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INVESTORS, CONSUMERS, AND THE PUBLIC UTILITY HOLDING COMPANY ACT

Those of you who may have had occasion to read through the Public Utility Holding Company Act will recall the constantly recurring refrain "for the protection of investors and consumers". Tonight I should like to give primary emphasis to the word "consumers" and the interplay between consumer and investor interests, because this important and, I believe, intriguing aspect of the statute has been overlooked by most observers and critics. You will appreciate that all views expressed are merely personal and should not be taken as representing official policy of the Commission or its Public Utilities Division.

Let us first review a few familiar aspects of utility regulation by the States before the enactment of Federal legislation. In State regulation of utilities the consumer interest is paramount. The utility business by its nature tends toward monopoly, and generally speaking it has not been found desirable to enforce or encourage competition. Instead, and as a substitute for the automatic control of prices which competition is supposed to afford, most of the States have instituted some form of regulation of utility rates.

The theory of rate regulation is quite simple. The utility company is supposed to earn no more than a fair return on its property devoted to the utility business. But the application of this formula in actual practice has developed into one of the more complex problems of public administration and of law, and the end result is often far removed from the original theory. This complexity is partly inherent in the items

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themselves; for example, the determination of property and earnings of a large business enterprise, in a pure accounting sense, is seldom easy and may be exceedingly difficult. In part the difficulties relate to certain legal principles which have been adhered to by the courts, until perhaps very recently, in rate cases. And in large part these difficulties have arisen out of the phenomenon of the holding company.

Let us examine this latter point by taking two simple examples. Assume that I own electric utility assets on which a fair return would be 6%. If these assets represent $1,000,000 I am entitled to earn $60,000, and if they represent $2,000,000 I am entitled to earn $120,000. Therefore, if I can take $1,000,000 of assets and make everybody believe that they are really worth $2,000,000, I can also create the illusion that the fair return is $120,000 instead of $60,000, or in other words, that in my special case the 6% fair rate really means 12%.

There are many ways of creating this illusion, some of them simple and obvious and come complicated and subtle. The existence of a holding company is not essential, but it is certainly a big help. Historically most major operating company writeups have been accomplished through inter- company transfers following this simple pattern: Holding company H buys assets for $1,000,000 and transfers them to subsidiary S for $2,000,000. Two important things have happened, H has recorded a profit of $1,000,000 for itself, and S has established and recorded a cost of $2,000,000 instead of $1,000,000 for its utility assets.

Let us take a similar example relating to the second component of the formula — the so-called "return" to the utility. If a 12% return can

be made to look like a 6% "fair" return by doubling the property base, obviously the same can be accomplished without touching the property base if we can make $120,000 of earnings look like $60,000, or $60,000 like $30,000. The earnings figure is of course a net figure — gross revenues minus expenses — so that any increase in expenses has the same effect as a decline in revenues. Let us then, as a holding company, organize a separate department or company to perform a large variety of "services" for our subsidiary company and let us charge $3 for each $1 of services performed, including services which are really for our own benefit in exercising control of this subsidiary.

From our own point of view as a holding company, you will note that a special form of income has again been created for ourselves — and a steady income at that, which our subsidiary pays as an operating expense prior even to the interest on its publicly held bonds. From the point of view of the operating company, and therefore of the consumer, the illusion has been created of increased expenses and reduced net earnings, thus distorting one of the major components of the rate formula. In actual fact the company is earning the same return for security holders, but part of the return is being paid by way of servicing profits and is thus disguised as an operating expense. And lest any of you might have the impression that this is a trivial item I might point out that during the late 1920's well over $60,000,000 a year in service fees was paid by operating companies to the various holding companies, and for some holding companies income from this source exceeded income from all other sources.

Here, of course, is where the consumer comes in. I do not want to suggest that the simple expedient of inflating the cost of assets or

operating expenses automatically increases everyone's electric bill in exact proportion. A great many other factors, economic, legal and otherwise, enter into the picture. Indeed the industry has emphatically disputed that consumers have been hurt by either of the holding company practices which I have described, and its spokesmen have pointed out that cost of electricity and gas to the consumer has substantially declined over the last 30 or 40 years. This is quite true, but during the same period there have been revolutionary technological improvements in the utility field, particularly as to electricity. The real question, therefore, is whether the savings resulting from improvement in the art have been sufficiently passed on to the consumer, and on this point I think that only an emphatically negative answer is possible.

Why have not the States found their own remedy without intervention of the Federal Government? The answer is simply that operating companies are located in Ohio and Oregon and Pennsylvania and every other State of the Union, while holding companies and service companies invariably have their offices in New York or one of the other financial centers. A State utility commission might have had complete jurisdiction over the accounts, records, and practices of a local operating company, but it still could not ascertain the most elementary facts as to intercompany profits without examining the parent company's books, and these were usually inaccessible.

I should like to read you a few passages from a document in the public records of the SEC which sums up the situation concretely and pointedly. This document is dated in 1927 and is from the files of Electric Bond and Share Company. It seems that the operating properties of the Electric Bond and Share system in Pennsylvania were being reorganized into a larger operating

company, and that one of the company's financial experts had drawn up a reorganization program. This program was reviewed by one of the Electric Bond and Share lawyers — a lawyer who has since become president of the system — and he made the following comments, among others:

"As a general comment I suggest that as far as possible both reorganizations be run at the same time and in connection with each other; that is all agreements and all plans of reorganization should be laid so that no one will be able to separate one part of the reorganization from the other part. My reason for this is that while in the Pennsylvania Power & Light reorganization the increase in the Plant Account is apparently not so large, the increase of the Plant Account in the so-called Susquehanna Power & Light reorganization is tremendous, and we must not forget that in Pennsylvania the Commission has the right to approve or disapprove the acquisition of utility properties by a public utility.

"I suggest, therefore, so that the Commission will find it much more difficult to unravel the cost of the various properties, that we go before them with a plan that contemplates both the transfer of certain properties to Pennsylvania Power & Light Company as well as the formation of a new utility company, and also the transfer to the Lehigh Valley Transit Company of the railway properties, so that it will be practically impossible for anyone to find out what the cost of any individual property was or the cost of any particular group of property. I believe that while you could get the Commission to approve your Pennsylvania Power & Light reorganization they would not approve the Susquehanna Power & Light reorganization, but they might be willing to approve the reorganization of all your properties in Pennsylvania if it would be impossible for anyone to determine at what figure the various properties were going into the whole reorganization."

Now skip two pages:

"I again desire to impress upon you the importance, in my opinion of scrambling all these reorganisations together so that about the only thing the Pennsylvania Commission will be able to understand will be the result and not how the result was reached. Root's reorganization, in my opinion, is too simple and too easy to follow, particularly the Plant Account of the Susquehanna reorganization from $25,000,000 to $61,000,000 through a merger. I also desire to call your attention to the fact that Mr. Sawyer desires to talk over this whole matter with Governor Fisher of Pennsylvania, and I believe that we do not want to put Mr. Sawyer in the embarrassing position of giving him a plan to submit to the Governor, which the Governor would approve if no figures were presented to him, and then have the Commission refuse to approve the transfer of the utility properties because of the tremendous increase in Plant Accounts. The net result of Root's plan as I see it is to have the whole Susquehanna situation cost Lehigh "—that is the holding company—" nothing, and while I believe that is a very salutary result in the ordinary case, I do not

believe that we ought to risk obtaining this result by damaging our reputation before the Pennsylvania Commission. Such a result, in my opinion, might start an investigation into our whole rate and financial structure in Pennsylvania and lead to all sorts and kinds of consequences."

So much for the lawyer's memorandum itself. It is an interesting document, to say the least, but in some respects its most striking feature consists of certain comments written in the margin by the author of the plan which was under criticism. For example, where the memorandum emphasized the importance of "scrambling" for purposes of obscurity, the marginal comment reads:

> "This plan at its present stage is for home consumption only, and I tried to make it simple for that reason. Is not scrambling just a matter of presentation?"

And where the memorandum pointed out that there might be an investigation into the whole rate and financial structure in Pennsylvania if it were known that the holding company's cost was zero, the marginal comment reads "Don't see how Commission" -- that is the Pennsylvania Commission -- "will see original costs, as they are all on Lehigh books."

You will observe in this memorandum a very real respect for the Pennsylvania Commission - not for the job it was required to do, as such, but for its ability and its purpose to do that job if the facts were honestly presented. You will also notice that the importance of accomplishing a write-up is taken for granted all around, so that the discussion is confined to the methods of concealment. Of the various suggestions made, not the least interesting nor the least important is that the Pennsylvania Commission would not have access to the books of Lehigh because Lehigh was a Delaware corporation whose books were kept in New York.

I have been attempting to cover briefly, and I realize over-simply, some of the difficulties encountered in State-by-State regulation of utilities prior to the enactment of Federal legislation to regulate holding companies. I will not take up in detail how the Holding Company Act deals with these problems, but will merely mention that the statute confers broad regulatory powers over service contracts, including provisions designed to outlaw inter-company profits; over property acquisitions, including standards as to the consideration to be paid in relation to sums invested in and earning capacity of the assets to be acquired; over inter-company transactions of various kinds; and over records and accounts. And in addition to provisions dealing with specific regulatory problems, there are the general integration and simplification provisions of Section 11, which are designed to afford a more fundamental solution by confining holding company systems to those which can justify themselves economically, both as to size and form, without exploitation of subsidiary operating companies and their investors and consumers.

I wish I could tell you that all problems of utility regulation have now been solved and that a consumers Paradise has been realized. Unfortunately I cannot do so. I can only tell you that progress is apparently being made, that the pace seems to be quickening, and that the long-run prospects appear considerably better, as a result of these provisions of the Holding Company Act and other recent developments which I shall mention in a moment.

In this transitional phase of utility regulation the SEC's obligation to protect consumers and investors is a peculiarly difficult one, and I should like to turn briefly to this problem.

To point up the difficulties let us elaborate somewhat our previous hypothetical case of holding company H acquiring assets for $1,000,000 and transferring them to subsidiary S for $2,000,000. Let us suppose that there are 10 different S's and that each one has originally acquired its assets from H in the manner described, set them up on its balance sheet at $2,000,000, and issued to H $1,000,000 of senior securities and $1,000,000 stated value of common. H has sold to the public the $1,000,000 of senior securities of each of the 10 subsidiaries, retaining a total of $10,000,000 of common stocks at no cost. These securities, however, are carried on H's balance sheet at $15,000,000, and H has outstanding with the public $10,000,000 of its own debentures and $5,000,000 of common stock.

This structure is obviously a precarious one. The hypothetical holding company system can support itself and service its securities if, but only if, everything runs smoothly. The whole thing is too tightly geared to absorb readily the impact of a major business depression, for example, or any other adverse economic change. If it does not collapse entirely in such circumstances, it will probably be held together by various dodges and makeshifts to maintain the flow of income, such as reduced depreciation accruals for the subsidiaries, so-called downstream loans to permit payment of dividends, and similar practices which only aggravate the difficulties for the future. The subsidiaries may become financially incapable of expanding their service to meet new demands, or even to maintain proper standards of service for present customers. And even so, preferred dividend arrearages will probably begin to accumulate at various points in the structure.

But even assuming that there is no general depression and everything else is running smoothly for all security holders of the system, you will note

that the foundation for the whole structure is the continued ability of the operating subsidiaries, under existing regulatory machinery, to charge consumers sufficiently high rates to yield a 12% return or better on system cost.

Now let us assume that certain changes occur in the field of regulation.

First, an agency of the Federal Government ascertains and publishes for the first time the facts concerning the $1,000,000 write-up on the books of each of H's subsidiaries.

Second, the Federal Power Commission and many State commissions adopt a uniform system of accounts requiring utility companies to segregate their property accounts so as to show original cost separately from write-ups and so-called acquisition adjustments, and requiring that the latter items be written off, amortized, or disposed of as the commission may direct; also, requiring that depreciation accounting shall be substituted for so-called retirement accounting.

Third, the Supreme Court, apparently overruling a long established body of decisions, holds that a regulatory commission may use any appropriate method for determining the property base in the rate formula, and is not bound to any single method. As a practical matter this is widely interpreted as permitting the authorities to base rates upon original or prudent investment instead of being tied to reproduction cost.

Fourth, the F.P.C. and other rate authorities begin to exclude reproduction cost evidence and to base their rate decisions on original or prudent investment.

Fifth, Congress enacts into the Holding Company Act a requirement that all inter-company service contracts be performed on a cost basis.

Sixth, the same statute requires that giant holding company systems be broken down into units which are, among other things, not too large for effective regulation.

These things have happened or are happening today. Their potential future effect upon our hypothetical holding company system may be very great. But as to their immediate effect, numerous qualifying and opposing factors must be borne in mind.

In the first place one or more of the ten subsidiaries may operate in States where there is no general machinery for rate regulation, or where there is regulation only in a very loose sense. Obviously the benefits of any Federal regulation in aid of State regulation can be realized only to the extent that State regulation has been instituted.

Secondly, nothing has happened so far to compel the abandonment of reproduction cost and the substitution of original cost as the primary determinant of the rate base. Established habits of thought do not change overnight, particularly in the semi-religious atmosphere of "due process" versus "confiscation" which has surrounded reproduction cost for many years. Some of the subsidiary companies in our hypothetical case may continue for many years to ride the merry-go-round of earnings based on valuation based on earnings; that is, they may continue to enjoy rates based on a reproduction cost and going concern valuation of $2,000,000 or $2,500,000 or more, even though system cost is now discovered to have been only $1,000,000.

Thirdly, even where a State commission follows the lead of the F.P.C. in rejecting reproduction cost, we should not expect an operating company to sustain a 50% cut in rates or revenues overnight. The new developments in regulation which I described above are all fairly recent. In many instances the difficult first step of ascertaining original cost is just getting under way. Furthermore, even after the basic facts are ascertained, rate making is not an automatic, mechanical thing. It is a complex and often cumbersome process, involving economic, legal, political, and human factors, and even a major change in underlying assumptions and facts may not be reflected in the final result except over a period of years.

Suppose, now, that our imaginary holding company is required under the geographic integration provisions of the statute, to dispose of several of its subsidiary companies. Subsidiary Number 1, like the other nine, has $1,000,000 of senior securities held by the public and $1,000,000 of common stock held by the holding company, H. For the present the subsidiary is enjoying rates sufficient to yield a 6% return on $2,000,000 book value or 12% on $1,000,000 of original system cost. However, the $1,000,000 write-up has recently been uncovered, and a few alert citizens, usually called agitators, have begun to protest. The State commission is studying the matter but has not instituted a formal proceeding nor had occasion to reconsider, in the light of recent pronouncements of the Supreme Court, whether reproduction cost or original cost is to be paramount in rate making. In the meantime H continues to receive $60,000 annually in common dividends, or (we will assume) $6 per share, as it has done regularly for 20 years.

H now proposes to dispose of this particular common stock by offering it in exchange for its own outstanding debentures. Let us assume that a share of stock paying regular dividends of $6 per year would normally be fair exchange for $100 of H's debentures. Yet if such an exchange is proposed today, H's debenture holders may object that the changed regulatory outlook casts a cloud on the future ability of the operating company to pay regular dividends of $6. On the other hand, if H should offer 5 or 10 or 20 shares of the same stock for each $100 of its own debentures, the common stockholders of H would rise in protest. They would point to the fact that the stock has always paid and is still paying $6, and would contend that regardless of any new-fangled theories of regulation each share is still worth $100 today.

But our principal interest tonight is in regard to consumers. In strict theory the degree of inflation of assets or security structure is not a factor in the rate-making formula, and therefore should not affect consumers one way or the other. As a practical matter, however, this consideration certainly has had some influence, conscious or sub-conscious, and in varying degrees, upon many regulatory authorities. I will not venture to say whether this influence is or should be greater or less when the common stock is publicly held than when it is owned by a holding company. But in any event it is reasonable to assume that the pressure will not be decreased, and is likely to be increased, by any transaction which brings in a new group of investors at a price which has received some sort of sanction of the SEC.

Thus a further dilemma is presented. To the extent that the current rate structure and current earnings figure are permitted to govern the exchange ratio in the present transaction, it will become more difficult to protect

consumers in the future except with loss of value to a new group of investors. And conversely, the latter can avoid a loss of values only at the expense of consumers. But on the other hand, so long as the earnings record is there, can it be disregarded in the present transaction?

This is merely one sample of a type of problem which recurs in the Commission's work in numerous forms and in many different settings — exchanges, sales, reorganizations, liquidations, etc. I regret that time does not permit further definition of the problem through additional examples. I regret even more that I have no simple and obvious answer to suggest to you tonight, but can only tell you a little of the scope and limitations of the SEC's role in seeking the answer.

The core of the problem in all the varying situations is that present earnings value is out of line with original investment because past rate regulation has not succeeded in restricting earnings to a fair return on such investment. The only real solution, therefore, is effective regulation of rates, and the SEC has no direct jurisdiction over rates. Hence it can operate only on the periphery of the problem, and its role as a champion of consumers must inevitably be merely ancillary and secondary.

Bearing in mind this basic limitation, the field of action open to the Commission may perhaps be defined somewhat as follows.

First of all, in passing upon transactions of sale or purchase or exchange, the Commission must be satisfied as to the reasonableness of the price. For the present at least, except in certain transactions between affiliates, this obligation probably cannot be discharged by merely insisting

that the price be approximately equal to original cost, regardless of earnings. But on the other hand the price cannot be left solely to agreement of the parties, even in non-affiliated situations. The Commission must see that the price bears a fair relation to demonstrated earning capacity, as distinguished from mere hope and prayer, and that it is related to investment at least in the sense that any potential reduction of earnings to a level more consistent with original cost is adequately taken into account.

In other words, since the Commission does not have direct jurisdiction over rates, it is presumably limited in most instances to making its own best objective judgment as to the prospect of action on the part of other agencies, in much the same way and for the same purposes, that it must often make similar judgments concerning future income taxes or fuel costs or volume of business in estimating future earning capacity. For this purpose it would obviously be wrong to assume that effective regulation has been accomplished everywhere or is about to be realized tomorrow. But I submit that it would be equally unacceptable and unrealistic to brush aside as entirely futile and fruitless all the recent improvements in regulatory theory and technique, including the Commission's own obligations and its own accomplishments under the Holding Company Act, and to assume that earnings of the past and present, however exorbitant, will inevitably carry forward into the indefinite future.

Apart from their relevance to the Commission's duty of determining fairness of price in a present transaction, the facts and circumstances concerning prospects of regulation may be sufficiently significant to warrant explicit disclosure for the guidance of wary investors. And where there is a substantial disparity between the approved price and the original cost it

may be desirable to point out specifically that the price is found to be reasonable only in the sense that the present earning capacity is far out of line with investment, so that the Commission's approval is not taken as any indication of value for rate-making purposes.

Where an acquisition of utility assets is approved at a price in excess of known original cost, it should be uniformly required that such excess be shown separately on the balance sheet of the purchaser and at least amortized within a reasonably short period. A clean balance sheet affords no guarantee of proper rates, but among its other advantages, there is at least a considerable psychological difference for rate purposes between a $1,000,000 statement and a $2,000,000 statement of identical assets. Where original cost is now known at the time of transfer, it becomes necessary to use the next bést substitute in the form of reservations of jurisdiction and the like.

Where there is a transfer of securities but not of physical assets as such, it is still necessary to pursue diligently the program of segregating and disposing of all inflationary items in the property accounts, including concealed write-ups in the form of insufficient depreciation reserves, deferred retirements and the like. These are important phases of regulation apart from the incidence of particular transactions, but it is particularly important that any necessary steps be taken or at least mapped out prior to consummation of any transaction which brings into the picture a new group of security holders, such as the exchange program which we discussed earlier.

Further, there are many situations where a cleaning up of the asset accounts should be accompanied by a readjustment of the security structure. This is mostly a problem of protection of investors but it also has some importance from the point of view of consumers, because the existence of any so-called senior security which is actually only a common stock inevitably creates an impediment against voluntary or involuntary rate reductions and may well impair the ability to render adequate service. The same reasoning, of course, makes it important for consumers as well as investors that the conservative financing standards of Section 7 be rigorously applied.

Finally, and in many respects most important, enforcement of the service contract provisions of the statute must be carried forward so that utility companies will pay only the cost of services performed for their own benefit, and not holding company expenses in disguise; and the integration program must be pursued until utility systems are so limited in size and form that the interests of investors and consumers may be made once more compatible instead of conflicting.

I will repeat and emphasize the caveat that these things do not add up to complete consumers' protection. Nor do they do so when taken in conjunction with the other recent developments in rate and accounting regulation. The degree of achievement ultimately depends upon the local rate-making machinery and personnel, and perfection is no more to be expected, nor any sooner, in this field than in any other. But we do have grounds for hoping and believing that some of the inherited barriers to effective regulation on behalf of consumers are being permanently destroyed.