WASHINGTON METROPOLITAN AREA TRANSIT COMMISSION

WASHINGTON, D. C.

ORDER NO. 1090

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| IN THE MATTER OF: | Served September 9, 1970 |
| Application of D. C. Transit System, Inc., for Authority to Increase Fares. | Application No. 613<br>Docket No. 216 |

John M. Cleary, a regular bus rider, has filed a Petition for Reconsideration of Order No. 1052. Mr. Cleary appeared at the hearings which preceded the issuance of that order and sought to intervene as a formal party. It was not possible to grant him that status because his motion was untimely and he could not show good cause for permitting a late intervention. We asked Mr. Cleary to state the areas of concern to him, however. He said that he wished to raise the question of possible violations of Section 10 of the Clayton Act in connection with certain real estate transactions undertaken by D. C. Transit System, Inc. While we could not permit Mr. Cleary to participate as a formal party, we instructed the Commission staff to investigate the question raised by him and report to us during the course of the hearing. Subsequently, our general counsel informed us that the staff had made an investigation into the transactions and the provisions of the Clayton Act and had concluded that there was no evidence of violations to bring before the Commission.

Mr. Cleary now seeks reconsideration of Order No. 1052, alleging a number of errors in that order. We will take up his points one by one in the order in which they were made.

I

Mr. Cleary suggests a number of proposals designed to increase usage of mass transportation. Some of them are ideas which we ourselves have espoused in Congressional testimony, such as a tax on parking. Others are less direct and practical in nature, such as a suggestion that a more vigorous enforcement of the income tax laws, as applied to charging off the expense of using private vehicles, would increase bus ridership. None of the ideas suggested could be implemented directly by this Commission. They would require legislation or affirmative action by other agencies of government. Mr. Cleary suggests that we committed error in failing to consider the revenue which implementation of these ideas would produce.

We reject Mr. Cleary's allegation of error as thoroughly impractical and unjustified as a matter of law. It is perfectly obvious that implementing the suggestions he makes would be far from easy. Imposition of a parking tax, while in our view eminently desirable, would be a difficult and lengthy legislative undertaking. Simply to assume that it exists and impute additional income to Transit on the basis of it would be regulation of the most capricious kind. We believe the wiser course is to continue to press for developments of this kind and to give effect to them in the ratemaking process as they come into being and their impact can be measured.

II

In a related point, Mr. Cleary alleges as error our failure to impute additional income as a result of the marketing improvement program directed by Order No. 1052. Again, we do not agree. The program we have directed is a novel one. We have no way of knowing just what will be its impact upon ridership and revenues. We have high hopes for a successful outcome but no factual basis on which to predict either success or the impact of success on revenues. Meanwhile, we are dealing with a company which is in a critical financial condition and clearly requires relief. Moreover, we are not unaware, as pointed out at p. 6 of Order No. 1052, that the ridership projections on which we based our revenue computations could turn out to be overly optimistic. We think the wisest course is to require the company to institute the marketing program and monitor both ridership levels and financial results as the program gets underway. If and when the figures show that rate adjustments are justified, then means exist for us to take such action promptly.

III

Next, Mr. Cleary questions our allowance of an increase in the provision for injuries and damages expense from $1,300,000 to $1,900,000. Mr. Cleary apparently misunderstands our action in Order No. 1052 since the basis for this claim of error is that the increase is based on the need to make up a deficiency in the reserve. Since this deficiency will be made up in a year, he argues, it is error to allow an increase in this expense which will extend beyond a year. However, in Order No. 1052, we disallowed that portion of the increase sought by Transit in an effort to make up a deficiency in the reserve. The increase we granted, as Order No. 1052 makes clear, was based on an increase in the anticipated actual expenditures for injuries and damages claims during the future annual period. The only item in the nature of a deficiency involved was the inclusion of an amount required to maintain the reserve at the level experienced at March 31, 1970, and this was a small part of the increase. Since the cost of settling claims has been on the increase, we think that the amount of expense in the future annual period which is attributable to maintaining the reserve at the March 31, 1970 level will be required thereafter to meet the then current expense of settling claims.

Next, Mr. Cleary suggests that the amount allowed as injuries and damages expense should be invested, with the yield credited to the ratepayer. Apparently, he does not understand that the amount allowed in current expense is equivalent to the amount which the company will actually be paying out on current suits and claims.

Finally, he seems to think that the amount allowed is designed to allow the payment of claims by Transit on a "no-fault" basis. This, of course, is not the case. Transit is liable, and pays claims, only where fault on its part is shown or conceded.

IV

Mr. Cleary claims we erred in failing to disallow a portion of management salaries. These salaries are an item which always receive our close scrutiny in rate proceedings. In the present case, we disallowed a portion of those salaries since we felt that in view of the company's current financial condition, certain raises granted should not be borne by the ratepayer. The salaries actually allowed are not unreasonable for those responsible for the conduct of a $40,000,000 per year business.

The company's expenses are audited on a continuing basis by our own accounting staff. They regularly point out items which we disallow for rate-making purposes. We are confident that their scrutiny provides protection for the riding public. We certainly find no basis for disallowing 20% of administrative and general expenses on the basis of Mr. Cleary's vague reference to unspecified press reports.

V

Mr. Cleary would have us disallow any expense for track removal, apparently in an effort to force the District Government not to charge these expenses. The charge allowed for in Order No. 1052 was based on a careful investigation of expenses actually anticipated in the coming year. Under existing law, the company has a clear legal obligation to pay those expenses. We have no justification for engaging in the kind of irresponsible ploy which Mr. Cleary suggests. We have repeatedly made known our belief that the burden of track removal expense should be lifted from the bus-riding public and borne by the community-at-large. We will not indulge in personal whim to achieve that end, however. Until the law is changed, we will allow this expense as we are required to do.

VI

In two separate points, Mr. Cleary alleges error in our treatment of Transit's below-the-line real estate. He urges that depreciation expense should have been adjusted on the basis of the market value of the properties, title to which has been transferred to wholly-owned subsidiaries.

He also states that we erred in failing "to include the profits, retained earnings, earning capacity and asset value for sale or security on loans, of the wholly owned subsidiaries of D. C. Transit." (Petition, p. 13) He never states with specificity what he believes we should do in order to "include" these elements. We take it, however, that he means that we should take into account the earnings of the subsidiaries in computing Transit's revenue requirements.

We have, of course, already given consideration to the proper impact of these properties. It was not discussed in Order No. 1052 because no party directly raised the question there and we did not have the occasion to articulate our views.

We were aware of, and did consider the specific point raised by Mr. Cleary before we issued Order No. 1052. Indeed, the question of the proper rate-making treatment of the below-the-line real estate is a subject which we have repeatedly considered and discussed among ourselves. We have familiarized ourselves with the history of these properties and the transactions concerning them. We have obtained through our staff current financial statements of the subsidiary companies involved. We have had occasion to familiarize ourselves with the physical location and general characteristics of the properties themselves. We have researched both the case law and the discussions in public utility regulation texts as it bears upon the questions raised by the existence of these properties. On the basis of all this review, we do not feel that the treatment of these properties suggested by Mr. Cleary is proper.1/

There is, first, the question whether we should adjust depreciation expense on the basis of the excess of market value over book value of the properties. There is no question that, when depreciable operating property is sold and a gain is realized, the gain should be used to

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1/ Many other protestants have raised the same points. We had occasion most recently to discuss the proper treatment of these properties in Order No. 981, in the Williams remand proceeding.

reduce the depreciation expense which ratepayers have paid but which the company, because of the gain, does not actually incur. However, the properties in question here have not been sold. They have been placed in non-operating status and their title has been transferred to subsidiary companies, but those subsidiaries are wholly-owned by Transit. Thus, Transit continues to own the property just as it always has. The only change is that the ownership occurs through holding all of the stock of the company having title, rather than retaining title directly. In no real sense can it be said that Transit's investors realize the gain represented by market value of these properties when their title is transferred to wholly-owned subsidiaries. Thus, the question presented to us is whether depreciation expense should be reduced on the basis of an appreciation in value which remains potential and unrealized.

The Commission partially answered that question in 1966 when it promulgated Regulation 61. That regulation provides that when depreciable property is transferred to below-the-line status, depreciation expense in the year of transfer will be reduced to the extent of the gain -- i.e., the excess of market value (determined by appraisal) over unrecovered cost. Thus, as to prospective transactions, the Commission's established practice comports with Mr. Cleary's suggestion. The question he really raises, therefore, is whether that same treatment should be applied retroactively to properties whose status changed prior to promulgation of the regulation.

Again, this is a subject about which we have thought carefully and repeatedly in considering Transit's rates. It has been our conclusion that it would not be proper to give retroactive effect to Regulation 61. The Commission promulgated Regulation 61 on the basis of the history of Transit's dealings with below-the-line properties. During the few years preceding its issuance, a number of properties had become unnecessary to the company's current operations. The company had put these properties to work in activities not related to mass transit operations. There was nothing in the Uniform Systems of Accounts or in regulatory precedent which required or suggested that depreciation expense be adjusted on the basis of the changes in status of these properties. Nonetheless, there was the prospect that additional properties would become unnecessary and be put to other uses. There was also the basic fact that economic pressures were tending to force fares upward. Balancing all of the factors in the public interest, the Commission felt that it was justified in taking the novel and unprecedented step of adjusting depreciation expense when the status of property changed, rather than waiting until an actual sale, and consequent realization of gain, took place.

However, we do not feel that retroactive application of that principle is justified. First, we are aware that the retroactive application of administrative regulations is not favored. Second, we feel that Transit's investors made decisions as to their own treatment of these properties on the basis of the regulatory principles prevailing at the time of the transactions in question. We do not regard it as orderly, considered, and just regulation to change the rules on the basis of which they made their decisions. Third, we do not regard the ratepayer as having been irretrievably deprived of the benefits which flow from the treatment prescribed by Regulation 61. If the properties in question are ever actually disposed of by Transit, the Commission could consider and take whatever action is justified to protect the ratepayer's interest. Thus, the question is not the ratepayer's entitlement to reimbursement for depreciation expense which ultimately turns out to be unnecessary but merely the timing of that reimbursement. Fourth, we are aware that many of the properties in question have, in recent years, been used to further the interests of the company's mass transit operations. Some of the properties in question have been mortgaged and the proceeds of the mortgages have been used to support the transit operations of the company. Thus, retention of the ownership of these properties by Transit has been in the best interest of the riding public. If Transit were required to provide the riding public with the benefit of the appreciation in value of these properties, there is considerable likelihood that it would seek actually to sell them. We are not convinced that such an action would be in the best interest of the company's overall stability.

For a variety of reasons, therefore, it has been our considered best judgment that we should not seek to apply the treatment called for by Regulation 61 to those properties whose status had changed prior to promulgation of that regulation.

Similarly, we do not feel that the income and earning capacity of these below-the-line properties should be taken into account in the rate-making process. In this conclusion, we are squarely in accord with the most basic of rate-making principles. The regulatory process is intended to apply only to business operations in the public utility sphere. Where a utility is able to engage in other business activities, those activities are separated from both the benefits and responsibilities of regulation. We are acutely aware that, if we rule that the profits from these real estate operations must be taken into account in setting transit rates, we would also be faced with the contention that the expenses and any potential or actual losses on such real estate must be borne by the ratepayer. We are unwilling to vest Transit's investors with this power to call upon the bus-riding public to support activities unrelated to the provision of transportation services. As matters now stand, the ownership of these properties redounds to the benefit of the bus-riders. The properties have been mortgaged and the proceeds used to support transit operations. This has helped the company to weather the financial difficulties of recent years. In addition, we have judged the business risk for which Transit is entitled to be compensated in the form of return in light of the value of these properties to Transit. See Order No. 684, p. 34. On the other hand, Transit can make no claim on the rider for any losses which these properties might generate and must exercise its business judgment accordingly. We think this is a desirable situation for the riding public.

In this connection, we might note that a suggestion or inference which could be drawn from Mr. Cleary's argument is entirely faulty. We refer to the assumption that consideration of the income produced by the below-the-line properties would have a substantial impact on transit fares. Actually, the record in this proceeding shows that these properties produced total net income in 1969 of $191,000. This is about the same amount as they produce on the average each year. Inclusion of this amount in the rate-making equation would have very little impact on fares.

Finally, we have noted the statement on p. 15 of Mr. Cleary's petition that the company's financial problems stem from its treatment of these real estate assets. We are constrained to point out once again that this is simply an erroneous view of Transit's basic problems. This company has encountered the difficulties it has because of certain basic economic and social problems. It is a labor intensive business; more than 75% of its costs are labor-related. Those labor costs have been escalating regularly as a result of the inflationary trend of the economy. A large part of the increase in recent years has been automatic and uncontrollable because it stemmed from the operation of the cost-of-living escalator clause in the former labor contract. At the same time these costs have been escalating, social and economic conditions in the community have caused a decline in ridership -- a decline accentuated by the impact of fare increases which have been necessary. Transit has not been alone in facing these problems. Every major transit system in the country has been wrestling with them. Substantial fare increases in cities such as Chicago and New York have received considerable public attention in those areas. The fares charged by Transit here are not at all out of line with those charged in other cities where little or no subsidy is provided for mass transportation. It is simply unrealistic and naive to believe that Transit's treatment of these below-the-line properties or the way in which we deal with them for regulatory purposes has either been the cause of the transit fare problem or contains the solution to that problem.

This is not to say that the questions raised by those properties are not important or have not received our careful attention. We have given them as much thought and care as any regulatory question presented to us. We are simply saying that the questions raised by those properties should be considered in proper perspective and should not be regarded as the panacea for all of this company's ills.

## VII

Mr. Cleary alleges error in our use of the carrier's total capitalization in discussing the proper level of return. The interest expense figure set out at p. 12 of Order No. 1052 includes only interest on debt attributable to mass transit operations and is directly based on Staff Exhibit 10 in the record. The return on equity is not intended or designed to provide a return on the company's non-transit activities. It is the amount which, in our judgment, provides a return on gross operating revenues which meets the standards set out in the Compact and in the case law, particularly D. C. Transit System, Inc. v. WMATC, 350 F. 2d 753 (D.C. Cir. 1965).

We have recently set out a more detailed discussion of the argument urged here by Mr. Cleary in our Order No. 981.

VIII

Mr. Cleary claims error in allowing a profit margin for the purchase of new buses. "It is error to require ratepayers to provide equity investment," he states. (Petition, p. 16) This is, of course, not so. The return element properly includes a return on equity and, to the extent that such return is retained in the business, the ratepayer properly provides equity investment. In D.C. Transit System, Inc. v. WMATC, supra, the court said that the return must permit the company "to retain a sufficient surplus to permit it to finance down payments on new equipment." 350 F. 2d 753, 778. We did not base our return allowance solely on the amount needed to finance the bus purchase program. We did, however, take that requirement into account in gauging the adequacy of the return. In ordinary circumstances, the return allowed would have to suffice not only for internally generated capital but for dividends. It was only because we felt that dividends were inappropriate at this time and that the necessary capital for the bus purchase program should be assured, that we required the escrow of the down payment amount.

Moreover, Mr. Cleary erroneously claims that the rider is treated unfairly because the cost of the buses will be added to the rate base, thereby increasing the allowable return. We do not compute the return by applying the rate of return to rate base. We use the return on gross operating revenues approach.

IX

Finally, Mr. Cleary argues that the return we allowed is excessive. His argument is based on an analysis of the return in percentage terms. We pointed out in Order No. 1052 that we felt, in the circumstances of this proceeding, that a conventional percentage analysis of the return was misleading. The reduction in equity capital stemming from the losses incurred by the company in recent years must be taken into consideration. The dollar return allowed is of the same order of magnitude which we have approved in recent proceedings and which has been upheld by the court in Payne v. WMATC, 415 F. 2d 901 (D.C. Cir. 1968). We pointed out that the return would undoubtedly be used, not for the enrichment of the investors, but to be retained in the business as a step toward the restoration of financial health. Since issuance of the order, the company's president has confirmed our estimate in this regard, assuring the Court of Appeals for the District of Columbia Circuit that no dividends will be paid in the future annual period.

We believe that our return allowance meets the applicable legal standards and we reject Mr. Cleary's allegation of error in this regard.

THEREFORE, IT IS ORDERED that the Petition of John M. Cleary, for reconsideration of Order No. 1052, filed on July 27, 1970, be, and it is hereby, denied.

BY DIRECTION OF THE COMMISSION:

George A. Avery

GEORGE A. AVERY
Chairman