MUTUAL AND SUBSIDIARY SERVICE COMPANIES

ADDRESS

of

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It is a pleasure to be with you to participate in a discussion of mutual and subsidiary service companies. We welcome the interest that you have shown in the servicing problem which is one of the important phases of our program of regulation under the Public Utility Holding Company Act of 1935.

Our program in the administration of Section 13 of the Holding Company Act which deals with service companies, divides itself into two major phases.

The first phase comprises the study and analysis of mutual and subsidiary service companies as a basis for permitting their operation on a conditional basis. The major part of our work on this phase of the program has been completed.

The second phase involves a continuing study both in the office and in the field of the operations of previously qualified service companies in order to insure compliance with the requirements of Section 13, and also to serve as a basis for further development of the various standards that appear necessary in order properly to administer this Section of the Act.

I shall discuss these two major phases of our work in more detail and attempt to illustrate some of the problems we have had and are still encountering.

51 holding company systems with consolidated assets as of December 31, 1938 of approximately $14,100,000,000 have registered with the SEC. Of this group 22 systems with approximately 74% of the total assets are serviced by one or more of the 38 mutual or subsidiary service companies. 9 systems with consolidated assets representing 2-1/2% of the total are serviced to a major extent by independent companies. The remaining 20 systems whose consolidated assets represent approximately 23-1/2% of the total apparently consider themselves too small to warrant a service company or have arrangements whereby the holding companies render services without charge or the operating companies are large enough to be self-sufficient from a servicing standpoint.

Most of the service companies which have been conditionally qualified by the Commission are now rendering services at a cost of less than 1% of the consolidated gross revenues of the system. The costs in specific instances range from approximately 1/2 of 1% to 3% of consolidated gross revenues, being affected by the extent of services rendered and by the amount of salaries of the so-called operating personnel carried on the service company's payroll. In one situation the cost approximated 7-1/2% and in another which has not as yet been approved, but is now being studied, the cost of servicing due to unusual circumstances is approximately 10% of the consolidated gross revenues of the system.

In administering the first phase of our program, we have reviewed or are considering 38 service companies. Of this group, 28 were subsidiaries and 10 mutuals. 20 of these subsidiaries and 8 of the mutuals have been permitted to continue operations on a conditional basis. Of the 10 companies awaiting Commission action, 8 are subsidiary companies and 2 are mutuals. The majority of these remaining companies represent special types of services such as coal handling, pole treating and appliance finance companies as differentiated from the so-called management companies. Most of the 10 cases which are awaiting Commission action were filed within recent months and several involve servicing organizations which were brought to light as a result of office and field studies made by the staff in connection with

our administration of Section 13. Preliminary studies indicate the existence of other servicing arrangements which seem to be within the scope of Section 13. In practically all the pending cases the necessary office and field studies have been made or are nearing completion and action upon these matters is expected at an early date.

The accomplishments under the first phase of our program may be summarized briefly as follows:

All service companies are now operating under the Uniform System of Accounts for Service Companies and are required to file annual reports which will enable the State Commissions and the S.E.C. to follow closely the operations and expenses of these companies. In this connection it should be noted that there has been a substantial change in the method of allocating cost as compared with the old arrangements in effect prior to the passage of the Act. Service companies are now required to make direct charges to a specific company for specific transactions insofar as possible, as compared with the old methods of making arbitrary charges on a basis of percentage of gross or of construction. The significance of this requirement is that it has brought into relief the amounts which the operating companies are paying for each specific service so that regulatory authorities may analyze and question the necessity for, or the reasonableness of the charges for the various services rendered. We have been working very closely with many state commissions on this requirement, the importance of which cannot be over-emphasized in the future regulation of servicing activities.

In this connection, may I recall to your attention the provisions of paragraph (d) of Section 13 whereby the S.E.C., upon its own motion, or at the request of a member company or a state commission may, after notice and opportunity for hearing, require a reallocation of costs among member companies of a mutual service company if it finds the existing allocation inequitable, and may require the elimination of a service or services to a member company which does not bear its fair proportion of the costs or which, by reason of its size or other circumstances, does not require such services.

Substantial reductions in the cost of servicing have been brought about in several instances, amounting in one instance to approximately $400,000, or 30% of the servicing cost of this particular company. Other reductions have been made in such items as office rent and in other instances, through the elimination of unnecessary services. Material changes have been made in the balance sheets of many companies through the elimination of items not necessary for the efficient and economical performance of service, sales or construction contracts. As a result of these eliminations, the capitalizations of several service companies have been reduced materially. Consequently, the service companies which have received conditional qualification have had their assets, liabilities and activities limited principally to the purpose of the company, that is, the performance of beneficial services.

In the first phase of our program another important problem has presented itself which also will require close study, and that is the relationship of the holding company to the service company, and the allocation of costs by the service company to the holding company.

The Act permits a service company to render services to a holding company provided that a fair allocation of cost is made. In most instances the

officers and directors of the service company occupy similar positions in the holding company as well as in many operating companies. The salaries of these individuals in many cases are paid directly by the service company and then allocated to the holding and other companies.

We have questioned the equitableness of the allocation to the holding companies in many cases which we have acted upon, and our orders have been conditioned to provide for both prospective and retroactive adjustments after public hearing where conditions warrant. This problem along with others is and will be the basis for continuing studies by the staff.

Shortly after the first of the year we began active work on the second phase of our program which involves an examination both in the office and in the field of the operations of service companies which have been previously qualified by the Commission on a conditional basis. Studies have been made of the annual reports filed by these companies and field studies are now under way with respect to the operations and activities of several companies in order to insure compliance with the requirements of Section 13, and also to compare actual operations with the information set forth in the original filings with the Commission. At the time of the original qualification, substantial changes were made in the method of allocating costs, and for that reason it is now desirable to review the operations of the service companies in order to determine the effectiveness of the new allocation systems in identifying and classifying the services rendered and the expenses in connection therewith. Of perhaps greatest importance is the problem of determining if services are being performed efficiently and economically and for the benefit of the client companies or whether the service company is merely a vehicle to enable the holding company to supervise its investments and to impose the cost of such supervision on the operating companies.

On the basis of our experience with both mutual and subsidiary service companies, I should like to comment upon the belief sometimes held that the mutual service company is an ideal solution of the servicing problem. Our experience indicates that the mutual type of service organization may have potential disadvantages as well as advantages. To be sure, one of the principal evils of servicing arrangements before the passage of the Holding Company Act was the profit element which usually inured to the benefit of the holding company or other controlling or affiliated interests and the practical effect of the formation of mutual service companies was to return profits to the operating companies serviced. This, no doubt, has contributed to the favor shown by leaders in the field of regulation towards the mutual type of service organization. Under the terms of Section 13 of the Holding Company Act, however, both mutual and subsidiary service companies are required to service associate companies at cost. Our experience with the administration of Section 13 indicates that each type of service company may have disadvantages as well as advantages. For example, in the mutual service company there is a greater possibility for log-rolling tactics, which may permit the continuance of undesirable practices developed in individual companies. On the other hand, the subsidiary type of service company may have a tendency towards greater centralization and thereby restrict the initiative of operating company officials or reduce their sense of responsibility to the public.

Since the problem of service companies deals to a large extent with personnel and the efficiency and economy of their operations, you can readily

understand that it does not lend itself to exact measurement. To analyze and study the efficiency and economy of a management organization we must necessarily study its impact on the system companies receiving services. The importance and value of this second phase of our program cannot be overemphasized and the problem necessarily is a mutual one requiring the coordinated efforts of all interested regulatory bodies.

In addition to the study and analysis of system service companies, we also have the problem of reviewing and analyzing the operations of affiliate and independent companies which fall within the scope of paragraphs (e) and (f) of Section 13, in order to determine what standards should be applied. To date we have required that all such companies file a statement with us, disclosing the nature of their activities, their detailed costs and salaries, and their financial returns. This material is now being reviewed by the staff.

Section 13 (g) of the Act makes provision for studies and investigations and the compilation of pertinent data with respect to the operations of these various service companies. In addition to the annual reports filed by these various service companies with the Commission, which are now a matter of public record and available to all interested parties, we are accumulating considerable additional data with respect to the operations and functions of conditionally qualified service companies. These studies will be continued and will form the basis for reports which we will publish from time to time.

It may be of interest to know that our studies have brought to light various servicing arrangements not being conducted by ordinary types of companies. These arrangements involve no formal type of incorporated or partnership entities but often are stated to represent joint arrangements between companies cleared through a special fund or account. Our jurisdiction extends beyond the regulation of what one ordinarily regards as service companies and it embraces any type of arrangement through which services may be rendered to system companies. In this connection the Commission is not concerned with the form which the particular servicing arrangement may take but rather with the substance of the servicing activities. These studies have in fact opened up a new field of inquiry in connection with our future administration of Section 13.

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