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OF

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RECENT DEVELOPMENTS IN THE REGULATION OF SERVICE COMPANIES

I deem it a privilege to attend this Convention to discuss a subject in which we all have such an important mutual interest.

The dramatic fight against the looting of utility companies through servicing charges by Hopson and his ilk are over forever I trust and we are now in the stage of unspotlighted progress toward insuring that investors and consumers are protected from more subtly concealed unjustifiable servicing charges.

The energy of regulatory authorities, however, has been no less applied to the solution of servicing problems during this less dramatic period, and, while the work is more tedious and at times may seem plodding, we have reason for great encouragement.

Our somewhat incomplete studies of service charges made in past years indicate that well over $60,000,000 a year was extracted from utility operating companies during the lush periods of unregulated holding company domination. In decided contrast, current figures submitted by service companies under our jurisdiction indicate that annual charges to operating companies are now approximately $20,000,000 a year--a saving of over $40,000,000 a year to consumers and investors as a result of our joint regulatory efforts.

Concurrently with the helter-skelter development of the holding company phenomenon, the utility industry experienced the growth of system service companies created and dominated by the company and its officials at the top of the pyramided structures. These service companies, superimposed on the subservient operating company personnel, purported to supply almost every need — actual or artifically created -- from officers and management to accounting and billing. The result, as you well know, was an unconscionable burdening of operating companies with unwarranted servicing charges. This was one of the major reasons for the enactment of the Public Utility Holding Company Act of 1935.

Sections 13 and 15 of this Act, together with the Commission's rules promulgated thereunder, have established basic equitable standards for the performance of service, sales and construction contracts rendered by associate companies in holding company systems. These basic standards, I am glad to report, are in large measure now accepted as desirable at least in theory by the industry itself.

First there is the prohibition against holding companies' performing services to operating public utility subsidiaries for a charge, except in very limited situations. The prohibition was designed primarily to force servicing into channels susceptible of regulation -- avoiding the almost impossible task of determining fair and equitable allocation of charges where servicing functions were intermingled with holding company activities.

Although it was generally believed that this prohibition presented a relatively easy enforcement problem, subtle ways were resorted to by holding companies to avoid its terms. And, as I shall describe in a moment, one of the more significant steps recently taken by the Commission in regulating servicing has been closely related to this prohibition.

The Act further requires that services rendered to associate companies by mutual or subsidiary service companies must be rendered "economically and efficiently for the benefit of . . . associate companies *at cost* fairly and equitably allocated among such companies."

As a most necessary corollary to this provision, the Commission has prescribed a Uniform System of Accounts and annual reports for service companies which for the first time opened up the books and activities of service companies for understandable inspection. The requirement of departmental breakdowns of salaries and expenses now makes possible a real analysis of the varied functions of the companies and claimed bases of charges.

The problem of insuring a fair and equitable allocation of costs is complex and difficult but an important advance was made by our rule providing for direct charges to a specific company for specific services in so far as practicable. Such a disclosure, thus pinning down the facts, aids materially in determining the proper allocation of costs as well as the necessity of services rendered.

The major advances in servicing, I believe, have come only as a result of constant day by day work directed to insure that these basic standards are complied with by the industry. It is a process requiring careful analysis of each situation, of investigation, of effecting needed changes by voluntary adjustments or under order of the Commission following hearings.

At the Convention in Miami last December, the report of the Committee on Uniform Service Company Contracts presented to the Convention by Alexander M. Mahood of the West Virginia Commission, referred to a proceeding before our Commission concerning servicing arrangements between the New England Power Service Company (a Massachusetts corporation) a subsidiary of New England Power Association and Bellows Falls Hydro-Electric Corporation and Green Mountain Power Corporation, associate companies in Vermont. You will recall that proceeding had been instituted by the Securities and Exchange Commission at the request of the Public Service Commission of the State of Vermont.

I should like to tell you briefly of the subsequent developments in that case. The service company was the largest in the industry with annual charges to the operating companies well in excess of 5% of annual gross operating revenues. With the active cooperation of the Vermont Commission and its staff many of the weaknesses of the existing servicing arrangements were brought to light during the investigation. Thereafter, a close analysis of the facts developed at the hearing was made and in May of this year S.E.C. issued its tentative conclusions.

The Commission found among other things, that the organization of the service company was top-heavy and its method of doing business cumbersome. A complete reorganization of the service company and the elimination of many charges heretofore exacted from the system companies including the two Vermont companies was recommended. The service company was required, thereupon, to file an answer to these conclusions and to show cause why our previous order of approval should not be revoked unless the differences and inequities were met.

A final order has not been issued to date; however, the changes which the company has already effected and the further ones contemplated to be made in the near future promise substantial savings not only to the Vermont companies but to all public utility operating companies in the system. The estimates submitted by the service company indicate that the reduction in annual service charges to one of the Vermont companies, the Green Mountain Power Corporation, will approximate 50% annually.

One significant result has been the transfer of thirty-three persons, with aggregate annual salaries of $304,000, to the holding company payroll, thus relieving the operating companies to that extent. The personnel of the service company itself will ultimately be reduced from 1048 at the outset of the proceeding to 626, and the service company payroll will be reduced correspondingly from $2,824,032 to $1,608,897.

The results speak for themselves and we hope that other commissions, whenever the occasion warrants, will feel free to request the Securities and Exchange Commission for such assistance as will be helpful to them. While the Commission may, of course, institute such proceedings upon its own motion, action is likewise made obligatory by statutory provision upon the request of a State Commission.

The present function of service companies in holding company systems is not clear-cut. They serve a number of purposes in addition to performing services directed toward supplying the operating companies with needed services. Continued study, confirms an earlier realization of the extent to which service companies also provide a control medium for holding companies in their own interests to supervise public utility operations, to protect their investments, and to pass on costs arising out of this function to the operating companies, as well as to divert to consumers the burden of supporting large salaries of top executives which stockholders themselves find so objectionable.

It is apparent, of course, that holding companies, which are in the business of supervision and control of operating subsidiaries, should pay their own way and should not require their subsidiaries to assume, wholly or partially, holding company expenses. The problem arises most obviously in instances where the salaries of the principal holding company executives and the expenses arising out of their activities are paid, wholly or in part, by the operating companies directly or through the medium of a service company. In a number of recent decisions, the Commission has declared that such practices are not permitted by Section 13 of the Act and must be stopped.

In the first of such cases, concerning *Ebasco Services, Incorporated* (7S.E.C.1056(1940)) the subsidiary service company of the Electric Bond and Share system, the issue was presented as to whether a substantial portion of the salaries of the officers of Electric Bond and Share Company could be justifiably paid by operating companies through the medium of the service company. When Ebasco was organized as a service company in 1935, the principal executives of Bond and Share were placed in identical positions in the service company, retaining their positions in the holding company.

Their duties and compensations remained unaltered except for the basic fact that then approximately 43% of their salaries was paid by the holding company and over 55% was paid by the service company directly -- the service company, in turn, charging the operating companies for the "services" of the holding company officials and their staffs. It was admitted by the Ebasco and Bond and Share witnesses that the allocations between the holding company and the service company were "somewhat arbitrary."

The Commission concluded that it would be an almost impossible and wasteful task to attempt to determine what a proper allocation of these salaries should be and that so long as this situation of blended functions continued there could be no insurance of a fair and equitable allocation. As a result, then, the Commission prohibited such further sharing of the charges of this group and required the holding company to absorb all the salaries of its officers and employees so long as the dual situation continued.

An analysis was made of other service companies subject to the Commission's jurisdiction in the light of the Ebasco decision and attention of other systems was called to the enunciated principle. A number of holding company systems, after cooperative round-table conferences, agreed to make changes in their service company operations to conform with the Commission's decision. Discussions did not produce adequate adjustments in other systems and proceedings were instituted.

The United Light & Power Service Company, the service company in the United Light & Power Company system, was among those which voluntarily adjusted their practices. The United Light & Power Service Company had on its payroll practically all of the officers of the United Light & Power Company and other system holding companies. These salaries, paid in the first instance by the service company, were then allocated to the various operating and holding companies on the basis of time records.

In form this was different from the Ebasco case where the holding company officials were paid partially by the holding company and partially by the operating companies through the service company. The Commission, however, found that in substance both cases were the same--that is, officers, directors and employees of the holding company who owed their primary fealty to that company were rendering services for a charge to operating companies. The Ebasco decision had stressed Section 13 (b) of the Act and the fact that the over-lapping situations made impossible or wasteful the process of insuring an equitable allocation. In the United Light & Power Service Company decision, however, the Commission indicated its conclusion that likewise Section 13 (a), which, as you will recall, prohibited the rendition of services for a charge by holding companies, may be violated by this practice. It was reasoned that a holding company, being an artificial entity, could, of course, perform services only through its officials and personnel, and, to give meaning to the prohibition, it must also be held to include the prohibition against the performance of services for a charge by holding company officials and their staffs. The Ebasco principle was also applied to prohibit the direct sharing of salaries and expenses of the holding company personnel between the holding company and the operating companies where the service company was not involved.

Changes were made in this company's method of operation which resulted in well over half of the salary expenses of the service company being borne by the holding companies in the system. The remaining charges to operating companies will amount to only a fraction of one per cent of annual gross revenues.

The Commission reiterated these principles in connection with the Middle West Service Company case and expressed the further view that where the holding company and service company have common executives, officers

and directors, the holding company and service company are identical and that if the service company is to continue in business there must be a *bona fide* serverance of the functions of the two companies or as an alternative that the holding company must absorb all such salaries and expenses.

One of the pending proceedings concerns Columbia Engineering Corporation, the system service company of Columbia Gas & Electric Corporation. In that system, prior to 1938, the salaries and expenses of the top officials were paid by the holding company. In that year, however, the service company was revived and these principal officers became the principal officers of Columbia Engineering Corporation as well. Admittedly, their functions and duties remained unchanged -- the only difference was that their salaries and expenses and the salaries and expenses of their staffs were charged to the service company, which, in turn, charged the operating companies and Columbia Gas & Electric Corporation itself on the basis of time sheets kept by these individuals.

The contention has been made that the case is distinguishable from the Ebasco case inasmuch as in this instance the parties are paid entirely by the service company and an allocation is thereafter made. In answer, however, the Staff of the Commission has urged that the difference is merely one of form. The Staff also urged that even where in form there was no conflicting position the functions of the individuals rather than the positions held by them should be the major factor to consider in determining whether or not the holding company should absorb these charges. The case has not been decided by the Commission but if the Staff's recommendation is adopted there will be a further expansion of the Ebasco principle.

Another case pending before the Commission which may be of interest to you concerns Atlantic Utility Service Corporation, successor to a number of former servicing organizations in the Associated Gas & Electric Corporation

system. As you are aware, the past practices followed by Hopson and the myriad of servicing organizations in that system presented, perhaps, the most striking example of abuses in the syphoning of enormous fees from operating companies through the rendition of a wide variety of alleged services. Not many years ago, an annual tribute of well in excess of $7,000,000 was exacted through the system and private organizations dominated by Hopson. This intricate structure has been collapsed and there now remains the single system-wide service organization, with annual charges of less than $1,900,000.

A serious question was raised in that case as to the necessity of services, or, stated differently, whether the operating companies actually benefit from the services received. The Staff's position, briefly, is that many of the activities of this organization are not necessary from the viewpoint of the operating companies and that the facts disclose that its functions in the future should be limited to the rendition of not much more than engineering and purchasing services.

Careful consideration and detailed study is being given to the question of necessity of services in other systems and the result of careful analysis of this feature of regulation promises in many instances to achieve further drastic reductions in servicing charges borne by operating companies.

The Commission, in addition to its jurisdiction over servicing contracts performed by associate companies within a holding company system, is entrusted by Congress with jurisdiction over service contracts performed for a charge by affiliates of system companies, as well as by persons principally engaged in the performance of service contracts for registered holding companies and their subsidiaries or public utility companies engaged in interstate commerce. The Commission, to this date, has required only that such non-system companies file reports disclosing among other things the character of the services

rendered, total charges and expenses, ownership and copies of servicing contracts.

A heterogeneous assortment of companies and persons filed the required material which was designed to provide the Commission with the basis for considering the problems present in this field. An interesting example of the problem confronting the Commission in enforcing the reporting requirement was furnished by the Edison Electric Institute, successor to the National Electric Light Association, whose activities had been the subject of inquiry and condemnation by the Federal Trade Commission. The Association did not comply with the requirement of filing and so it was with interest that the Commission observed reported information by a certain holding company system characterizing the Institute as a service organization principally engaged in the performance of service, sales and construction contracts for registered holding companies and their subsidiaries.

An investigation of the organization was conducted and on the basis of the facts disclosed, the Institute complied with the Commission's reporting rule. Investigation and study with respect to other organizations of this general character which properly may be subject to this provision is now being made. We believe it will prove beneficial both to the industry as well as to regulatory authorities for these servicing organizations to operate in the light of day with their activities and expenditures matters of public record. The history of the National Electric Light Association suggests that an observance of this practice would prevent many headaches both for regulatory commissions and the public utility industry.

One of the many problems before us all is the necessity of embracing within the scope of regulation those activities which by their mere form have thus far avoided regulation. I refer, for example, to those devices such as direct charges by individuals to a group of operating companies, and

joint checking accounts or joint payrolls to which operating companies are compelled to make payments.

Likewise, in looking toward future servicing regulation we must recognize that the utility industry today presents a dynamic picture with far-reaching changes in the offing as a result of the enforcing of the integration provisions of the Public Utility Holding Company Act. This will undoubtedly lead to substantial changes in the present-day service company picture since in many respects the service company problem is the holding company or control problem.

The record of the past few years shows gratifying progress by both state and Federal commissions in the reduction of exhorbitant fees and the elimination of surplus services. A great deal, however, remains to be done. We have won battles but not the war.