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Lewis E. Gettle

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“Controlling Elements in Rate Making”
especially
“The Value of Service”

By Commissioner Lewis E. Gettle,
Railroad Commission of Wisconsin

Presented before the
Annual Joint Convention
Wisconsin Gas Association
Wisconsin Electric Association
Milwaukee, Wisconsin, March 22, 1922
"CONTROLLING ELEMENTS IN RATE MAKING"

ESPECIALLY

"THE VALUE OF SERVICE"

By Commissioner Lewis E. Gettle, Railroad Commission of Wisconsin

To discuss all of the controlling elements in rate making would be entirely beyond the scope of this paper. Many of these elements have been the subject of a voluminous and exhaustive literature with which most of you are probably familiar. The cost of service doctrine, with the determination of value, the analysis and apportionment of expenses and the more or less involved assignment of costs which its application entails has been so fully discussed that there is little that I can add within the limits of this paper. It has seemed to me, however, that it might be worth while to discuss with you some of the limitations upon the cost of service doctrine. These limitations may be discussed generally as limitations imposed by the value of the service. In a sense the question of the value of the service is the old doctrine of what the traffic will bear under a different name. Rate and price fixing will always break down when it reaches a point where it restricts the use of the product. This point may of course be somewhat less than the monopoly price but when this point is reached it is not long before the evidence of it is unmistakable.

The limitations imposed on price fixing by the value of the service are limitations both on the aggregate amount of revenue which may be produced by the service and upon the maximum rates in the several schedules. It may be suggested also that as a corollary to this there should be a limitation upon the lowest rate which will be fixed, that if the utility is to be limited in the securing of the full cost of certain classes of service, because of the value of that service, it should be entitled to keep its lowest rates somewhat above the bare cost, provided that they are properly proportionate to the value of the service.

The strict application of the cost of service theory which has been attempted in many cases seems to me to result in part from a failure to analyze the conditions which have led to the present development of the public utility business and to some extent from a misinterpretation of the essential nature of that business. The most fundamental form of public utility is the public highway. Nowadays it is very rarely that we find a public highway supported on a toll
basis. This public utility is supported by general taxation with no attempt to distribute the cost in proportion to its use. An effort in this direction was defeated in Wisconsin at the last session of the Legislature when the bill for assessing automobiles for highway purposes failed of passage. The vote of the Legislature may be considered an expression of the general public attitude toward the distribution of the cost of highway maintenance and this attitude does not countenance a distribution of that expense on a cost basis. If our highways had been developed on a toll road basis it is altogether probable that we would have had a rate scheme more or less closely approximating the cost of the service. To some extent we have evidence of this in the rates on toll bridges in Wisconsin at the present time although it must be admitted that the schedules are very imperfect.

Another stage is the development of the municipal public utility is represented by the public sewer system. The thought of a sewer system supported by rates as a public utility is supported has probably never occurred to the majority of the people living in our cities, yet there have been sewer systems in this country privately operated and supported, I believe, by payments made by private customers. It is not difficult to find the reason for the total departure in the case of highways and sewer systems from rates assessed to the individual on the basis of the cost of serving him. These utilities are so fundamental and their use so absolutely essential for social and health purposes that their operation has come to be almost universally recognized as a function to be supported by general municipal or state funds. The closer the public utility service comes to being an absolute essential, not a convenience but a real necessity in order that communication and health can be maintained, the greater the departure from the cost of service theory of meeting its expenses.

The modern water works system illustrates this principle probably less has been done in attempting to fix water rates scientifically than has been done in either the gas or electric fields. The proportions of water rate schedules have been fixed quite largely by custom which is merely another way of saying that they have recognized what experience has shown the different classes of service to be worth in proportion to each other. Up to a certain point of course the limit in the value of water service does not appear. Some water service is absolutely essential for drinking and sanitary purposes,—as essential as public highways are for communication or as sewer systems are for sanitary purposes. The same conditions which have resulted in the support of highways and sewer systems out of general public funds apply to a considerable extent to water works systems.
In the very small cities it is simply out of the question to have the rates to general customers fixed at a point which will carry the entire cost. In the large cities it often happens that rates fixed at that point would restrict the use of water for sanitary purposes to a point which would interfere with the health of the community. This has been demonstrated in this state even in cases where the schedules in themselves did not appear high. I think it may be safely stated that, when the application of cost basis rates restricts the use of the service below the level necessary for the maintenance of public health, the cost basis rate must be abandoned. Probably we would be safe in going much farther than this and saying that when a cost basis rate seriously interferes with proper sanitary measures, with reasonable development of communication systems, or with that degree of development in the use of conveniences which we associate with modern civilization, the cost basis must be modified and adjusted and that the value of the service must be recognized as an element in rate fixing. Illustrations of this in the every day operation of Wisconsin utilities are not hard to find. I have already spoken of the water situation. The past two years have given us some illustrations of the limitations imposed by the value of the service upon rates for gas. These limits have applied particularly at the extremes of the schedules. The higher rates applicable to small quantities of gas have brought the companies into competition with other kinds of fuel, particularly in some of our northern cities. Of the fifteen gas plants operating in the smaller cities of Wisconsin, there were three which had fewer customers at the end of 1921 than at the end of 1920 and the increase for the entire group was only 3%. Not all of these cities had high gas rates but they include those with the highest rates. Seven of these utilities sold less gas in 1921 than they did in 1920. Of these seven the decreases in two cases was probably in industrial gas sales. The others, however, are the utilities which, on account of the high cost of furnishing gas service following the war, have had unusually high rates for their service. The sales for the entire group decreased about 6½%. I think there is no question that the limiting effect of the value of the service was felt in these utilities during the past year. A number of these rates have recently been reduced, some of the reductions having been made at the initiative of the companies and others upon the Commission’s own motion. In one case the reduction was based strictly upon the value of the service as indicated by the record of the sales for 1921.

During the war when industry was running at full capacity and when in many lines the seller fully controlled
the price, the effect of competition on the lower steps of gas
schedules was not very noticeable. Recently, however, the
competition of oil has been distinctly felt, particularly in
such companies as supply gas for large industrial uses. The
value of the service is most distinctly an element which
must be recognized in gas rates for the future. Inasmuch
as the value of the service serves to place a limiting rate
upon both extremities of the rate schedule it points to the
necessity for the exercise of every possible economy and
efficiency in the furnishing of gas, since there is little oppor-
tunity to distribute the losses over other parts of the
schedule. For large industrial uses the value of the service
tends to become the competitive price, competitive with
other forms of supply or competitive with other localities.
To be sure, the industry cannot ordinarily move to another
locality without loss and inconvenience but in the market
it must sell in competition with similar industries located in
other localities and the value of the service to it is in many
cases dependent to a large extent upon what its competitor
pays.

While we are discussing the value of the service it is
highly important that we do not confuse this with the cus-
tomary price for the service. We have all known probably
of concerted movements for the discontinuance of public
utility service because of rate changes which were un-
popular with the customer. We should be careful to dis-
tinguish, however, between those concerted movements
which are the result of prejudice and agitation and those
which are the result of the limits imposed by the value of
the service. Where the standard of service rendered has
been a reasonable one, I do not believe that any of the con-
certed movements for the discontinuance of telephone ser-
vice indicate that the limit of the value of the service has
been reached. They indicate rather that custom and long
experience with inadequate schedule has led to conclusion in
the minds of customers as to the real value of the service.
One of the most unfortunate conditions in the telephone bus-
iness today results from the fact that a very large part of
the telephone business has been developed on rates less than
the cost of service. It is true that such rates brought an
earlier development of many rural districts than would
otherwise have been obtained but they have made the
adoption and continuance of proper standards of service
exceedingly difficult. I have no question that if those rates
had been fixed from the beginning upon the basis of the cost
of service we would now, except in sparsely settled commu-
nities, have as complete development of the telephone bus-
iness as we actually have and a much better understanding
among the public of both the value and the cost of the ser-
vice. We have rural electric service in Wisconsin at rates varying all the way from 4c or 5c per kilowatt hour to probably 25c or 30c per kilowatt hour after the inclusion of rural charges. In none of these schedules, except possibly to a limited extent in connection with rural power business, does it appear that the limit of the value of the service has been reached, yet what complaint there is and what dissatisfaction has been expressed has been just as marked in connection with some of the lower schedules as with the higher. There are manifestations of public disapproval of rate schedules which arise out of misunderstanding and there are manifestations of this which arise out of agitation and prejudice. Neither should be taken of itself as an indication of the limit of value of service having been reached.

It is highly important that the public utility company distinguish between the dissatisfaction which grows out of misunderstanding or agitation and that which grows out of the limited value of the service. The first cause of dissatisfaction can almost always be corrected where it is intelligently handled. The necessities of the past few years have led to rate increases in Wisconsin for individual companies involving a great many thousand customers almost without a single complaint of the results because the commercial relations of the companies were such that misunderstandings were cleared up and prejudice removed. In the few instances in which complaints were made against the rates of these companies the complaints related principally to minor matters on which customers had not the same opportunity for information that they had regarding the general schedule. I think this is an illustration of the point that I am trying to make that with proper commercial relations dissatisfaction with increased rates can largely be prevented where the increases are not in excess of the value of the service.

Analysis of the rate situation so that where any dissatisfaction exists the utility may determine in what degree it is due to the limited value of the service is a first essential to proper commercial relations and to the proper development of a rate schedule. Despite all that has been said in favor of the cost of service basis the utility which fails to recognize that in developing its system for the service of a municipality it has assumed the obligation of serving the residents of that city in the broadest possible way and which permits in its rate schedules features which, though they may be based upon the cost of service, nevertheless restrict the ordinary use of its service, is to that extent failing in the performance of its public functions and in the proper analysis of its rate problems. The commission which regards the problem of fixing rates as a mathematical one, and
which may fail to consider the value of the service, will not have to wait long to be advised of its mistake. Public complaint as it comes to the Commission just as public complaint which comes to the company may be classified as that which arises from prejudice and misunderstanding and as that which arises from the limited value of the service.

Not only should we try to avoid the unworkable rate conditions which may result from too strict adherence to costs, for various classes of service and various portions of schedules, but it seems to me that there may be a danger in too great reliance on costs in determining the advisability of extensions. I think I have said enough to indicate the social nature of the utility business and to illustrate my position that other elements than the cost of serving each group or class of customers must be considered. Some limitation of the duty of the utility to extend service is undoubtedly proper and necessary but here, also, I think that cost is not the only consideration. Public health may require extensions of water systems which are not remunerative. Public welfare and convenience undoubtedly should temper application of the cost of service rule for gas and electric extensions. This does not mean that I am advocating any requirement for extensions which will deprive a properly managed utility of a fair return on its property, but in any municipality I think it is generally true that the community of interests of its people and the social aspects of the utility business warrant some distribution over the community of the cost of extending service where the return may not be up to normal. In saying this I have in mind that good judgment must be exercised and that the statement of the principle should not result in a rule requiring a total disregard of costs, but the cost is not and should not be by any means the sole consideration.

By what I have said I may have given the impression that I do not consider the determination of the cost of service for various classes of service of much importance. That inference, if it has been drawn, I want to correct. Costs are of great importance and their complete analysis is almost fundamental to the construction of a rate schedule. But a schedule which recognized only costs would ordinarily be unworkable and unsatisfactory. A rate schedule must be based upon judgment, experience, and common sense as well as upon costs—but to disregard the cost of furnishing the several classes of service which a utility must render would be to discard one of the best aids to a sound judgment. I want to stress the limitations upon the use of costs, in the belief that a realization of those limitations makes the intelligent and workable use of the costs more likely of attainment.

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You have all heard a great deal of the importance of maintaining proper standards of service and it is not my intention to speak at any length of this factor as affecting rate schedules. I would only call to your attention the fact which you already know that the value of the service is determined both by quantity and quality and that where proper standards are maintained the complaints due to the limited value of the service will not start to come in at the same point that they will where service standards are not adequate. We have several prominent independent telephone companies in the state of which my last information is that we have never had a complaint on service. There are probably gas and electric companies of which the same might be said. It goes almost without saying that in the rate increases which have been necessary in the case of these companies there has has been practically no complaint regarding the rate.