

Principles of Public Utility Rates

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petitive pricing good enough to render price control unnecessary.

Since the competitive-price standard of rate regulation has so often been identified with the acceptance of a replacement-cost or "fair-value" principle of rate control, one may raise the question to what extent the types of competition characteristic of large-scale industrial companies have actually brought prices into rough correspondence with current costs of production plus a normal rate of profit on the depreciated replacement costs of plant and equipment. This question is unanswerable in the absence of wide-scale and careful appraisals of industrial plant and equipment comparable to the tremendously expensive "physical valuations" of the American railroads made by the Interstate Commerce Commission under the Valuation Act of 1913. I think it almost certain, however, that the correspondence would not be close.¹⁴

Lest the reader of this chapter gain the impression that it is intended to deny the relevance of any tests of reasonable rates derived from the theory or the behavior of competitive prices, let me state my conviction that no such conclusion would be warranted. On the contrary, a study of price behavior both under assumed conditions of pure competition and under actual conditions of mixed competition is essential to the development of sound principles

¹⁴During the years since the Second World War, prior to the time of the recent stock-market boom, the stocks of many of the best-known industrial companies sold at market prices below their book values, values in turn presumably well below depreciated replacement costs. The steel industry offers a conspicuous example. In testimony before the Senate Banking and Currency Committee in 1955, Mr. Benjamin F. Fairless, chairman of the United States Steel Corporation, was reported to have stated that the current cost of building fully integrated steel-plant capacity from mines to finished product was on the order of \$300 per ton, whereas the investor valuation of the plants, as measured by current security prices, was only \$56 per ton for the ten largest steel companies, on the average. In its 1954 Annual Report to Stockholders, the Marquette Cement Manufacturing Company stated that, in 1953, it had earned 9.6 per cent on its "original-cost value" but that these earnings represented a return of only 3.6 per cent on estimated reproduction cost (after adjustments for additional depreciation charges on this higher cost). No doubt these and other examples of substandard returns based on replacement-cost tests could be matched by examples of superstandard returns.

The Feb., 1955, issue of *The Exchange*, a monthly publication of the New York Stock Exchange, reported that a study of 1,053 listed common stocks disclosed that 42 per cent were selling at less than their latest available book values. At the extremes among the separately noted industrial stocks, Armour and Company common was selling at 68 per cent below book value, whereas International Business Machines common was selling at 588 per cent above book value.

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of utility rate control. Not only that: any good program of public utility rate making must go a certain distance in accepting competitive-price principles as guides to monopoly pricing. For rate regulation must necessarily try to accomplish the major objectives that unregulated competition is designed to accomplish; and the similarity of purpose calls for a considerable degree of similarity of price behavior.

Regulation, then, as I conceive it, is indeed a substitute for competition; and it is even a partly imitative substitute. But so is a Diesel locomotive a partly imitative substitute for a steam locomotive, and so is a telephone message a partly imitative substitute for a telegraph message. What I am trying to emphasize by these crude analogies is that the very nature of a monopolistic public utility is such as to preclude an attempt to make the emulation of competition very close. The fact, for example, that theories of pure competition leave no room for rate discrimination, while suggesting a reason for viewing the practice with skepticism, does not prove that discrimination should be outlawed. And a similar statement would apply alike to the use of an original-cost or a fair-value rate base, *neither* of which is defensible under the theory or practice of competitive pricing.

This chapter has been written under the assumption that the utility subject to regulation enjoys a monopoly, so that any emulation of competitive-price behavior would have to be imposed by governmental authority or adopted as a matter of policy. But this assumption is never strictly valid; and in the field of intercity transport, the degree of railroad monopoly has now become so limited because of road, water, and air competition, that the acceptance of a competitive-price standard of rate control, in some sense of competition, would cease to be the acceptance of a mere make-believe. While the complete abandonment of rate regulation is even here out of the question, the development of new and less rigid standards of rate control seems necessary. In this development, more is to be said for standards suggested by modern ideas of "workable competition" than can be claimed for such standards with the more nearly monopolized utility companies.

So far as concerns the electric power utilities, competition in the sense of rate making by a comparison of the performance of other utility enterprises, including public "yardstick" plants, has been