

STATEMENT

OF

GANSON PURCELL

Chairman, Securities and Exchange Commission

BEFORE THE

COMMITTEE ON DEPRECIATION OF THE NATIONAL
ASSOCIATION OF RAILROAD AND UTILITIES
COMMISSIONERS

WITH REFERENCE TO THE COMMITTEE'S
1943 DEPRECIATION REPORT

Chicago, Illinois
March 8, 1944

On behalf of the Securities and Exchange Commission, I am very happy to take advantage of your invitation to present our views with respect to your 1943 Depreciation Report. The interest of the Securities and Exchange Commission in this subject stems not alone from our duties in administering the Public Utility Holding Company Act but also from our responsibilities under the Securities Act of 1933 and the Securities Exchange Act of 1934, and our functions in reorganization cases under Chapter X of the Bankruptcy Act, as amended. The provisions of the Holding Company Act apply to some 52 utility holding company systems, which include 1,217 individual holding, sub-holding and operating companies. The total consolidated assets of these registered companies amount to approximately \$16,000,000,000.

While we are interested in sound depreciation practice under each of the statutes I have mentioned, our powers and responsibilities under the Holding Company Act go far beyond the mere disclosure principles of the Securities Act and the Securities Exchange Act. Thus current accruals for depreciation and the size of the depreciation reserve are matters of particular importance in the decisions that we have to make under the Holding Company Act. They enter into our judgment when we pass upon the issuance and sale of securities, the acquisition or sale of utility securities or assets, and plans of reorganization or recapitalization. Moreover under Section 12 (c) of the Holding Company Act, it is unlawful for any registered holding company or any of its subsidiaries to declare or pay any dividend on any of its securities in contravention of such rules and regulations or orders as the Commission deems necessary or appropriate to protect the financial integrity of companies in holding company systems, to safeguard the working capital of such public utility companies, or to prevent the payment of dividends out of capital or unearned surplus. It is clear that the availability of earnings for dividend distribution is directly affected by the adequacy or inadequacy of current accruals for depreciation and in certain extreme cases such availability may be affected by substantial deficiencies as to past provisions for depreciation. In administering these provisions, we believe it is important to determine whether depreciation is being accrued on a systematic basis related to reasonable estimates of service life.

Turning now to your 1943 Depreciation Report, let me compliment your Committee upon the great contribution that you have made to the literature on this important subject. We have reviewed your report with care and believe that you have presented a most comprehensive analysis of the principles of public utility depreciation. Your statement of principles, both in the summary of your report and throughout the text, have been written with great clarity and you have exercised painstaking effort to avoid ambiguity and inconsistency. I express the unanimous opinion of the Securities and Exchange Commission when I say that we agree with your principal conclusions and recommendations. In particular, let me say that we believe that straight-line depreciation accounting for public utility companies is the most practicable and desirable method which has been suggested to date. We also feel that it is both practicable and sound to base straight-line computations on age-life studies of depreciable property as modified from time to time by actual experience.

We have considered the effects on investors and consumers of different methods of accruing depreciation and we have concluded that in addition to its other advantages, straight-line depreciation accounting affords greater financial stability to the business unit and greater financial security to the investor than retirement or compound interest methods. As stated in Chapter IX of your report, the depreciation reserve under the straight-line method builds up more

rapidly in the earlier years and indeed throughout the life of the enterprise than it does under the interest methods. Accordingly, the use of the straight-line method tends to reduce risks for investors. Furthermore, the direct financial effect of the larger straight-line reserves as compared with compound interest reserves is to reduce the amount of securities that would otherwise be outstanding against the assets of the enterprise throughout its life. These are important advantages. They signify more conservative financial policy than has frequently prevailed in the past. We, therefore, believe that the change-over to straight-line depreciation accounting will afford a greater protection of the financial integrity of public utility companies and thereby strengthen their credit standing.

There is one subject concerning which I should like to make special comment, namely, the problems involved in the change-over from retirement to straight-line depreciation accounting. On this subject, certain spokesmen of the public utility industry have expressed considerable apprehension lest the change-over be required in an unduly abrupt manner with adverse effects upon the credit of the companies. They have also urged that your recommendations would involve retroactive features unfair to investors from the point of view of rate regulation. The objections of the various industry committees are summarized in the memorandum submitted by the Depreciation Committee of the Edison Electric Institute as follows:

- "1. In accounting, the books of account would ordinarily be adjusted to conform with whatever theoretical computations are selected as 'proper'.
- "2. In financing or reorganization cases, the adjusted reserve as above, or an equivalent theoretical reserve computation, would be used in determining the amount of securities permitted to be issued or to remain outstanding.
- "3. In rate making proceedings, the theoretically computed reserve would be used as the measure of depreciation in establishing a depreciated rate base; and a corresponding annual accrual on an age-life basis would be used in determining the allowed return."

These statements appear to give inadequate weight to certain passages in your report which clearly reflect your judgment that the objective of correcting inadequate reserves should be approached with due regard for what is equitable and feasible under all of the circumstances of the individual case.

While the three aspects of the change-over problem, namely, accounting, financing and rate making, are interrelated to a great extent, I shall confine my comments to the accounting and financing phases with respect to which we have had some experience under the Holding Company Act. Since we have no rate making duties, I shall not attempt to comment on that particular phase of the problem. As to the remaining aspects of the change-over problem - accounting and financing - our Commission has taken into account the fact that there has been a substantial change in thinking as to proper depreciation practices both on the part of the industry and the regulatory authorities. Accordingly we have tended to require a gradual rather than an abrupt change-over to straight-line depreciation.

Perhaps some of the experience that we have had in connection with re-fundings and with reorganizations, both formal and informal, may throw some light on an approach which we have found to be feasible and beneficial to the companies, their security holders and the public generally. Usually when a utility reorganization case is before us, we find that not one but a number of financial and accounting matters require correction. These may include inadequate depreciation reserves, inflationary items that must be eliminated and excessive senior securities that must be scaled down. While there are certain objective standards toward which we aim, we have found as a practical matter that we attain or fall short of our goal depending upon the ingredients with which we have to work in the particular case. The diversity of results reached, with respect to depreciation and debt ratios for example, is due to the difference in practical obstacles from case to case. I may say that with the cooperation of the companies concerned, the application of that method has been most successful. In all such cases, the more important defects have been eliminated and where it has not been feasible to obtain an ideal financial structure immediately, provision has been made for the transition to that goal over a period of years.

In the case of debt financing it is usually customary to provide for a maintenance and depreciation fund in the mortgage indenture. Its purpose is to assure as certainly as possible that the amount of net property securing the mortgage will not decrease and thereby distort the ratios of bonds to net property contemplated in the mortgage. The kind of provision that is necessary in any given situation to provide for adequate maintenance and depreciation is difficult to determine. There has been no unanimity of opinion as to how such a calculation should be made. In the majority of cases it has been customary to use a percentage of gross revenue as the sum necessary for this purpose in the absence of a more satisfactory basis. Generally, 15 percent of gross revenues is specified as the amount which must be accounted for to the trustee of the mortgage for maintenance and depreciation. Under the increased revenues of the war period this percentage has resulted in a substantial increase in depreciation reserves. I think it should be realized, however, that while these indenture provisions generally serve the purpose for which they are intended, they are not, except as a matter of coincidence, the equivalent of a systematically determined provision for depreciation and maintenance.

It has been our experience that the application of the foregoing policies has materially improved the financial condition of the utility companies concerned. This has been accomplished not only without burden to their security holders and their consumers but with positive benefits to them.

Let me give you a few illustrations from our experience which will indicate some of the specific improvements that have been made with respect to depreciation policy. In connection with a refunding program by a large electric utility system, the depreciation reserve was increased from \$10,800,000 or 4.01 percent of its plant account to \$23,900,000 or 10.1 percent of total plant. I may also add that in the case of this company the annual accrual for depreciation increased from \$1,724,000 in 1936 to \$4,491,000 in 1942. In other such cases depreciation reserves were increased from 6.9 percent of total property to 11.2 percent in one case; from 5.89 percent to 8.77 percent in another; and from 1.35 percent to 11.5 percent in still another case. Numerous other illustrations can be cited to show the extent

to which depreciation reserves in the electric utility industry have improved, especially over the past six years. The over-all figures for the private electric utility industry show that depreciation reserves increased from \$1,495,000,000 on December 31, 1937 to \$2,306,000,000 on December 31, 1942. On the earlier date, such reserves were 10.8 percent of the total plant account and at the end of 1942 that ratio had increased to 15.5 percent. As the Federal Power Commission has pointed out, annual depreciation and amortization charges increased by nearly \$100,000,000, or 40 percent, from 1937 to 1942. This represented an increase in the average annual rate of accrual from 1.7 percent of total utility plant in 1937 to 2.2 percent in 1942.

I have referred earlier to the industry's fears that your recommendations would involve unfair retroactive regulation. As I have said, we believe that such expressions of concern are not justified by a fair reading of your report. Nevertheless we do recognize that there are problems with respect to the change-over from retirement to straight-line depreciation accounting both as to the timing of its accomplishment and as to its effects upon investors and consumers. As you have pointed out in your report, it may not be practicable to draft a uniform rule in this regard to cover all cases. I think, however, that it would be advantageous if you were to extend your analysis of the change-over problem to indicate certain principles that should be followed in various types of situations. In this connection, to cite the experience of our Commission under the Holding Company Act, we have found in financing and reorganization cases that these problems can be resolved by a gradual approach and in a manner that achieves important improvements on a fair and equitable basis with lasting benefits to investors and consumers.