# SMITH ET AL., CONSTITUTING THE ILLINOIS COMMERCE COMMISSION, ET AL. *v.* ILLINOIS BELL TELEPHONE COMPANY.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS.

No. 90. Argued October 20, 21, 1930.—Decided December 1, 1930.

1. In a suit by a public utility to enjoin, as confiscatory, an order of a state commission lowering its rates, an interlocutory injunction was granted upon the condition that, if the injunction were dissolved, the plaintiff should refund to its subscribers the amounts paid by them in excess of those chargeable under the commission's order. A large excess had accumulated when, a number of years later, a final injunction was granted. On appeal, *held*, that, as the decree speaks from its date, the question is necessarily presented, not only whether the rate order was confiscatory when made, but also as to its validity during the period that has intervened, and as to the respective rights of the company and its subscribers in the funds accumulated. P. 142.
2. An Illinois telephone corporation owning an exchange system in Chicago and toll lines from there to other places in the State, did an exchange business local to Chicago, an intrastate toll business and an interstate toll business. The interstate service was performed by means of its Chicago property and connecting lines owned and operated by another corporation (here called the American Company,) and as compensation for its part in that service, including the use of its Chicago property, the Illinois Company received a division of the interstate tolls, agreed upon with the other company. The American Company owned a controlling interest in the stock of the Illinois Company and of like companies in other States, all of which, in connection with still other companies, were operated as a system, in which the American Company was the central authority performing general functions, while the associated companies served their respective communities and dealt with their own local affairs. The Illinois Company paid the American Company percentages of its gross revenues, partly for rent of instruments and partly as compensation for valuable engineering, financial and other services, and purchased, in large part, its equipment and supplies from the Western Electric Company, a

manufacturing subsidiary of the American Company, which sold its products to members of the system and to others also. In a suit by the Illinois Company, the District Court enjoined, as confiscatory, the enforcement of an order of an Illinois commission reducing that company's rates for local exchange service in Chicago. *Held:*

(1) That the Illinois corporation, notwithstanding the control of its stock by, and its intimate relations with, the American Company, was the proper plaintiff. P. 143.

(2) The method adopted by the District Court of testing the adequacy of the reduced rates on the basis of the total Chicago property of the plaintiff, without specifically separating intrastate from interstate property, revenues and expenses, was erroneous, although that court deemed the division of the interstate tolls to be fair, and found, with the aid of computations showing percentages of interstate calls originated by Chicago subscribers and percentages of property used in intrastate and interstate toll service, respectively, that the percentage of return for the total Chicago business was greater than that for the total intrastate business, or than that for the intrastate exchange business. P. 146.

(3) The separation of intrastate and interstate property, revenues and expenses of the company is important not simply as a theoretical allocation to two branches of the business; it is essential to the appropriate recognition of the competent governmental authority in each field of regulation. P. 148.

(4) The fairness of the interstate rates, or of the divisions thereof, was not for the state commission or the court to decide. *Id.*

(5) The validity of the commission's order in this case can be suitably tested only by an appropriate determination of the value of the property employed in the intrastate business and of the compensation receivable for the intrastate service under the rates prescribed; and there should be specific findings as to the value of that property and as to the revenue and expenses of that business, separately considered. P. 149.

(6) This involves a reasonable apportionment of the telephone exchange property used in both classes of service. P. 150.

(7) Although the Illinois Company has the advantage of being a component of a large system to which the benefits of its operations accrue, and obtains through this relation the coöperation of the manufacturing, research, engineering and financing departments

of the American Company, the Illinois Company is to be treated as a segregated enterprise. P. 151.

(8) The plaintiff company having purchased most of its equipment from the Western Electric Company, manufacturing subsidiary of the American Company, and it being contended by the commission that the prices paid were excessive and should not be credited in full to the plaintiff in testing the adequacy of the rates in question, it was erroneous to determine the fairness of the prices by reference to the percentages of net profits realized by the Western Electric Company from all its business, including transactions with outsiders as well as with the plaintiff and other members of the system, or by reference to higher prices charged for like articles by other manufacturers or by the Western Electric Company to independent telephone companies; but there should be findings as to the net earnings made by that company in furnishing equipment to the plaintiff and the other companies in the system, and as to the extent to which, if at all, such profit figured in the estimates upon which the charge of confiscation was predicated. P. 152.

(9) With regard to the services rendered to the plaintiff by the American Company, for which the former paid percentages of its gross income, the court below should make specific findings as to their cost to the American Company and the reasonable amount that should be allocated in this respect to the operating expenses of the intrastate business of the plaintiff in the years covered by the decree. Pp. 153–157.

(10) The property of a public utility represented by the credit balance in a reserve for depreciation can not be used to support the imposition of a confiscatory rate; but due recognition of this property does not require that an amount of annual addition to the reserve, which is shown by experience to have been excessive, shall be allowed for the future. P. 158.

(11) The power of the State to prescribe intrastate rates, and the jurisdiction and duty of the District Court, in considering their validity, to determine the amount properly allowable for depreciation in connection with the intrastate business, are not taken away by the action of Congress in granting jurisdiction to the Interstate Commerce Commission over the depreciation rates of telephone companies doing interstate business, (Interstate Commerce Act, § 20 (5),) where that Commission has taken no action which could be deemed validly to affect depreciation charges in connection with intrastate business so as to affect intrastate rates. P. 159.

(12) Accordingly, the court below should make appropriate findings with respect to the amount to be allowed in this case as an annual charge for depreciation in connection with the intrastate business. *Id.*

(13) In determining whether a regulation of rates is confiscatory, it is necessary to consider the actual effect of the rate in the light of the utility's situation, its requirements and opportunities. P. 160.

(14) The court below should find in this case the rate of return which was realized from the intrastate business and the rate of return which it is fair to conclude would have been realized from that business under the prescribed rates. P. 161.

(15) A rate order which was confiscatory when made may cease to be confiscatory, and one which was valid when made, may become confiscatory at a later period. P. 162.

(16) As the disposition of the amount withheld by the plaintiff under the conditions of the interlocutory injunction will depend upon the final decree, there should be findings as to the results of the intrastate business in Chicago, and the effect of the rates in question, for each of the years since the date of the commission's order. *Id.*

38 F. (2d) 77, reversed.

APPEAL from a decree of the District Court of three judges, which enjoined the enforcement of an order of the Illinois Commerce Commission reducing local rates of the Telephone Company. See also, 269 U. S. 531.

*Messrs. George I. Haight* and *Benjamin F. Goldstein,* with whom *Messrs. Oscar E. Carlstrom,* Attorney General of Illinois, *Samuel A. Ettelson,* Corporation Counsel, City of Chicago, and *Edmund D. Adcock* were on the brief, for appellants.

*Mr. William Dean Bangs,* with whom *Messrs. Charles M. Bracelen* and *Horace Kent Tenney* were on the brief, for appellee.

The Illinois Company, being a distinct corporate entity, was the proper party plaintiff.

The court below found as a fact, after "careful scrutiny" of all the evidence relating to the relationship between these two companies, that the American Company had not dominated or controlled the officers and directors of the Illinois Company; that there was co-ordination of activities between the companies to produce efficient unified service; and that there was nothing in the evidence justifying a departure from the rule established by this Court as to transactions between the American Company and a local company whose stock it thus owns. Hence no question of law as to the relationship between these companies is presented which has not already been decided by this Court and by the lower federal courts, *Houston* v. *Southwestern Bell Tel. Co.*, 259 U. S. 318, 323; *Missouri ex rel. Southwestern Bell Tel. Co.* v. *Public Service Comm.*, 262 U. S. 276, 288–289; *Northwestern Bell Tel. Co.* v. *Spillman*, 6 F. (2d) 662; *Pacific Tel. & Tel. Co.* v. *Whitcomb*, 12 F. (2d) 279, 284–285; *Chesapeake & Pot. Tel. Co.* v. *Whitman*, 3 F. (2d) 938, 957; *Indiana Bell Tel. Co.* v. *Public Service Comm.*, 300 Fed. 190, 204.

The fact of separate corporate existence cannot be disregarded and the fiction of corporate identity substituted. Controlling stock ownership does not destroy separate corporate identities, nor raise a presumption of control over the company whose stock is thus owned, or over the action of its officers. *Pullman's Palace Car Co.* v. *Missouri Pacific Co.*, 115 U. S. 587, 596; *Peterson* v. *Chicago, R. I. & P. Ry. Co.*, 205 U. S. 364, 391; *Porter* v. *Pittsburgh Bessemer Steel Co.*, 120 U. S. 649, 670; *Cannon Mfg. Co.* v. *Cudahy*, 267 U. S. 333, 335; *United Fuel Gas Co.* v. *Railroad Comm.*, 278 U. S. 300, 320–321.

To treat the company whose stock is owned as a mere agent, the stockholding company must in fact interfere in the regular affairs of the other company, and direct

its actions as if they were its own; and this must be brought about by the united intention of both companies. *Kingston Dry Dock Co.* v. *Lake Champlain Transportation Co.,* 31 F. (2d) 265.

The court below rejected the proposition that the real party plaintiff, and the real operator of the property of the Illinois Company, is the American Company; and that the inquiry as to confiscation and proper rate of return involves the question of confiscation of the property of the American Company, and the rate of return to the investors of that company, disregarding in this inquiry the corporate identity of the Illinois Company. This proposition is not consistent, either with reason or with the rule settled by controlling decisions, and is impossible of application.

The commission, in the enjoined order, did not adopt this proposition, or find that the American Company had exercised any domination over the officers of the Illinois Company. It merely assumed that, because of this stock ownership, contracts between the companies could not be regarded as "made between separate parties." This assumption is exactly contrary to the rule with reference to this very relationship established by the decisions in Illinois, under whose laws both the commission and the corporation were organized, and of the federal courts. *State P. U. Comm. ex rel. Springfield* v. *Springfield Gas & Elec. Co.,* 291 Ill. 209, 234. Quoted with approval in *Southwestern Bell Tel. Co.* v. *Public Service Comm.,* 262 U. S. 276. *Public Utilities Comm.* v. *Romberg,* 275 Ill. 432, 447.

The assumption is also inconsistent with the commission's prior action, for it authorized each increase of the stock of the Illinois Company, which was afterward purchased by the American Company; and also authorized the sale of the stock to, and the purchase by, the American Company. The relationship between these com-

panies thus established by stock ownership has received the commission's repeated official approval.

The cases relied upon by appellants on this question are not in point. Distinguishing: *United States* v. *Lehigh Valley R. Co.*, 220 U. S. 257; *Chicago, M. & St. P. Ry. Co.* v. *Minneapolis Civic & Commerce Assn.*, 247 U. S. 490; *Michigan ex rel. Attorney General* v. *Michigan Bell Tel. Co.*, 246 Mich. 198; *Chesapeake & Pot. Tel. Co.* v. *Whitman*, 3 F. (2d) 938, 957; *United Fuel Gas Co.* v. *Railroad Comm.*, 278 U. S. 300.

The finding of the court below that the American Company did not in fact exercise any control over the officials of the Illinois Company is sustained by the evidence.

The efforts of the Bell System to secure universal telephone service by a general policy with reference to matters which affect the service of all companies do not sustain the appellants' contentions. *Public Utilities Comm.* v. *Romberg*, 275 Ill. 432, 445.

The annual reports issued by the American Company cannot be treated as statements made by the Illinois Company, and are not admissible against it. *Peterson* v. *Chicago, R. I. & P. Ry. Co.*, 205 U. S. 364; *Holland* v. *Holland City Gas Co.*, 257 Fed. 679; *Elenkrieg* v. *Siebrecht*, 238 N. Y. 254; *General Motors Corp.* v. *Moffett*, 27 Ohio App. 219. And in any view they do not sustain the theory of appellants' case on this question.

There was no abuse of discretion by the directors and officers of the Illinois Company with regard to the license contract with the American Company. The record shows that the services rendered to the Illinois Company under this contract were necessary to the conduct of its business, the compensation paid therefor was reasonable, and the value of the services was greatly in excess of their cost.

The advantages to the Illinois Company of its general supply contract with the Western Electric Company

are shown by the evidence, which conclusively supports the finding of the court below approving the contract. *Houston* v. *Southwestern Bell Tel. Co.*, 259 U. S. 318; *Southern Bell Tel. & Tel. Co.* v. *Railroad Comm.*, 5 F. (2d) 77; *Northwestern Bell Tel. Co.* v. *Spillman*, 6 F. (2d) 663; *New York Tel. Co.* v. *Prendergast*, 36 F. (2d) 54; *Southwestern Bell Tel. Co.* v. *Public Utilities Comm.*, 115 Kan. 236.

Approval of the method of separation of the interstate property of the company by the court below is sustained by the evidence and the decisions of courts and commissions thereon. *Pacific Tel. & Tel. Co.* v. *Whitcomb*, 12 F. (2d) 279; *New York Tel. Co.* v. *Prendergast*, 300 Fed. 822, 827; *State ex rel Hopkins* v. *Southwestern Bell Tel. Co.*, 115 Kan. 236. The question is one of management in selecting units of service. *Chicago, M. & St. P. Ry. Co.* v. *Wisconsin*, 238 U. S. 491.

No affirmative evidence of any other method of separation was offered by appellants, and the reasonable method used by the company must be approved. *Rowland* v. *St. Louis & S. F. R. Co.*, 244 U. S. 106, 108; *Groesbeck* v. *Duluth, S. S. & A. Ry. Co.*, 250 U. S. 607, 614.

No conflict exists between the method of partial separation approved by this Court in *Houston* v. *Southwestern Bell Tel. Co.*, 259 U. S. 318, and the complete interstate separation presented in the present record.

The commission and the lower court were in substantial agreement in their findings as to reproduction cost new, after correcting the error in the commission's finding. Both the court and the commission sustained the accuracy of the company's books as to original cost, adding an amount for undistributed construction costs not shown in the company's accounts.

The arbitrary act of the commission in finding the property in 90 per cent. condition, and then deducting

the company's depreciation reserve, was an error of law. *Public Utility Commissioners* v. *New York Tel. Co.*, 271 U. S. 23; *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, 416; *Pacific Gas & Elec. Co.* v. *San Francisco*, 265 U. S. 403, 406; *Standard Oil Co.* v. *Southern Pacific Co.*, 268 U. S. 146, 159.

Only actual observed, existing depreciation can be deducted to ascertain present fair value. *New York Tel. Co.* v. *Prendergast*, 300 Fed. 822, s. c., 36 F. (2d) 54; *Southern Bell Tel. & Tel. Co.* v. *Railroad Comission*, 5 F. (2d) 77; *Monroe Gaslight Co.* v. *Public Utilities Comm.*, 292 Fed. 139; *Garden City* v. *Garden City Tel., L. & M. Co.*, 236 Fed. 693; *Kings County Lighting Co.* v. *Prendergast*, 7 F. (2d) 192, affirmed, 272 U. S. 579; *Pacific Tel. & Tel. Co.* v. *Whitcomb*, 12 F. (2d) 279, affirmed, 276 U. S. 97.

A depreciation reserve account is a matter of bookkeeping, under the accounting rules of the Interstate Commerce Commission. Under the existing law, the Interstate Commerce Commission has exclusive jurisdiction of accounting of expense of depreciation. *Oregon-Washington R. & N. Co.* v. *Washington*, 270 U. S. 87; *Southern Railway Co.* v. *Railroad Commissioners*, 236 U. S. 439; *Northern Pacific R. Co.* v. *Washington ex rel. Atty. Gen.*, 222 U. S. 370; *New York Central R. Co.* v. *Winfield*, 244 U. S. 147; *Pennsylvania R. Co.* v. *Public Service Comm.*, 250 U. S. 566; *Postal Telegraph Co.* v. *Warren-Godwin Lumber Co.*, 251 U. S. 27.

The judgment of the company's officers as to the proper rate of depreciation cannot be set aside on the evidence in the record. The evidence would have sustained a much greater valuation than the minimum value used by the court in its computations finding the proposed rates confiscatory.

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

This is an appeal from a final decree of the District Court, composed of three judges as required by section 266 of the Judicial Code, enjoining the enforcement of an order of the Illinois Commerce Commission which prescribed rates for telephone service in the City of Chicago, upon the ground that the order was confiscatory and hence was in violation of the due process clause of the Fourteenth Amendment (38 F. (2d) 77). The order of the Commission was made on August 16, 1923, to be effective October 1, 1923. It reduced rates for four classes of coin box service and thus applied to a large part of the intrastate service of the complainant, the Illinois Bell Telephone Company.

An interlocutory injunction, restraining the enforcement of the rates, was granted on December 21, 1923, and the order was affirmed by this Court on October 19, 1925. 269 U. S. 531. This interlocutory order was made upon the condition that, if the injunction were dissolved, the complainant should refund to its subscribers the amounts paid by them in excess of the sums chargeable under the Commission's order. The suit was not brought to a final hearing until April, 1929, and the court found that at the time of its decision (January 31, 1930) the amount thus reserved for refunds exceeded $11,000,000. The court said that the delay in bringing the case to trial was attributable to the City of Chicago and that the complainant had been ready at all times to proceed. But the decree enjoining the rates speaks from its date, and the question is necessarily presented, not only whether the order of the Commission was confiscatory when made, but also as to its validity during the period that has intervened, and as to the respective rights of the complainant and its subscribers in relation to the fund thus accumulated. *Groes-*

*beck* v. *Duluth South Shore & Atlantic Railway Company*, 250 U. S. 607, 609.

The court found that ninety-nine per cent. of the stock of the complainant, the Illinois Company, is owned by the American Telephone & Telegraph Company which also owns substantially the same proportion of the stock of the Western Electric Company; that the Illinois and American companies unite in rendering long distance service under an arrangement for a division of tolls; that at the time to which the inquiry related, in October, 1923, there was in effect an agreement by which the Illinois Company paid to the American Company 4½ per cent. of its gross revenues for rent of instruments and as compensation for enginering, executive, financial and other services; that a large part of the materials entering into the construction of the plant and equipment of the Illinois Company were purchased from the Western Electric Company and much of its operating expense consisted of payments made under a contract with that company for apparatus and supplies. The court further found that the American Company owned a controlling interest in fifteen telephone companies which, in connection with other companies controlled by those subsidiaries and some companies in which its interest was not controlling, were operated as a system with the avowed purpose of rendering a nation-wide and unified telephone service; that the American Company had stated that "the associated companies are specialists in local service problems, with local operating forces, identified and familiar with the needs of the communities they serve"; that "the parent company undertakes the solution of the problems that are common to all," and in this way there was provided a central authority equipped to perform adequately general functions, leaving to the local companies responsibility for local affairs.

Upon these facts the City attacked the standing of the Illinois Company as the real plaintiff in the case. The

court overruled this contention, holding that the ownership of stock by the American Company, and its power to control the Illinois Company, did not destroy the distinct corporate identity of the Illinois Company. The court pointed out that the order of the Commission was directed against the Illinois Company, and that it was treated as a corporation for the purpose of compelling it to establish the prescribed rates for service furnished by the operation of the property to which it had legal title. No ground appears for assailing this ruling. The fact that the relation of the Illinois Company to the American Company may demand close scrutiny, in dealing with certain questions which bear upon the validity of the rate order, cannot obscure the essential basis of that order, that is, that the Commission was imposing its requirement upon a corporate organization engaged in an intrastate public service and, as such, amenable to a valid exercise of the Commission's authority.

The Commission, in its final order of August 16, 1923, made the following findings with respect to the value of the property of the Illinois Company: That the original cost as of December 31, 1922, of the property used and useful in the rendering of telephone service in the City of Chicago and exclusive of working capital, materials and supplies, work in progress and going value, but including overhead, was $90,687,816; that the reproduction cost new of that property, with the same exceptions, was $128,769,000; that the property as it then existed was "in at least 90 per cent condition"; that the amount of construction work then in progress, which would eventually be included in capital account, was not more than $4,250,000; that the amount necessary to provide a sufficient cash working capital and to permit the carrying of sufficient materials and supplies was $3,000,000; that the going value of the Chicago property of the Illinois Company was $4,196,872; that the Chicago division of the Illinois

Company had a depreciation reserve of $26,000,000 which had been contributed by the subscribers of the Company and had been used by the Company for extensions and additions to its property, and that these extensions and additions should not be considered in arriving at a base upon which to compute rates for telephone service; and that the fair rate-making base for the Chicago property of the Illinois Company, "including physical property, overhead, working capital, going value and work in progress" as thus found was $96,000,000, which was "exclusive of the $26,000,000 of money taken for depreciation reserve and put into plant and equipment." The Commission also found that on a readjustment of the account of operating expenses, and on making a fair allowance to take care of maintenance and retirement charges, the existing rates, if permitted to remain in effect for the ensuing year (1923) would afford a return of nine per cent. upon the rate-base above stated; that this was an excessive rate and that the reduced rates prescribed by the Commission would enable the Company to obtain a return of seven and one-half per cent. upon that rate base.

The court found that the original cost of the property, taking the Commission's finding of cost as of December 31, 1922, with net additions to June 30, 1923, was $101,626,014; that the reproduction cost new, as of the latter date, was at least $145,000,000; that the finding that the property was in 90 per cent. condition was supported by the evidence, and that on this basis the reproduction cost new, less depreciation, was $130,500,000; that the amount allowed by the Commission, $4,196,067, was the minimum allowance that could be made for going value; that the valuation, or rate basis, of $96,000,000, found by the Commission as of December 31, 1922, or $106,000,000, if the net additions to June 30, 1923, were added, was clearly insufficient, and that the valuation should be not less than $125,000,000, estimating the depreciation at ten per cent.

The court held that the exclusion from the rate base of extensions and additions to the amount of $26,000,000, for which payment had been made from the Company's depreciation reserve, was erroneous; that the customers had paid for service, not for the property used to render it, that in paying for service they had not acquired any interest in the property of the Company, and that profits of the past could not be used to sustain confiscatory rates for the future, citing *Board of Public Utilities Commissioners* v. *New York Telephone Company,* 271 U. S. 23, 31, 32.

The court further found that the readjustment made by the Commission of the Company's account of operating expenses involved a reduction of $360,000 from the payment made to the American Company under the license contract, and a reduction of $1,800,000 from the annual allowance for depreciation; that the amount available for return in 1923 on the value of the property under the rates in force was $6,280,000; that if to this amount were added the above deductions on the license contract and for depreciation there would have been available for such return the sum of $8,440,000; that the reduction for the entire year under the rates established by the Commission would have been $1,700,000, thus leaving a return of $6,740,000, or less than five and one-half per cent., which was held to be confiscatory under conditions existing in 1923.

At the threshold of the discussion, we are met with the fact that, in these findings, the Commission and the court made no distinction between the intrastate and the interstate property and business of the Company. It appears that the property of the Company in Chicago is used to render (1) what is called exchange service, all of which is intrastate, (2) intrastate toll service over its own lines and under arrangements with companies other than the American Company, and (3) interstate toll serv-

ice, which includes all the toll service rendered under arrangements with the American Company. The Company introduced evidence separating the intrastate and interstate business and also the intrastate exchange business. While the court regarded these computations as correct, and approved the method in which they had been made, still the court made no specific findings based on a separation of the intrastate and interstate property, revenues and expenses, but determined the issue on the basis of the total Chicago property of the Company.

The court stated that this was done because that basis was less favorable to the Company than that of its total intrastate property or of its intrastate exchange property. In support of this view, the court said that according to the computations of the company, one-half of one per cent. of calls originated by subscribers resulted in interstate toll calls; that 3.62 per cent of the Company's property in Chicago was used in furnishing interstate toll service, and 2.54 per cent. of its property was used in furnishing intrastate toll service; that both on the reproduction cost new, as claimed by the Company, and on the original cost, the percentage of return was greater for the total Chicago business than for the total intrastate business, and that the return for the latter was greater than for the intrastate exchange business. Considering that the difference would not affect the result, the court deemed it to be more convenient to pass upon the order of the Commission without recasting the figures in order to make allowance for interstate or intrastate toll property and earnings.

The appellants challenge this conclusion.[1] They insist that the American Company used in its long distance service, without properly reimbursing the Illinois Company, the Chicago local exchange plant, and other facili-

[1] In *Board of Commissioners* v. *New York Telephone Company*, 271 U. S. 23, the appellants did not raise this question (*id.* p. 30).

ties of the latter company, and that the additional net income to which the Illinois Company was properly entitled in connection with the long distance service, or that suitably taking into account the value of the property used and the expenses incurred in the long distance service and not deducted from the Chicago property and expenses, would affect the result. It is apparent that this contention can not be dismissed simply on the basis of the number of interstate calls originated by subscribers of the Illinois Company in Chicago, without considering other factors of time and labor entering into the relative use. Nor can the question be disregarded by assuming a rate of return from the total Chicago business, as compared with a rate of return from the intrastate business or the intrastate exchange business, as such an assumption would beg the point in issue.

The separation of the intrastate and interstate property, revenues and expenses of the Company is important not simply as a theoretical allocation to two branches of the business. It is essential to the appropriate recognition of the competent governmental authority in each field of regulation. In disregarding the distinction between the interstate and intrastate business of the Company, the court found it necessary to pass upon the fairness of the division of interstate tolls between the American and Illinois companies. The court held that the division was reasonable and the appellants contest this ruling. But the interstate tolls are the rates applicable to interstate commerce, and neither these interstate rates nor the division of the revenue arising from interstate rates was a matter for the determination either of the Illinois Commission or of the court in dealing with the order of that Commission. The Commission would have had no authority to impose intrastate rates, if as such they would be confiscatory, on the theory that the interstate revenue of the Company was too small and could be increased to

make good the loss. The interstate service of the Illinois Company, as well as that of the American Company, is subject to the jurisdiction of the Interstate Commerce Commission, which has been empowered to pass upon the rates, charges and practices relating to that service (Interstate Commerce Act, section 1 (1) (c), (3), (5); section 15 (1); section 20 (5)). In the exercise of this jurisdiction the Interstate Commerce Commission has authority to estimate the value of the property used in the interstate service and to determine the amount of the revenues and the expenses properly attributable thereto. By section 20 (5) of the Interstate Commerce Act, that Commission is also charged with the duty of prescribing, as soon as practicable, the classes of property for which depreciation charges may properly be included in operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property. The proper regulation of rates can be had only by maintaining the limits of state and federal jurisdiction, and this cannot be accomplished unless there are findings of fact underlying the conclusions reached with respect to the exercise of each authority. In view of the questions presented in this case, the validity of the order of the state commission can be suitably tested only by an appropriate determination of the value of the property employed in the intrastate business and of the compensation receivable for the intrastate service under the rates prescribed. *Minnesota Rate Cases,* 230 U. S. 352, 435. As to the value of that property, and as to the revenue and expenses incident to that business, separately considered, there should be specific findings. *Railroad Commission* v. *Maxcy,* 281 U. S. 82, 83.

The court found that the Illinois Company owns and operates all the property in the City of Chicago used in interstate calls and connects with the property owned by

the American Company at the city limits. In the method used by the Illinois Company in separating its interstate and intrastate business, for the purpose of the computations which were submitted to the court, what is called exchange property, that is, the property used at the subscriber's station and from that station to the toll switchboard, or to the toll trunk lines, was attributed entirely to the intrastate service. This method was adopted as a matter of convenience, in view of the practical difficulty of dividing the property between the interstate and intrastate services.[2] The appellants insist that this method is erroneous, and they point to the indisputable fact that the subscriber's station, and the other facilities of the Illinois Company which are used in connecting with the long distance toll board, are employed in the interstate transmission and reception of messages.[3] While the difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required, only reasonable measures being essential (*Rowland* v. *Boyle,* 244 U. S. 106, 108; *Groesbeck* v. *Duluth South Shore & Atlantic Railway,* 250 U. S. 607, 614) it is quite another

[2] On this ground, this method of separation has been approved by a number of state commissions. See Re Northwestern Bell Telephone Co., P. U. R. 1923-B, 112, 170; Public Utilities Commission *v.* New England Telephone & Telegraph Co., P. U. R. 1926-C, 207, 261; Re Hawkinsville Telephone Co., 138 Commission Leaflet (1923), 1112, 1115-1117. But compare Missouri & Kansas Telephone Co., P. U. R. 1918-C, 55; Re Southern California Telephone Co., P. U. R. 1925-C, 627; Re Chesapeake & Potomac Telephone Co. of Virginia, P. U. R. 1926-E, 481, 626; *Chesapeake & Potomac Telephone Co. of Virginia* v. *Commonwealth of Virginia,* 147 Va. 43.

[3] The Interstate Commerce Commission has had under consideration the application of section 20 (5) to the local exchange property which "is open for use in interstate commerce and at any time may be so used." Telephone and Railroad Depreciation Charges, 118 I. C. C. 295, 328-333; also Proposed Report (I. C. C.) of August 15, 1929.

matter to ignore altogether the actual uses to which the property is put. It is obvious that, unless an apportionment is made, the intrastate service to which the exchange property is allocated will bear an undue burden—to what extent is a matter of controversy.[4] We think that this subject requires further consideration, to the end that by some practical method the different uses of the property may be recognized and the return properly attributable to the intrastate service may be ascertained accordingly.

Other questions are presented growing out of the relation of the Illinois Company to the Western Electric Company and to the American Company. While the Illinois Company is a distinct corporate organization, it has the advantage of being a component part of a large system to which the benefits of its operations accrue. Through this relation the Illinois Company obtains the coöperation of the manufacturing, research, engineering and financing departments of the American Company. This does not alter the fact that the Illinois business is to be treated as a segregated enterprise. If a single individual or corporation, having a number of technical staffs, engaged directly in local public services within several States, each State would be entitled to regulate the transactions within its own domain according to its own conception of public pol-

[4] In *Houston* v. *Southwestern Bell Telephone Co.*, 259 U. S. 318, 322, relating to the ordinance of the City of Houston prescribing telephone rates for the Company which operated not only the Houston local exchange but also long distance toll lines connecting the local exchange with various towns and cities in Texas and several other States, the Company in practice, and for the purpose of the suit, "credited the local exchange with 25% of the long-distance toll revenues received from calls originating in Houston as compensation for the use made of the local plant in rendering long distance service," and upon the facts there shown the Court held that the allowance was reasonably sufficient.

icy, provided there were no infringement of the fundamental rights guaranteed by the Federal Constitution, and, if the latter were invoked by reason of the action of any State, it would still be necessary to consider the local enterprise separately and to make whatever apportionments were necessary in that view. The corporate organization of the Illinois Company not only created a legal person amenable as such to governmental authority, but facilitates the examination of the particular transactions subject to that authority. The question presented in the present case is not one of the abuse of intercorporate relations, or of domination or control affecting the integrity of the direction of the affairs of the Illinois Company, but of alleged confiscation through prescribed intrastate rates.

Contentions of the appellants in this relation are directed to the purchases from the Western Electric Company and to the payments to the American Company under what is called its "license contract." It appears that the Illinois Company has purchased practically all its equipment from the Western Electric Company. The state commission in laying the basis for its rate order made no finding as to the fairness of the prices on such purchases. On the record in this suit, the court concluded that the City had failed to support its contention that these prices were exorbitant. The court said that it appeared that for the past fourteen years the average profit of the Western Electric Company on its total business had not been "in excess of seven per cent. and never above ten per cent." That fact has 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 sales 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 material, or by the Western Electric Company to independent telephone companies. The point of the appellants' contention is that the Western Electric Company, through the organization and control of the American Company, occupied a special position with particular advantages 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 estimates upon which the charge of confiscation is predicated. We think that there should be findings upon this point.

At the time to which the evidence was primarily directed (1923), there was in force a "license contract" between the Illinois Company and the American Company, granting a license under the patents owned or controlled by the American Company and providing for the payment to the latter of 4½ per cent. of the gross revenues of the Illinois Company covering the rental for the use of instruments and for engineering, financial and advisory services. The total amount sought to be charged by the Illinois Company to operating expenses, in 1923, for payments under this contract in relation to the Chicago business was about $1,724,000. The order of the Public Utilities Commission of Illinois, made in December, 1920, which fixed the rates charged in 1923 (the rates still in force under the interlocutory injunction in

this suit) had provided that an allowance of $1.13 was reasonable solely for the use of each telephone instrument, that the services of the American Company were of great value to the Illinois Company, that the annual payment under the license contract then averaged $2.10 per station for the City of Chicago, and that this payment was not excessive.[5] The Illinois Commerce Commission, in the order now under attack, continued this allowance of

[5] The Public Utilities Commission found as follows: "The record in the instant case shows that the present market price for the same instrument is $4.50 and on this basis the Commission finds that an annual allowance of $1.13 is reasonable and adequate solely for the rental of each telephone instrument. The record shows, however, that the license to use various patented devices, the patents covering which are the property of the American Telephone and Telegraph Company, together with engineering, financial and advisory services, are of great actual value to the Chicago Telephone Company, such value being evidenced in part by the actual annual saving effected over and above the operating costs should such devices and services not be available. The present payment made by petitioner and under the present license contract to the American Telephone and Telegraph Company averages about $2.10 per station per annum for the City of Chicago and about $1.91 per station per annum for the suburban territory. At $2.10 per station per annum, therefore, the maximum effect upon any one rate for service cannot exceed $0.18 per station per month. Since payment is made to the American Telephone and Telegraph Company by the Chicago Telephone Company of whose stock the former owns approximately 98%, it is necessary that the underlying contract be given scrutiny notwithstanding the fact that the Chicago Telephone Company, as a legal entity, is a free agent. A careful consideration of the evidence in the instant case discloses the unquestioned value of the general services rendered petitioner by the American Telephone and Telegraph Company. . . . The particular amounts involved have been approved as items of operating expense in different jurisdictions by nine Commissions within the last three years, however, and the Commission after carefully considering all the evidence is of the opinion and finds that the present annual payment under the license contract, limited to $2.10 per station per annum for the City of Chicago and to $1.91 per station per annum for the suburban territory, is not excessive and may be allowed as an item of operating expense."

$2.10 per station as sufficient to cover the rental and the services in question.[6]

The Illinois Company, in its evidence before the court, presented an estimate showing that it would have cost that Company the sum of $709,000, or $1.07 per station, during the year 1923 to provide its own supply of instruments, purchasing them in the open market and providing for a return of eight per cent. on the investment. The appellants urge that this amount is too large by $120,000, and that, in any event, the remainder of the total charge of $1,724,000 for payments under the license contract, that is, $1,015,000, treating this amount as compensation for services in addition to rentals, should be rejected. The court overruled this contention. The court found that the case for the allowance of the entire amount for services was a strong one; that on the basis of a total charge of $2.10 per station, as allowed by the state commission, there would be a reduction of $360,000 in the amount chargeable to operating expenses by virtue of the payments under the license contract, and that there was

[6] The finding of the Commerce Commission, after referring to the ownership of stock by the American Company, was as follows: "The Commission believes from all the circumstances surrounding the payments made by the Illinois Bell Telephone Company to the American Telephone and Telegraph Company and the services rendered by the latter to the former, and the cost thereof, should be at some time fully investigated, to the end that charges for the services may be properly established. The present record does not contain sufficient information to warrant this Commission in departing from the findings of the previous Commission in respect to the payments that should be made by the Illinois Bell Telephone Company to the American Telephone and Telegraph Company. The previous Commission found that payment by the Chicago Telephone Company to the parent company of $2.10 per station was sufficient to cover the value of the services rendered. It is certainly more equitable to base the charges for services rendered on the number of stations rather than on the gross revenue because any change in revenues results in a change in payments to the parent company, and would be made without respect to the services rendered."

no warrant for any further reduction. Without approving the reduction, the court accepted the ruling of the Commission for the purpose of determining the issue of confiscation.

It further appears that in the early part of the year 1926, the payment under the license contract was reduced from 4½ per cent. of the gross earnings to 4 per cent. This reduction was made effective as of January 1, 1926, and the reduced rate was applied in the years 1926 and 1927.[7] At the end of the year 1927, the conditions of the license contract were again changed by providing for the sale by the American Company to the Illinois Company of the telephone instruments (receivers, transmitters and induction coils) and the American Company was relieved from its obligation with respect to their replacement and repair. It is said that the price paid was substantially the current price less 20 per cent. At the same time the payment under the license contract by the Illinois Company to the American Company was reduced from 4 per cent. to 2 per cent. of the gross earnings.[8] On January 1, 1929, the

[7] In the Annual Report of the American Company for 1926 it was stated: "The American Telephone and Telegraph Company was able during the year to make a reduction in its charge to its Associated Companies under its contracts for service, including the furnishing of telephones. The charge was reduced from 4½ per cent. to 4 per cent. of the gross revenue of those companies, effective from January 1, 1926. The purpose of these contracts is not to make money for the American Telephone and Telegraph Company, but to further the development of the telephone art and to enable the growth and expansion of telephone service on a nation-wide basis. While the cost of furnishing the services to any one company, from the nature of the services rendered, cannot be determined, the total cost of furnishing services for all of the companies under the contracts can be approximated. The revenue of $29,850,303 received under the contracts during 1926 only slightly more than offset the estimated cost of over $29,250,000."

[8] With respect to these changes the American Company stated in its report for 1927: "As the business grows and the country

rate of payment was further reduced from 2 per cent. to 1½ per cent. of the gross earnings.

There is evidence that the payment under the license contract in the year 1924 exceeded the amount allowed by the state commission by $358,952; in 1925, by $387,284; in 1926, by $223,249; and in 1927, by $251,964. We find no similar statement for the subsequent period under the reductions of rate then applicable. In view of the findings, both of the state commissions 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 cost of these services to the American Company and the reasonable amount which should be allocated in this respect to the operating expenses of the intrastate business of the Illinois Company in the years covered by the decree.

There is also the question of the annual allowance for depreciation. The Illinois Commission concluded that the accumulation of a large reserve ($26,000,000) despite the fact that the property had been maintained "in at least 90 per cent. condition," showed that the reserve had been built up by annual additions that were in excess of the amounts required. The Commission by its order pro-

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grows, conditions change. In the early days of the telephone business it seemed essential that telephone instruments be owned and maintained by a central organization. This condition no longer obtains, and, therefore, as previously stated, the telephone instruments heretofore owned by the American Telephone and Telegraph Company were sold to the operating companies and a reduction was made in the charge for services furnished under service contracts with those companies. In 1926 this charge was reduced from 4½ per cent. to 4 per cent. of their gross telephone revenues, and this present reduction to 2 per cent. will result in revenues to the American Telephone and Telegraph Company somewhat less than the estimated cost of performing its services under these contracts. This is, however, in accord with our efforts to assist our Associated Companies in keeping down the cost of telephone service in every way practicable."

vided for a "combined maintenance and replacement allowance" which it deemed to be adequate "to fully protect the investment in this property and permit the Company to accrue a reserve in the anticipation of property retirements." The court found that by this method the amount as charged by the Company to operating expenses in 1923 with respect to depreciation had been reduced by the Commission to the extent of about $1,800,000. It was on the assumption of this reduction, that the court, without making any finding as to the proper annual allowance for depreciation, reached its conclusion as to the inadequacy of the rates.

While it has been held by this Court that property paid for out of moneys received for past services belongs to the Company, and that the property represented by the credit balance in the reserve for depreciation cannot be used to support the imposition of a confiscatory rate (*Board of Commissioners* v. *New York Telephone Company, supra*), it is evident that past experience is an indication of the Company's requirements for the future. The recognition of the ownership of the property represented by the reserve does not make it necessary to allow similar accumulations to go on if experience shows that these are excessive. The experience of the Illinois Company, together with a careful analysis of the results shown, under comparable conditions, by other companies which are part of the Bell system, and thus enjoy the advantage of the continuous and expert supervision of a central technical organization,[9] should afford a sound basis for judgment as to the amount which in fairness

[9] The Interstate Commerce Commission has observed: "In devising methods for accumulating, recording, and utilizing the data essential to the ascertainment of service lives and depreciation rates, the railroad companies may well take note of the experience of the telephone companies. Much of this research and planning work has been done for the Bell System companies by a central organization of a few carefully selected engineers and accountants, and in this way

both to public and private interest should be allowed as an annual charge for depreciation.

The Company urges that, as Congress has granted jurisdiction to the Interstate Commerce Commission over the depreciation rates of telephone companies doing an interstate business (Interstate Commerce Act, section 20 (5) as amended by Transportation Act, 1920) this subject is now completely withdrawn from the power of the State. It is said that two rates of depreciation cannot be charged on the same property. The Interstate Commerce Commission has had the matter under consideration (Telephone and Railroad Depreciation Charges, 118 I. C. C. 328-333) but, so far as we are advised, a final determination has not yet been made. The Interstate Commerce Commission has its accounting rules with reference to depreciation charges and, pending its order under section 20 (5) of the Interstate Commerce Act, telephone companies, as well as others subject to the Act, have been directed to continue to observe these requirements. The Company argues that, although the Interstate Commerce Commission has not finally ruled, the action taken by Congress excludes the jurisdiction of state tribunals under familiar principles (*Northern Pacific Railway Company* v. *Washington,* 222 U. S. 370, 378; *Pennsylvania Railroad Company* v. *Public Service Commission,* 250 U. S. 566, 569; *Oregon-Washington Railroad & Navigation Company* v. *Washington,* 270 U. S. 87, 102). We are unable to assent to this view. As the Interstate Commerce Commission has not acted finally in the matter, we are not now called upon to consider the scope of its authority in relation to depreciation charges, but we are of the opinion that, in any event, until action has been

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it has been done better and more economically than if each of the numerous operating companies had been left to its own initiative. The independent telephone companies have also profited from this work." Telephone and Railroad Depreciation Charges, Proposed Report of August 15, 1929, [p. 20].

taken which could be deemed validly to affect the amount to be charged to depreciation in connection with intrastate business so as to affect intrastate rates, the prerogative of the State to prescribe such rates, and the jurisdiction and duty of the statutory court in considering their validity to determine the amount properly allowable for depreciation in connection with intrastate business, are not to be gainsaid. Compare *Board of Commissioners* v. *Great Northern Railway Company,* 281 U. S. 412. Accordingly, the court should make appropriate findings with respect to the amount to be allowed in this case as an annual charge for depreciation in connection with the intrastate business.

Upon the hypotheses adopted by the statutory court, the return to the Illinois Company was found to be inadequate, but what would be a proper rate of return was not determined. In determining what is a confiscatory regulation of rates, it is necessary to consider the actual effect of the rates imposed in the light of the utility's situation, its requirements and opportunities. As was said in *United Railways* v. *West,* 280 U. S. 234, 249, 250, a rule as to rate of return can not be laid down which would apply uniformly to all sorts of utilities; "what may be a fair return for one may be inadequate for another, depending upon circumstances, locality and risk." In that case the Court restated the general rule in the language of the opinion in *Bluefield Company* v. *Public Service Commission,* 262 U. S. 679, 692, 693, as follows: "What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country

on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."

It is evident that in the present case we are not dealing with an ordinary public utility company, but with one that is part of a large system organized for the purpose of maintaining the credit of the constituent companies and securing their efficient and economical management. The record of the Illinois Company shows that for many years it has been able to expand its business so as to meet increasing demands, to pay its operating expenses including interest on money borrowed, to pay dividends of eight per cent. upon its capital stock, and to accumulate a surplus. It was found by the court that the reduction in revenue caused by the rates in question, as applied to the entire business for the year 1923, would amount to about $1,700,000, and the question is whether the loss when ascertained with respect to the intrastate business would cause confiscation under the applicable standard as above set forth in the *Bluefield* case, *supra*. In order to determine this question, the court should find the rate of return which was realized from the intrastate business and the rate of return which it is fair to conclude would have been realized from that business under the prescribed rates.

The conclusion reached by the court as to confiscation had particular reference to the evidence bearing upon the business of the year 1923. The court said that this finding applied "with increasing force to the succeeding

years." But no findings were made as to the value of the property and the revenues and expenses in these years. A rate order which is confiscatory when made may cease to be confiscatory, or one which is valid when made may become confiscatory at a later period. *Des Moines Gas Company* v. *Des Moines,* 238 U. S. 153, 172, 173; *Lincoln Gas Company* v. *Lincoln,* 250 U. S. 256, 268, 269; *Brush Electric Company* v. *Galveston,* 262 U. S. 443, 446; *Bluefield Company* v. *Public Service Commission, supra.* In view of this fact, and as the disposition of the amount withheld by the Company under the conditions of the interlocutory injunction will depend on the final decree, there should be appropriate findings as to the results of the intrastate business in Chicago and the effect of the rates in question for each of the years since the date of the Commission's order.

In order that the necessary findings may be made, and such additional evidence as may be required for that purpose may be received, the decree is set aside and the cause is remanded to the District Court, specially constituted as provided by the statute, for further proceedings in conformity with this opinion, the restraining order entered in this suit to be continued pending further action of the District Court.

*It is so ordered.*

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## CHICAGO, ST. PAUL, MINNEAPOLIS & OMAHA RAILWAY COMPANY *v.* HOLMBERG.

ERROR TO THE SUPREME COURT OF NEBRASKA.

No. 1. Argued October 10, 1928. Reargued October 23, 1930.—Decided December 1, 1930.

A state law so applied as to require a railroad company to provide an underground cattle-pass across its right of way partly at the