APPRAISAL OF PUBLIC UTILITY PROPERTIES.*

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THE control of public utility enterprises through regulatory bodies is still in a somewhat experimental stage, although broadly stated, the present preference of the public inclines towards private ownership and public regulation, rather than towards the purchase of these properties with public funds and their operation by public officials.

The whole structure of commission regulation is built upon the foundation that private ownership shall be required to furnish adequate and satisfactory service at reasonable rates, and shall be allowed to earn a reasonable return upon the fair value of the property dedicated to public use.

It would, therefore, seem that for the present, aside from the matter of character of service, this whole proposition resolves into the two questions—

(*a*) What is a reasonable return?

(*b*) What is a fair value of the property?

At a time when rates of return and even the fundamental elements constituting the value of the property are apparently in such a state of controversy, it is not surprising that the large majority of the papers on valuation written by men eminent in their respective lines of endeavor, should be devoted almost exclusively to the discussion of the basic principles involved and arguments on the broad issues at stake.

Rate of Return.—A fair and reasonable rate of return may well be defined as that rate which will not only attract funds from investors but allow as well for a reasonable excess for surplus, contingencies and normal hazards. No conservatively managed company can afford to pay out all its income, neither can it issue securities to raise money unless the investor who buys such securities knows there is a reasonable margin earned over that required to pay interest and dividends.

The determination of the amount of return which utility investors are to be allowed to earn upon the fair value of the "used and useful" property can hardly be considered as purely an engineering problem. The percentage factor, called rate of return, is not susceptible of exact mathematical determination. On the contrary, as those who are constantly seeking new money to provide for required improvements and extensions know from practical experience, the rate of return is governed by broad and fundamental economic considerations.

Broadly speaking, money is raised by utilities through the sale of two classes of securities—bonds or "senior securities," where the protection is better and the rate of return relatively low, and stock or "junior securities," which, due to their more speculative nature, require a higher rate of return. It is impossible to finance a utility throughout with bonds, and seldom possible to finance with stocks alone, and thus in raising money for utility needs, it is necessary to finance in part with senior securities and in part with junior securities, and while the theoretically ideal way of financing is through the sale of profit-sharing junior securities, it is always difficult and frequently impossible to prevail upon capital to invest on this basis, even when exceptional inducements are offered.

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All investors do not bring to the security market the same point of view, but all of them are influenced by the following principal qualifications of an investment:

(*a*) The security of the investment;

(*b*) Its marketability;

(*c*) Its rate of return.

Every intelligent investor will make these three his principal considerations in weighing the difference and comparative advantages of one industry over another, or of a "senior" over a "junior" security, or in passing upon the relative merits of two different securities of the same class.

It is not intended to suggest that the regulating body should undertake to state any standard of financial plan which should be adopted by utilities as a basis for raising money, but in fixing rates of return, however, it would seem that commissions must possess a broad knowledge of and have a due regard to the controlling economic laws, and after weighing the difference existing between utilities and other enterprises in different communities and the various risks involved, so fix rates of return that the utilities can successfully compete for new money with other industries.

Utilities are not finished. They are in a constant state of extension and construction which continually calls for new capital. These demands must be met by inducing investors to furnish the necessary funds or the utilities will stagnate and our communities will suffer accordingly.

It is cold comfort to the prospective investor invited to enter an unseasoned property in a small though growing community, and worse for the party who has already made such an investment, to be told that the Federal Court has decided that anything less than a six per cent. return on the enormous and thoroughly well-established gas business in New York City is confiscation, and at the same time to hear the inference drawn that anything which just falls short of confiscation is ample profit.

Because the legal rate of return in some States is six or seven per cent. on well secured loans or safe real estate mortgages, and the courts hold that anything less than six or seven per cent. is confiscatory, it does not follow that capital can be induced to invest its time and money in the utilities in any State for any such rate. On the contrary—capital maintains that the gap between confiscation and a reasonable and fairly well secured rate of return is very wide; that the legal rate is the minimum to be considered, and that an additional amount for profit, surplus and contingencies must be allowed to compensate for the risks assumed before it will go into public service and subject itself to commission regulation.

Thus it follows that the investor at large will ultimately have to be reckoned with as a strong controlling element in fixing the required rate of return, for although commissions may rule and courts may decide, the investor with funds will continue independent and will put his money in those enterprises where the permitted profit is made commensurate with the risks involved, with a further profit representing participation either in savings effected by high efficiency, or exceptional earnings secured by competent and aggressive management.

So, while the rate of return required to attract capital to any individual utility is not susceptible of exact mathematical determination, and that each case must be decided upon its individual merits, the whole matter is governed by broad and fundamental economic laws which cannot be disregarded with impunity.

It is not sufficient to avoid plain confiscation of the values which investors already possess in the public utility