gas. It is, of course, true that in a time of depression a natural gas pipe line is glad to continue to sell to a local distributing company, but in a time of industrial expansion it may well be that the entire capacity of the pipe-line could be sold to a few large industries along its route. If the demand was sufficient to allow charging these industries a high price for natural gas, it might well pay the holding company to shut off the flow of natural gas to the local distributing company (which could not meet such a price, as it is assumed to be more than a fair return upon a fair value of the property of the producing companies). This would involve the financial ruin of the local company, but the greater profits to its other subsidiaries might more than repay this loss to the holding company.

Re Columbus Gas & Fuel Co. (Ohio 1931) P. U. R. 1931 C, 244; Re East Ohio Gas Co. (Ohio 1934) 4 P. U. R. (N. S.) 433; Re Lone Star Gas Co. (Okla. 1933) P. U. R. 1933 C, 1; Re United Gas System (1934) 4 P. U. R. (N. S.) 285.

The Missouri Commission in November 1932 accepted tentatively the contract figure for electric current supplied by an affiliate even though it was at a rate higher than paid by other companies in similar situations, saying there was "no evidence in this case which would justify the Commission in impugning the reasonableness of this contract. Re Missouri Utilities Co. P. U. R. 1932 E, 449. This probably represents an oversight by the commission. In a case in which the return which would have to be allowed if a fair return on a fair value was to be used was fifty percent higher than the agreed rental, the New York Commission held that the agreed rental was the maximum that should be allowed. Re Yonkers R. R. Co. P. U. R. 1933 B, 61. The lower Federal court in Central Kentucky Natural Gas Co. v. Public Service Commission (D. C. E. D. Ky. 1932) 60 F. (2d) 137 thought the agreed rental was probably the correct figure to use, but agrees to value the property concerned and allow a fair return on it as this would be more advantageous to the consumers and the company insists. This case was reversed outright by the Supreme Court on the ground the lower court had lost jurisdiction when it had set aside the original rates and could not now go ahead and fix new rates.

¹³⁹ Hopper v. Lassen El. Co. (Cal. 1932) P. U. R. 1933 B, 277; Marlborough v. Marlborough El. Co. (Mass. 1934) 4 P. U. R. (N. S.) 86; Commonwealth ex rel. Rosslyn Gas Co. (Va. 1933) 3 P. U. R. (N. S.) 61; City of Wheeling v. Natural Gas Co. (W. Va. 1933) P. U. R. 1933 D, 1.

The problem of the correct treatment of management contracts, charges for intangible services, and charges for materials sold to the local company is far more difficult than that presented by contracts involving the supply at wholesale to the local utility of the very thing the local utility is retailing to the public.

It may be worthwhile to examine in some detail the manner in which the courts and the commissions have dealt with the license contract binding the Associated Companies of the Bell system to their parent and the privilege which this contract gives to its signers to purchase supplies from the Western Electric Company as special rates below those charged to outsiders. At one extreme is the action of the Massachusetts commission which allowed the charges with the mere statement that they had been before the commission in 1925 and were not "detrimental" to the local telephone company.¹⁴⁰ The only authority cited for this method of treating these charges is the outmoded *Southwestern Bell* case. The other extreme is represented by the Oregon commissions which has recently forbidden any payments under the license contract.¹⁴¹ The lower court to which the Illinois Bell Telephone Company case was returned for further findings referred the whole subject to a special master. He took considerable testimony and was furnished with many exhibits. Thereafter the court made detailed findings concerning the total cost to the American Telephone and Telegraph Company of performing the various services performed by it. With the exception of a claim for an allowance for loss of interest occasioned by the fact that the American Company kept large sums in short term securities so as to be able to meet any demand for funds by the Associated Companies, the court allowed all the various items claimed by the American Company as proper items of expense under the license contract. During

¹⁴⁰ Re New England Tel. & Tel. Co. (Mass. 1934) 5 P. U. R. (N. S.) 333.

¹⁴¹ Re Pacific Tel. & Tel. Co. (Ore. 1933) 2 P. U. R. (N. S.) 384. This order was under the new Oregon Statute (Laws 1933 ch. 641) giving the Commission authority to reject in advance any expenditure and barring the setting up of such expenditures as operating expenses in a rate case and further providing as to any expenditure which the Commission deems "imprudent and unwise" the Commission may forbid the payment of the money involved out of the corporate treasury. The same order set up a wholly new and reduced salary schedule which the commission said was the maximum it would allow as operating expenses. The effective date of this order was postponed from time to time, but it is now in force. Public Utilities Fortnightly for Nov. 22, 1934 at 702.

the earlier years of the period under scrutiny the payments under the license contract were considerably in excess of the expense of rendering the service, but during 1931 and 1932 the cost of rendering the service was more than the payments under the license contract. The court also investigated the prices charged by Western Electric. It found that they were always below the competitive prices at which Western Electric sold the same articles to non-signatories of the license contract and were also always below the prices at which the same goods could be purchased on the open market. The court further found that the profits of Western Electric were not unreasonably large. Nevertheless, the court disallowed a ten per cent. price increase which had been put in effect in 1930. The ground for this action was the fact that general commodity prices were declining at the time. This course seems indefensible, if cost to the affiliate is to be criteria, for due to declining volume Western Electric profits were dwindling away so that it is at present operating at a deficit.¹⁴² Both parties appealed from this decision to the Supreme Court. Unfortunately for the legal student the Supreme Court found it unnecessary to pass upon this part of the lower court's decision, because it found that the depreciation charge claimed by the company as part of its operating expenses was so excessive as compared to actual experience as to invalidate the whole claim of the company that the commission's rates were not high enough to yield a fair return.^{142a} Perhaps the most thorough analysis of the problem is in the opinion of the Ohio Commissions handed down in January 1934.¹⁴³ This follows the ruling of the statutory court with reference to the disallowance of the ten per cent price increase by Western Electric, but makes a detailed study of the allowability of various classes of expenses incurred under the license contract. The following table setting forth the situation with reference to the year 1931 (the last year for which detailed figures were available) shows the result of this study:

¹⁴² *Illinois Bell Tel. Co. v. Gilbert* (D. C. N. D. Ill. 1933) 3 F. Supp. 595.

^{142a} *Lindheimer v. Illinois Bell Tel. Co.* (1934) 54 S. Ct. 658.

¹⁴³ *Re Ohio Bell Tel. Co.* (Ohio 1934) 2 P. U. R. (N. S.) 113.

Class of Expense	Amount Allowed	Amount Disallowed
Operations	164,528	
Research	235,932	102,068
Information (Advertising)		52,365
Personnel	33,886	5,674
Public Relations		1,483
Treasurer's Department	1,260	58,949
Comptroller's Department	30,505	31,810
Secretary's Department		2,038
General Administration	12,923	12,922
General Service Bureau	9,535	9,535
General Operations		10,071
Legal	31,437	
	520,006	286,915

It may be useful to examine the reasons assigned for the various sums disallowed. The Commission took a narrow view of the field of research which might profitably be investigated with reference to the improvement of the telephone and refused to allow any expenses in connection with the development of equipment for picture transmission, television, radio transmission, submarine cables, or vacuum tubes. The advertising and public relations costs were disallowed on the ground that they were for the benefit of the system as a whole, while the disallowances in the other departments were all on the basis that the work performed was for the benefit of the American Company rather than for the benefit of the local company. The Commission refused to allow any sum as a reserve to protect against liability for patent infringements, on the ground that there had been no successful claims against any of the Associated Companies since 1925 and that hence such a reserve was unnecessary. None of the other commissions and court which have considered the license contract have been as drastic as this,¹⁴⁴ although the District of Columbia Commission has disallowed seventy-five per cent of the amount spent for research on the ground that it

¹⁴⁴ *Chesapeake & Potomac Tel. Co. v. West* (D. C. D. Md. 1934) 3 P. U. R. (N. S.) 341; *Southwestern Bell Tel. Co. v. San Antonio* (D. C. D. Tex. 1933) 2 F. Supp. 611 (license contract accepted, but injunction denied because of failure of proof as Western Electric prices—no examination made of large unused depreciation reserves and inventory write-downs).

should be charged to capital rather than to current operations since it was primarily concerned with the invention of new equipment.¹⁴⁵

It would not pay to examine in similar detail the treatment accorded to the management contracts of other holding companies. In many cases they have been disallowed on the ground that no services were rendered under the contracts, or if any services were in fact performed, they were solely for the benefit of the holding company in enabling it to keep a better watch on its investment.¹⁴⁶ In other instances, sums roughly approximating the cost of rendering the service have been allowed.¹⁴⁷ In a few instances, the way has been made easy for the disallowance of management fees by the failure of the holding company to charge them until a petition for reduction of rates was filed.¹⁴⁸

¹⁴⁵ Re Chesapeake & Potomac Tel. Co. (D. C. 1934) 4 P. U. R. (N. S.) 346. An earlier opinion had assigned only forty percent to capital (1932) P. U. R. 1932 E, 193. Both cases disallow the ten percent price increase on Western Electric products.

¹⁴⁶ Re Cities Service Co. (Kan. 1932) P. U. R. 1933 A, 113 (as to payments to Doherty & Co.); New York State Electric & Gas Co. (N. Y. 1932) P. U. R. 1932 E, 1; Re Kentucky-Tennessee Light & Power Co. (Tenn. 1932) P. U. R. 1932 E, 386; Texas Border Gas Co. (Tex. 1933) 2 P. U. R. (N. S.) 503; Lone Star Gas Co. (Tex. 1933) 4 P. U. R. (N. S.) 541.

¹⁴⁷ Re Victor Water Works (Cal. 1932) P. U. R. 1932 D, 29; Re Portland Water Co. (Conn. 1934) 4 P. U. R. (N. S.) 265; Re Cities Service Co. (Kan. 1932) P. U. R. 1933 A, 113; Re Illinois Power Co. (Ill. 1932) P. U. R. 1932 A, 124; Marlborough v. Marlborough El. Co. (Mass. 1934) 4 P. U. R. (N. S.) 86; Re Western Light & Power Co. (Mo. 1931) P. U. R. 1932 C, 188; Re St. Joseph Water Co. (Mo. 1933) 4 P. U. R. (N. S.) 541; Re Long Island Water Co. (N. Y. 1934) 4 P. U. R. (N. S.) 541; Re Scranton Spring Brook Water Service Co. (Pa. 1934) 4 P. U. R. (N. S.) 541; Re Columbus Gas & Fuel Co. (Ohio 1931) P. U. R. 1931 C, 244; Re Western Ohio Public Service Co. (Ohio 1931) P. U. R. 1931 D, 1; Re Warren Tel. Co. (Ohio 1931) P. U. R. 1932 A, 416; Re Broad River Power Co. (S. C. 1933) P. U. R. 1933 C, 351; Re Kentucky Tennessee Light & Power Co. (Tenn. 1932) P. U. R. 1932 E, 386; Re Gray's Harbor Ry. & Lt. Co. (Wash. 1931) P. U. R. 1932 A, 140; Re Oregon-Washington Water Service Co. (1934) 4 P. U. R. (N. S.) 541; Re United Fuel Gas Co. (W. Va. 1931) P. U. R. 1932 B, 61; City of Wheeling v. Natural Gas Co. (W. Va. 1933) P. U. R. 1933 D, 1; Re La Crosse Tel. Co. (Wis. 1931) P. U. R. 1931 C, 81; Re Community Tel. Co. (Wis. 1931) P. U. R. 1931 C, 285; Re Mautson Tel. Co. (Wis. 1933) P. U. R. 1933 E, 161.

¹⁴⁸ Donnelly v. Consolidated Water Co. (N. Y. 1933) 3 P. U. R. (N. S.) 173; Re Seattle Gas Co. (Wash. 1934) 3 P. U. R. (N. S.) 433; Re Panhandle Lumber Co. (Wash. 1934) 4 P. U. R. (N. S.) 307.

The decision in Logan v. Public Utility Commission (1931) 77 Utah 442,296 Pac. 1006 that the commission could not disallow any contract charge unless it could show an abuse of discretion simply ignores the ruling of the Supreme Court in *Smith v. Illinois Bell Tel. Co.* The Utah court gives no argument to support its views, being content with the statement they represent well settled law.

Of great practical importance to the utility is the scope of the evidence which it must submit. If the required evidence is too detailed, it will involve great expense in its preparation and even greater inconvenience to the affiliate because of the disorganization of records necessary to prepare the required schedules and exhibits. Perhaps the most extreme example of the requirement of too great detail is the Montana commission's order which requests detailed invoices for each specific service rendered by each accountant, engineer, lawyer, or other official of the holding company which was managing the local company under a management contract.¹⁴⁹ This would apparently involve the absurdity of these officials punching a time clock each time they began another problem, so that they might accurately determine how long it took them to solve it. Moreover, there would be no method under this system of invoices to make any allowance for stand-by service furnished by the officials of the affiliate. The mere fact that the affiliate has persons capable of answering the questions of the local company as they arise saves the local company the expense of maintaining a staff of experts whose services would be vitally necessary at times but would rarely be used.¹⁵⁰ In the course of an inquiry into statewide telephone rates the Wisconsin commission issued a very sweeping series of demands for information. An idea of the mass of material required may be given by the fact that one item was a detailed statement of the manufacturing cost of each kind of article sold to the Wisconsin Telephone Company by the Western Electric Company between 1916 and 1930.¹⁵¹ Similar requests were made by the special master who was hearing evidence with reference to granting a permanent injunction against the enforcement of the orders of the Michigan commission requiring a rate reduction by the Michigan Bell Telephone Company.¹⁵² On the other

¹⁴⁹ *City of Polson v. Public Utilities Consolidated Corp.* (Mont. P. S. C. 1929) P. U. R. 1929 E, 557.

¹⁵⁰ Charges for such service were disallowed in *Re Los Angeles Gas & Electric Co.* (Cal. 1930) P. U. R. 1931 A, 132. The commission did not give this factor any real consideration, perhaps because the local company had not introduced any evidence as to the reduction that it had been able to secure in its operating expenses.

¹⁵¹ *Re Wisconsin Tel. Co.* (Wis. 1931) P. U. R. 1931 E, 101.

¹⁵² *Michigan Bell Tel. Co. v. Michigan Public Utilities Commission* (D. C. E. D. Mich. 1931) P. U. R. 1931 F, 222. The printed reports do not give the full terms of the requests, but they were before the Wisconsin Commission when it made its order, and the Wisconsin Commission states that they were substantially identical with those made by it.

hand the Ohio commission expressly indicated a desire to be more moderate in its demands. With reference to the same situation it only required a statement of the standard shop costs for each class of items. These were to be stated in lump sums and the amount of the profit involved stated in general percentages.¹⁵³ The subsequent history of the Wisconsin case is an example of the difficulties which may come from too sweeping demands. The company submitted the required evidence within the time allotted, but when the commission handed down an opinion a year later ordering a temporary reduction in rates, it confessed that it had not yet had time to study this evidence.¹⁵⁴ Meanwhile the evidence is rapidly becoming outmoded, as rates are based on present conditions rather than what existed two or more years ago. In some instances, this difficulty may be avoided by adopting the findings of the commission of some neighboring state as to the value of the property of the affiliate within that state.¹⁵⁵ With reference to the item of expense the commission should always remember that in the long run, it is the customers who pay for the increased cost of rate hearings, as these costs may be included in operating expenses, although they must be amortized over a period of years and cannot all be charged off in the year incurred.¹⁵⁶

Recently the commissions have undertaken to reach out and extend their control so as to forbid the utility to pay out money to an affiliate without prior approval of the terms of the contract. In large part this power has been conferred by a series of special statutes.¹⁵⁷ These statutes vary from state to state.

Most of these statutes contain express definitions of what is meant by the term affiliate. The original New York act passed in 1930 made the criteria direct or indirect ownership of more

¹⁵³ Re Ohio Bell Tel. Co. (Ohio 1932) P. U. R. 1932 D, 33.

¹⁵⁴ Re Wisconsin Tel. Co. (Wis. 1932) P. U. R. 1932 D, 173.

¹⁵⁵ Re Columbus Gas & Fuel Co. (Ohio 1932) P. U. R. 1932 A, 337.

¹⁵⁶ Mobile Gas Co. v. Paterson (D. C. M. D. Ala. 1923) 293 F. 208; Streater Acqueduct Co. v. Smith (D. C. S. D. Ill. 1923) 295 F. 385; State Public Utilities Commission ex rel. Springfield v. Springfield Gas & Electric Co. (1920) 291 Ill. 209, 125 N. E. 891.

¹⁵⁷ Ala., Laws 1932 (extra sess.) pp. 233-238; R. S. Ind. (Burns) ch. 54 sec. 403; R. S. Kan. (Supp. 1931) ch. 74 sec. 102; N. Y. Public Service Law sec. 110 (3); N. C. Code (Michie 1931) sec. 1037e; Ore. Laws 1933 pp. 815-817; Pa., Laws 1933 pp. 1535-1536; S. C. Laws 1932 p. 1504; Va. (Supp. 1934) sec. 3774b-3774k; Wis. (Code 1933) ch. 196 sec. 52; Wash., Laws 1933 p. 549. The South Carolina Statute only applies to electrical utilities.

than 10% of the voting stock of a utility, membership in a group or chain of companies connected by such ownership any one or more of which owner 10% of the voting stock of the utility, having one or more officers or directors who are also officers or directors of the utility, or being in a position either alone or with others with whom concert of action exists to substantially influence the utility. This provision was copied in a several other states.¹⁵⁸ The original Wisconsin statute and the present law of New York reduce the amount of stock to 5% of the voting stock. This is also the law in Alabama, Oregon, and Washington. The Virginia and Oregon laws require two or more officers or directors in common before affiliation exists on this ground alone. The definitions in some of the statutes are less exact.¹⁵⁹ These statutes all provide that the commission shall have access to the books of the affiliate and can force it to file reports in a form prescribed by the commission. Of course, if the affiliate is not doing business within the state so as to be subject to the jurisdiction of the state, these statutes can have no effect because of the fundamental principle that the statutes of a state cannot be given extraterritorial effect.¹⁶⁰ However, as we have seen, this difficulty is more apparent than real, since it would prove difficult for the affiliate to do much for the utility without having agents in the state, except in cases in which the affiliate sold gas or electricity to the utility and made delivery at a point outside the state. These statutes attempt to give the commissions power to approve or disapprove the contracts made by the utility with the affiliate. If the commission disapproves, payment is to be stopped.¹⁶¹ In some instances approval by the commission is made a condition precedent to the validity of the contract.¹⁶²

¹⁵⁸ Kansas, Indiana, Pennsylvania, and Virginia.

¹⁵⁹ The present North Carolina statute and the first Oregon statute (Laws 1931 ch. 103 sec. 9) made the possession of a "controlling" interest in the utility decisive. This might be interpreted to require ownership of 51% of the voting stock. The South Carolina statute requires a finding of "reasonably substantial affiliation" based on "reasonably substantial control."

¹⁶⁰ This is a fundamental principle of Anglo-American Law. *Pennoyer v. Neff* (1877) 95 U. S. 714.

¹⁶¹ Under the Oregon act the commission can exclude from the accounts if it finds them unreasonable but can only prohibit payment if it finds them "imprudent and unwise." The Alabama, North Carolina, and South Carolina statutes are silent on this point.

¹⁶² This is true except in Alabama, North Carolina, and South Carolina.

No cases have yet arisen in which courts have been called upon to determine the validity of commission action under these statutes.¹⁶³ It must be confessed that they go much further than the precedents derived from the power of the commission to disallow operating expenses justify. In these cases it is expressly stated that the decision of the commission in no way affects the validity and binding force of the contractual arrangement and therefore the affiliate is not a proper party to the proceedings before the commission.¹⁶⁴ Yet, there are analogies upon which this control may be supported. Commissions have power to supervise the issuance of securities by the utilities and have power to grant or refuse certificates of convenience and necessity authorizing or even compelling the utility to extend its lines so as to serve other persons.¹⁶⁵ These involve interference in questions of management which are no more drastic than the exercise of a power to forbid the making of such contracts. Statutes of such a nature but with special and limited application have existed for a considerable time in some jurisdictions. Commissions have exercised power under them and this has never been challenged in court.¹⁶⁶ The reason for giving the commissions such a power has well been expressed by the Alabama commission:¹⁶⁷

¹⁶³ In denying a motion to dismiss proceedings seeking injunctive relief against action by the New York Commission, a judge of the New York Supreme Court held that the Commission could not forbid payments under contracts made prior to the passage of the New York statute. *New York State Electric & Gas Corp. v. Maltbie* (1933) 264 N. Y. S. 97. The Ohio Supreme Court has recently sustained the action of the Commission (P. U. R. 1933 D, 482) in forbidding the payment of unreasonable salaries to persons who are also officers of the holding company and who turn all such salaries into the holding company's treasury. This decision was put on the basis that the Ohio statutes give the Commission "general supervision" over public utilities and that such salaries are in the nature of dividends which can only be paid out of earning or surplus. *Ohio Central Telephone Co. v. Public Utilities Commission* (Ohio 1934) 189 N. E. 650.

¹⁶⁴ Cf. cases cited note 125.

¹⁶⁵ This power is admitted and yet these orders may cause the companies great expense.

¹⁶⁶ *Mass. General Laws* (1921) ch. 164 sec. 94a (this was passed in 1916); *New Hampshire Public Laws* (1926) ch. 242 sec. 20a.

¹⁶⁷ *Re Southern Bell Tel. & Tel. Co.* (Ala. 1932) P. U. R. 1932 E, 207; Commissions have exercised this power in the following cases: *Re Alabama Power Co.* (Ala 1932) P. U. R. 1932 E, 323; *Re Alabama Water Service Co.* (Ala. 1933) 1 P. U. R. (N. S.) 166; *Re New York State Electric & Gas Co.* (N. Y. 1932) P. U. R. 1932 E, 1; *Re Commonwealth Tel. Co.* (Wis. 1932) P. U. R. 1932 D, 299; *Re Wisconsin Fuel & Light Co.* (Wis. 1933) P. U. Fortnightly Jan. 19, 1933 p. 134 (all under statutes); *Public Service*

We cannot conceive that it will be contended that a Commission is without authority to halt a raid on the treasury of the operating utility on the plea that it has no right in law to manage the property. From our point of view, it is not an assertion of management, but rather an assertion of reasonable control over practices which the Commission has a right to prevent and should prevent before the injury has been done if it is possible for us to arrive there in time.

It may be asked why should the commission, as representative of the consumers be concerned over a "raid on the treasury of the operating utility." Directly the consumers will not be affected whether the utility is solvent or insolvent. Their rates are based upon a fair return on a fair value and it should not matter to them who gets it. Unfortunately, this argument overlooks the simple facts that an insolvent utility has no credit with which to obtain the capital necessary for the continuous expansion of service demanded from a utility under modern conditions and that operation of a utility by receivers seems usually to be thought to result in higher operating expenses than would ordinarily be incurred. Of course, the harm to other security holders caused by such a "raid" would be very great, but the commissions have normally taken the view that they have no power to decide controversies which are purely between the stockholders or creditors of the utility.

The only case which has discussed fully the power of a commission to exercise such control over contracts made with affiliates, does not throw much light upon the problem. The New Hampshire Supreme Court recently ruled that the New Hampshire commission did not possess this power. However, the case is decided as a matter of statutory construction and is primarily based upon the peculiar provisions of the New Hampshire sta-

Commission v. Intercommunications Corp. (Ind. 1931) P. U. R. 1932 A, 536. The North Carolina commission has ordered that copies of all contracts now in force be filed with it. P. U. R. 1932 A, 536. The Alabama Commission has made a general order that no payments shall be made under contracts with affiliates until its approval is secured. P. U. R. 1932 E, 206.

The Oregon Commission has exercised this power in a large number of instances. 2 P. U. R. (N. S.) 384,387. The new Oregon statute gives the Commission power to reject in advance any expenditure. After such a rejection, the sum cannot be charged as an operating expense in any rate case. If the Commission after hearing makes the affirmative finding that the expenditure is "improvident and unwise," the Commission may forbid the payment of the money, no matter to what account the utility intends to charge it.

tutes which prevent the commission from taking steps to enforce its orders without the prior action of the state attorney general.¹⁶⁸ The court expressly refused to decide the general question of the commission's power over such contracts.

Certain recent developments have taken place by action of the holding companies themselves which seem to promise an easy solution to this problem if they are observed in good faith. The holding companies dominated by the Morgan interests and those associated with them in the United Corporation have adopted the scheme of having all managerial services performed by a specially chartered company whose stock will be distributed among the companies according to their gross revenue. Since the charges for managerial service are to be based upon a percentage of the gross revenue, this will ensure that any profits from such services will be held for the benefit of the local companies in proportion to the charges upon which these profits were made.¹⁶⁹ Moreover, the newly formed trade association in the electric power industry has announced that none will be accepted as members of it who do not promise not to make excessive charges to subsidiaries. This promise is apparently not intended to be an empty gesture for the governing board is given power, a staff, and funds to investigate the conduct of any member and see if it is obeying this and other by-laws of the association. However, some of the holding companies, including Cities Service Company and Associated Gas and Electric Company, have refused to join this organization. Another hopeful development is the fact that certain companies have voluntarily submitted contracts to the commissions for approval before signing them.

Some authorities have taken the view that this whole problem is too big to be handled effectively by the states and must be intrusted to some federal agency. Professor Bonbright and the Federal Power Commission have been the chief advocates of this doctrine.¹⁷⁰ These authorities base their conclusions upon the difficulty that a state commission may have in obtaining evidence concerning excessive charges made by holding companies

¹⁶⁸ *State of New Hampshire v. New Hampshire Gas & Electric Co.* (N. H. Sup. Ct. 1932) P. U. R. 1932 E, 369.

¹⁶⁹ *New York Times*, November 15, 1932 F 5: 3.

¹⁷⁰ Bonbright, *Can We Curb the Holding Company*, *New Republic*, November 2, 1932.

and upon the fact that most of the holding companies operate on a nation-wide scale. The first obstacle is largely fanciful if the proper legal technic is used. If the commission suspects that the charges are excessive, it can always institute a proceeding to determine the reasonableness of the rates charged and force the local company to prove that the charge is reasonable under penalty of having the charge disallowed as an operating expense. Under the newer statutes the commission could also summon the affiliate and the local company to come before it and show cause why the local company should not be forbidden to continue payments under the contract. It is significant that the state commissioners who have been forced to grapple with this problem consider that they are capable of handling it.¹⁷¹ Entrusting such problems to federal officials would result in a vast expansion in the number of persons in the federal bureaucracy, who would not be as thoroughly acquainted with local conditions as are the state commissioners. It would seem that the power of the state commissions in this field is ample if they would only exercise it with vigor and intelligence.

¹⁷¹ P. U. Fortnightly, December 22, 1932 P 723.