1-1-1920

Financial problems confronting public utilities during the period of reconstruction;

Henry E. Mendes
Financial Problems Confronting Public Utilities During the Period of Reconstruction

By HENRY E. MENDES, C. P. A.

of the Firm of

TOUCHE, NIVEN & CO.

Public Accountants

New York Chicago Cleveland
St. Louis Minneapolis

A paper presented at the Annual Convention of the American Electric Railway Accountants' Association at Atlantic City, N. J.

October 13th, 1920
Financial Problems
Confronting Public Utilities
During the Period of
Reconstruction

By HENRY E. MENDES
C. P. A.

A paper presented at the Annual Convention of the
American Electric Railway Accountants' Association
at Atlantic City, N. J.

October 13th, 1920
Financial Problems Confronting Public Utilities During the Period of Reconstruction

Delicately Adjusted Position of the Utilities Has Made Them More Respondent to Financial Disturbance of the War—Some Accounting Problems Must Be Clarified, but Solution Lies Chiefly in Frank and Full Publicity and Efficient Economy.

By Henry E. Mendes, C. P. A.,
Of the Firm of Touche, Niven & Co.

To anyone of an observing disposition it must be quite evident that during the past decade the corporate form of organization has been increasing in popularity, so that today practically all business of any importance is conducted through the medium of corporations, and it is perhaps not extravagant to predict that within a comparatively few years all business, excepting that of a purely professional or distinctly personal character, will be so conducted. The reasons for this trend must be obvious to everyone familiar with the corporate form of organization, but it is not so generally well known or realized that along with the increase in the number of corporations, restrictions have been imposed by statutes enacted in the various States, in some cases limiting the activities of corporations solely to the functions recited in the articles of incorporation, and in other instances, through the creation of regulatory commissions, bestowing upon the States increased supervisory powers over the activities of corporations, the supervision or control increasing in relation to the degree of intimacy of contact that either the services rendered or the things furnished by a corporation bear to the public and its needs.

This supervision or control we find exemplified to the fullest extent in companies of the class usually styled as public utilities, which, in contrast to the great majority of industrial organizations, occupy a position peculiar to themselves in the economic fabric of the nation. Their affairs and policies always have been subject to a close scrutiny and, in the final analysis,
criticism, more or less justified, that the other organizations, thus far, have escaped; indicating what some regard as a steady and no uncertain trend toward government, state or municipal ownership. This condition can be explained through the fact that public utilities, as such, possess essentially a dual character, being, on the one hand, accountable to the proprietary interests therein as represented by the stockholders and bondholders, and, on the other hand, amenable to the public because of the dedication to their use, by means of franchises, of public lands or property, resulting, as it were, in a sort of joint venture or partnership. It is quite obvious, therefore, that at the outset, conflicting elements have an interest in all public utilities, the one ever anxious of receiving the greatest return possible on its investment, the other always desirous of securing the most efficient service at a minimum of cost, by reason of which the officials and executives of the companies find themselves in what is, to say the least, a rather unenviable position. Because of the unusual conditions existing during, and created by, the war, and particularly because of the circumstances which now prevail during the period of reconstruction, the position of public utilities has not improved, but rather have the conflict of factors and the clash of interests, as just set forth, been accentuated. It is with this situation in mind that this paper has been written.

The history of every important war teaches that immediately thereafter a so-called period of reconstruction sets in, its length depending largely upon the extent of the conflict, the havoc wrought, both in lives and property, and the extent to which the morale of the population, generally, may have been affected through individual or personal losses, and also depending upon either the favorable or the unfavorable conclusion of the conflict. Such a period of readjustment usually is accompanied by a great number of abnormal conditions, the inevitable result of wastage, concentration of most of the available labor in war industries, curtailment of production of necessities with consequent depletion of surplus stocks, extravagant or ill-advised government expenditures, and a score of other factors with which everyone is more or less familiar, coupled with indifference on the part of the laboring element, the trend of
population to cities, etc. It would seem that in this country the present period is very much like that which existed during the decade or so immediately following the Civil War, but greatly aggravated because of the vastness of the World War, and this despite the fact that the actual conflict, fortunately, did not reach our shores. A period of reconstruction is generally a period when certain businesses, wage earners and other individuals derive extraordinary income or benefit in contrast to those who, unhappily, find themselves in the opposite condition, in which plight, it must be admitted, are to be found practically all public utilities comprising steam railroads, electric railways, both urban and interurban, telephone, telegraph, gas, electric and water companies.

By reason of the supervision exercised by the commonwealth, as already mentioned, public utilities, as such, are not in as favorable a position as most industries. Without the permission of either the State or the Federal commissions, they are unable, usually, to increase their revenue to conform to increased costs. To obtain additional revenue it is necessary for them to file applications requesting authority to increase rates or tariffs which, ordinarily, cannot be given without investigations more or less thorough, both on the part of the commission and the public utility affected. Considerable time usually elapses, therefore, between the date of the application for an increase in rates or tariffs and the date that it is granted, if at all, and the increase, if granted, does not always come up to the expectations of the public utility as evidenced by its application, the decisions of the commissions being necessarily governed or dominated to a considerable degree by public sentiment, or in some cases even by political expediency. Unfortunately, public sentiment, as a rule, is biased, being molded largely through the opinions expressed in the press, which may either be based upon incomplete information regarding the pertinent facts or may be deliberately suppressed by it. Increased operating costs accompanied by a public demand for better service at reduced charges, constitute a condition that has confronted the management of all public utilities during the past few years—a problem hard to solve, in some cases almost bordering on a dilemma. It should
be noted, however, that as a class steam railroads are, and have been, in a relatively more advantageous position in this respect than most other public utilities of importance—certainly, at any rate, better off than urban electric railways, due to the favorable Federal legislation recently enacted, to which it is only necessary to make passing mention. This advantage, however, is perhaps more apparent than real; but it, nevertheless, must be conceded that, compared with the local control exercised by the various State commissions, the supervision by the Federal Government of the utilities engaged in interstate business is broader and generally more satisfactory, not being dominated to the same extent by strictly local conditions or influences. The possible conflict of authority in such cases, however, of which a recent example has been afforded by the refusal of the New York State Commission to ratify for intrastate traffic the increase in railroad rates granted by the Interstate Commerce Commission, is on the other hand a misfortune to which the purely local enterprise is not subjected. Somebody is always taking the joy out of life for the railroads!

In order to give proper and efficient service for any length of time, a public utility must be in a healthy financial condition. It is known that a great number of public utilities, today, if not indeed practically all, are in a rather sad condition financially, the important exceptions being some of the larger railroad systems. It is reported that no less than one hundred and eighteen electric railroad properties, operating seven thousand eight hundred and twenty miles of track, or one-sixth of the total, are at present in receivership. This is a most unnatural and dangerous situation. The question naturally arises, then, when is a public utility in a healthy financial condition? The answer would seem to be: When the utility receives reasonable or ample compensation for the services it renders; sufficient to pay the necessary operating expenses commensurate with the service demanded by the public, sufficient to pay for renewals and replacements of worn-out and obsolete equipment, sufficient to provide necessary funds for the purpose of extending its service along with the development of the community served, and lastly, though not the least important factor, sufficient to
reasonably compensate capital for its investment and the consequent hazard undertaken. Unless a public utility finds itself in this position, with a gross income ample to provide for the elements stated, it is only a question of time, especially during a period such as we are passing through now, before it will find itself financially embarrassed; and, in the absence of immediate relief from the supervisory power, confronted with the necessity of restricting its service, regardless of demand, to conform to its revenue. It will also have to abandon all improvements, in some instances even of the most urgent and pressing nature, and eventually, if the condition is not remedied promptly, it will find itself in the bankruptcy courts. The notion seems to prevail quite generally nowadays that, because of the comparatively large capital investment in them, public utilities have unlimited and inexhaustible resources, to which the ordinary rule that income must at least balance expenditure does not apply, the public failing to realize that such a situation cannot exist and that, to use an old expression, "it is impossible to draw water from a stone."

It should be noted here that certain of the public utilities, principally the steam railroads, are in a rather peculiarly advantageous position in that they are enabled to collect a great part of their revenue before actually performing the service for which the revenue is received. While this condition has no direct bearing upon the adequacy of the rates charged, it is a financial advantage not to be overlooked, as it furnishes the railroads with a portion of the working capital necessary for operation, thereby enabling them to operate effectively, and quite safely, upon a smaller ratio of current assets to current liabilities than is necessary in the ordinary commercial or industrial business undertakings. This permits the railroads to use current revenue for defraying a portion, at least, of current expenditures, in contrast to a business that is conducted principally on credit, when a considerable period usually elapses between the date the service is performed and that when the revenue is collected. It is this very feature, however, that is perhaps occasionally responsible for railroads finding themselves in an embarrassed financial position, because it is not until they find that
the current revenue is insufficient to pay the current obligations, not the current operating expenses, that there is forced upon them a definite realization of the fact that their revenue is inadequate to maintain them in a sound financial condition.

To give adequate service in a growing community, as already indicated, a public utility must interest new capital, thus enabling it to secure the additional facilities required for an extension of service. Not the least problem, therefore, of a great many public utilities is the necessity of interesting additional capital. At the prevailing high rates of interest occasioned by the general financial situation the problem of interesting new capital is indeed a very serious one. The condition is emphasized particularly by the higher-rate securities now being floated by industrial enterprises which, in many instances, afford relatively better security, and certainly less mental anguish, than issues of public utility corporations. During the past year, new flotations of gilt-edged securities are known to have cost considerably in excess of 10 per cent per annum to the borrowing company, taking into consideration brokers' commissions, expenses, etc.; and if the facts were known, in all probability it could be shown that in certain instances new money has cost almost twice the rate stated. This situation, of course, is analogous to that which existed in the financial market during the corresponding period immediately following the Civil War.

Strictly speaking, public utilities are not in a position to compete in a tight money market. The margin between their gross revenue and expenses is never sufficient to warrant paying what might appear to be exorbitant rates of interest, even if they were willing. Because of the regulations and attitude of the commissions, however, and, in some instances, the restrictions placed upon them by statute, public utilities are not permitted to sell their securities at a discount, this term not only comprehending "discount" in its usually accepted meaning but including expenses incidental to the refinancing which proper accounting procedure would permit as a part of the cost of the new money.

Because of maturing capital obligations, some public utilities recently have found themselves in extremely
embarrassing situations. Public utilities in this predicament, assuming that they are not subject to restrictions regarding discount on securities, have had, in some instances, to negotiate for new capital at whatever rates have been asked. The electric railways, as already noted, have been in a particularly precarious position and from statistics compiled quite recently it would appear that approximately ten per cent of some four hundred and eighty companies went into receivership in 1919. Regarding this situation the recent report of the Federal Electric Railway Commission is interesting. Among other things it states:

"The electric railway industry as it now exists is without financial credit and is not properly performing its public function.

"This condition is the result of early financial mismanagement and economic causes, accentuated by existing high-price levels of labor and materials and by the failure of the uniform unit fare of five cents prescribed either by statute or by local franchise ordinances or contracts to provide the necessary revenues to pay operating costs and to maintain the property on a reasonable basis.

"The industry can be restored to a normal basis only by the introduction of economies in operation, improving its tracks, equipment, and service, and securing a reasonable return upon the fair value of its property used in public service when honestly and efficiently managed.

"Restoration of credit involves a readjustment of relations which will remove public antagonism, provide public co-operation, and insure the investor the integrity of his investment and a fair rate of return thereon."

The Commission also reports its estimate that from $175,000,000 to $200,000,000 annually will be required by electric railways for future needs, and states further that valuation of the properties on a fair basis is imperative, and that when such valuation is obtained, capitalization should be reduced to that basis. There
are numerous other important and valuable recommendations embodied in the report concerning some phases of the practical operation and management of electric railways.

SHORT TERM NOTES RECOMMENDED

Without necessarily desiring to lay down a fixed rule, under the present abnormal conditions it is probably the best theory for public utilities to issue short term notes at market rates, secured by long term treasury bonds at normal rates deposited as collateral for the short term notes. This is on the assumption, of course, that upon maturity of the short term notes conditions in the financial world will have adjusted themselves to a more normal basis, and it will then be possible to issue the long term bonds in substitution for the notes. In this connection, the fact should not be overlooked that in some instances refinancing may be prevented through the fact that other long term bonds already are outstanding, to which the new issue would necessarily be subordinated and would therefore have to bear a much higher rate than ordinarily rules for that class of security. This condition was one of the factors prevailing in some recent refinancings.

Despite the fact that the revenue of perhaps most public utilities has been increased during the past year, they still find themselves in the position where their earnings are not sufficient to provide for the essential factors. Everyone is familiar in a general way with the increase in wages recently allowed by the Railroad Arbitration Board under the provisions of the Cummins-Esch Railroad Bill passed by Congress at its last session, and the consequent increase in freight and passenger rates allowed by the Interstate Commerce Commission, which the railroads maintain is still insufficient to provide for the increased costs, not only of labor, but also of material, interest, etc. With particular reference to the street railways, it appears that rates of fares have been increased in practically all the important cities of the country, New York being one of the conspicuous exceptions. The rate of fare has been increased from the basic five-cent rate to ten cents in twenty-three cities, eight cents in fourteen cities, seven
cents in fifty-eight cities and six cents in seventy-one cities, during the past several years. Since April, 1919, fare increases have been put into effect in one hundred and ninety-five cities, of which seventy-three had already received increases above the five-cent basic rate, while forty-nine were still receiving only the five-cent fare. In the same period fares were decreased in two cities, but in at least one of the cities affected application has recently been made for an increase.

SERVICE-AT-COST ORDINANCES AND FRANCHISES

Consideration of this subject would not be complete without some reference to the so-called "service-at-cost" ordinances and franchises, which, so far, have only been applied effectively to electric street railways in several large cities—including Cleveland, Cincinnati, Youngstown, Rochester, Dallas and Montreal—although there is now agitation for the operation of gas and electric companies, and possibly other public utilities, on the same basis. A public utility operating under the "service-at-cost" plan, is only one step removed from municipal ownership, the terms of the ordinance or franchise providing for the purchase of the property by the community at its option. For purposes of the arrangement such an ordinance usually establishes a more or less arbitrary valuation of the property involved, ignoring true or reproductive values, the fixed valuation being generally less than the cost of the investment as shown by the books of the company. On this fixed valuation the company or investor is guaranteed a stipulated return, usually six or seven per cent, which is also to be applicable to extensions, betterments and other items of a minor nature.

In some cases a revolving or stabilizing fund in a definite amount, mentioned in the ordinance, is created in the first instance, the size of the fund depending upon the extent of the property covered by the arrangement. To this fund the actual revenue, based upon a certain basic rate of fare, derived from operation, in effect is credited and the guaranteed return payable upon the fixed capital is, on the other hand, charged. The ordinance provides for certain allowances for operating expenses and for maintenance and, in some cases,
depreciation, etc., based upon certain standard units, such as the car-mile or passenger-mile, which are charged to the revolving or stabilizing fund and credited to reserve accounts. Any operating expenses or maintenance charges and renewals are charged to the reserves therefor, and the other reserves, if any, are handled in like manner. The ordinance then further provides that the rate of fare shall be changed from time to time as may be necessary to maintain the revolving or stabilizing fund at approximately its fixed amount, the intention being to reduce the rate of fare in the event that the stabilizing fund reaches a certain maximum amount, and, likewise, to increase the rate of fare in the event that the fund gets below a stipulated minimum amount. In theory this is a commendable scheme, but the advantages to the community, on the one hand, and the proprietary interest, on the other hand, are frequently not as real as they may seem. The plan has a tendency to restrict service in some instances and, more particularly in a period during which abnormal conditions prevail, almost invariably prevents extension of property and improvement of service. The incentive to economy and efficiency is also to a very great extent removed by the guarantee of the return on the fixed capital investment of the company, which tends to make the operating officials feel that as long as the funds last the company will receive its stated return. Furthermore, a certain duplication of expense is almost inevitable under the plan, the ordinance usually providing for a traction commissioner with authority to organize a department of his own and, if so inclined, to employ assistants to check the work of the company which experience has shown to be, in effect, practically a duplication of details already quite efficiently handled by the company. To counteract the tendency to extravagance and to cultivate an incentive for economical management, bonus systems are in effect in some cities in conjunction with the "service-at-cost" plan. A bonus system started quite recently in one city fixes a certain allowance for operations, and then, if the company operates within the allowance, gives part of the saving to the company as a bonus. It should also be noted that in some instances the communities affected have been known to object to a proper interest return, even on the reduced valuation
placed on the property involved. Again, it should be noted that while the theory of the plan is good, it would seem that those who conceived and first advocated it were rather attempting to place theirvelves in a favorable light with the public, without regard to all of the essential elements; the result being that, in some "service-at-cost" franchises, no reference is made to such an important factor as depreciation, it being impossible, therefore, for the public utility to provide a fund for that purpose. Incidentally, the company is started out on an altogether unsound and erroneous basis, especially in relation to the public, which, once having formulated an idea, usually more or less hazy, regarding the provisions of the ordinance, can only adjust itself to the proper attitude with extreme difficulty, necessitating propaganda of an educational nature, which in certain communities the press is not willing to support.

Public utilities are not altogether blameless for the predicament in which they find themselves. They are largely responsible for a number of conditions that now give them embarrassment which, with a little foresight in the past, very easily could have been obviated. Perhaps the point most subject to criticism or, at any rate, the matter which has been responsible for the major part of the adverse criticism, is the overcapitalization and, it may be stated, the cumulative capitalization that unfortunately has prevailed in not a few instances, but which during later years has been prevented by the supervision of the commissions under the regulatory powers conferred upon them by statutes. Of course, some of the reorganizations and consolidations effected in the past were justified by the peculiar conditions prevailing in certain communities, and, while sometimes the apparent effect may have been to inject water into the undertaking, the actual result was to provide a more efficient and better co-ordinated organization, capable of expanding the service in direct relation to the increased demands of the community served. Subsequent benefits derived by the community, arising through these mergers, usually have justified them, as they not only tend toward economy in management, with consequent better service, but also make it possible to give
more extended service. The objectionable features, by reason of the supervision exercised by the commissions, have been corrected and practically eliminated during recent years.

**SOME ACCOUNTING SUGGESTIONS**

Certain erroneous principles of accounting, as reflected on the books of some public utility companies, are also partly responsible for their predicament. These may be summarized briefly as follows:

(a) Not a few companies accrue taxes and other expenses that are of a recurring nature on anything but a scientific basis. It is asserted quite often that public utilities, because of their peculiar nature, should not accrue taxes and other similar items of expense in that which most industries and businesses find the most desirable procedure to follow in order to reflect proper operating results. The claim is made that taxes should only be accrued, if at all, in an amount sufficient to take care of actual cash disbursements that must be made for taxes during a given period as and when they fall due. From an accounting standpoint such a procedure is indefensible, and as a practical proposition its merit can be questioned quite seriously. Proper accounting, whether it be either for an industrial organization or for a public utility, demands that taxes be accrued for the period covering which they are payable in relation to the expenditures of the state, or municipality, as evidenced by information usually shown on the tax bills, and if not so shown, by information that always can be obtained from the tax officials, and not necessarily for the period to the last date by which the taxes must be paid in order to obviate the assessment of fines or penalties. This seems to be so obvious as to require no further argument.

(b) Depreciation also seems to be quite a bone of contention, the amount provided for this item on the books of some public utilities being dependent, in a great measure, on how much tariff the gross income can stand. The manner in which reserve accounts for depreciation are handled quite often indicates that the first principles of good accounting theory and practice are ignored altogether. A reserve account, as such, is only an account established for the purpose of equalizing the expense or loss entailed through the gradual wearing away, or passing out of existence of property, by reason of its use or otherwise, so that when it eventually becomes necessary to replace the property, the entire charge will not be made to the operations of the period in which the replacement is made, or possibly capitalized, but may instead be borne by the reserve account. Properly to create a reserve for depreciation it is necessary to credit currently to the reserve account definite amounts, calculated on the basis of rates of depreciation developed as the result of experience, by cor-
responding reductions of the gross earnings derived from operations. Any other treatment of a reserve account, such, for instance, as crediting to it arbitrary amounts at irregular intervals, serves no useful purpose whatsoever and might as well be abandoned. From a financial point of view, of course, the stockholder and investor is interested in seeing, and is entitled to know, that adequate reserves are being made by a public utility in arriving at the results from operations shown in its published statements. It should be emphasized, furthermore, that a reserve account of itself does not provide the funds necessary for replacements and obsolescence. A proper program to insure that any business will be uniformly successful over a period of years, where the investment in plant is a vital and important factor, contemplates the laying aside, or earmarking, of specific funds or investments for the purposes stated. Any amount of bookkeeping would not provide the funds necessary to achieve the desired result as they can only be derived from the usual sources.

(c) Another questionable practice adopted by some public utilities, which is related very closely to the foregoing, is to write off over a term of years the capital investment in worn-out, old or obsolete equipment, after its replacement by new equipment, instead of, in the first instance, having written off the equipment over the period during which it was used, and providing a reserve for depreciation covering the new equipment, on the basis of recognized rates of depreciation, over the term of its probable life. Such practice merely tends to put off the evil day when an accounting eventually must be made, but, aside from a miracle, does not prevent it. Many public utilities, finding themselves in the predicament of having exhausted important units of their plant investment without having made due provision for their replacement, as explained, are confronted today with this situation.

(d) A further inconsistency that seems to prevail more or less generally is that of including allowances for depreciation in arriving at the basis for establishing rates and then, on the other hand, objecting to the reduction of the plant or investment account for the determination of capital values for the same purpose or of invested capital for Federal tax purposes and, occasionally, also for the purposes of the published financial statements.

Concerning the foregoing fallacies, no sound reasons can be advanced for handling the accounts of public utilities in any other manner than on the basis recognized by proper accounting procedure developed as the result of the experience gained in other sound businesses and representative industries. Public accountants are often confronted with the argument that certain features, by reason of conditions peculiar to a business under examination, must be considered from a different angle than that from which similar
items may be treated in other unrelated businesses. While, admittedly, differences do occur which require special treatment, the matters set forth above are fundamental, and should apply to all businesses, not even excepting public utilities.

Conclusions

To conclude, then, the principal financial problems which must be solved by public utilities during the so-called period of reconstruction through which we are now passing may be considered to arise, on the one hand, from the abnormally high interest rates which preclude the possibility of obtaining funds for development or of refinancing maturing obligations on anything short of the most ruinous terms; from the urgent necessity which exists for the carrying out of long deferred improvements and from the excessively high cost of new construction and equipment; and, on the other hand, from the shrinking margin between operating revenue and expenses, due to increasing costs and the indifference of the public to the vital need for adequate increases in rates. The remedy appears largely to lie in the presentation of facts and figures to the public and to the public service commissions, stated upon the soundest basis and with the utmost measure of frankness; in the education of the public to the justice of the claims of the public utilities and to a realization of the truth that efficient service cannot be rendered for any length of time without adequate compensation to capital and, lastly, in the practical exemplification of the truth that a penny saved is a penny earned, by a continuance of the measures tending toward the elimination of unnecessary costs or waste in any form, whether it be in power plant operation, abnormally high damage claims or inadequate control of stores and supplies.
TOUCHE, NIVEN & CO.

NEW YORK
J. B. NIVEN, C. A., C. P. A.
H. C. FREEMAN, C. P. A.
H. E. MENDES, C. P. A.
F. J. CLOWES, C. A., C. P. A.
42 Broadway

CHICAGO
C. R. WHITWORTH, A.C.A., C.P.A.
Resident Partner
10 South La Salle Street

ST. LOUIS
V. H. STEMPF, C. P. A.
Resident Manager
Syndicate Trust Building

CLEVELAND
W. F. VIEH, C. P. A.
Resident Manager
Society for Savings Building

MINNEAPOLIS
G. H. DRURY, C. A., C. P. A.
Resident Manager
McKnight Building

Affiliated Offices

ENGLAND
London and Birmingham

CANADA
Montreal, Toronto, Edmonton, Winnipeg,
Vancouver and Calgary

SOUTH AMERICA
Buenos Aires, Rosario de Santa Fe, Montevideo, Rio de Janeiro,
Sao Paulo, Valparaiso and Santiago