SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
(202) 755-4846

FOR RELEASE: 1:00 p.m. EST, May 17, 1973

THE COMMISSION AND THE REGULATION OF PUBLIC UTILITIES

An Address By

G. Bradford Cook, Chairman

Securities and Exchange Commission

PREPARED FOR PRESENTATION ON

May 17, 1973

American Gas Association
Financial Forum
Del Monte Hyatt House
Monterey, California

Addressing this American Gas Association Financial Forum presents an opportunity for me to share my views with you on questions of mutual interest. These forums allow the Commission to relate in broad terms to specialized audiences matters of policy concern -- a very crucial aspect of our role as an agency of disclosure, and one that is not always possible on a day-to-day basis because of the complex and legalistic nature of the matters in which we are involved.

As you know, the Commission today is confronted with a wide range of major policy considerations. The emerging central market, fixed commission rates, institutional membership, the questions of large-scale use and misuse of inside information, the growing problems involving the role and responsibility corporate directors, the impact and implications of the many enforcement matters now in the courts -- all are drawing increased attention. Most of you are not connected with registered or exempt holding company systems, and might ask: "What do those problems of the SEC have to do with me?" On reflection, I think you will recognize that a viable and healthy capital marketplace, where you can raise the funds that are necessary for your continued growth and operation, is a vital necessity and a matter that should be of continuing concern to you. In the area of your responsibilities as corporate "insiders," officers, directors or controlling persons, our activities on the use of inside information, takeover bids, proxy rules, and your legal liabilities are frequently all too evident. In the accounting area, which I will deal with in detail today, our problems are truly your problems in the most immediate sense. Last year, in order to deal more effectively with these matters, the Commission created five divisions out of the three that had previously existed.

Among the responsibilities of one of these divisions, the Division of Corporate Regulation, is the administration of the Public Holding Company Act of 1935, which gives the Commission broad jurisdiction over interstate public utility holding companies. I am sure that many of you are directly aware of the fact that in recent years, the major part of the Commission's work under the Act has involved the need of the registered

holding companies for vast amounts of new capital. Since 1969, the volume of financings authorized by the Commission under the Act has mushroomed from a relatively modest $926 million to about $2.8 billion as of the end of fiscal 1972, and the trend is still upward.

Today, I would like to discuss some of the problems and issues raised by these mounting capital demands and offer some observations of my own. In addition, I think it is particularly appropriate for me to review the Commission's involvement in and concern over reporting practices for lease accounting.

The step-up in financing activity by the utilities in recent years reflects to a great extent the surge in demand for energy which has drawn widespread public attention. These huge annual increases in new capital requirements, coupled with sharply higher interest costs, have resulted in a steady deterioration of capitalization ratios and debt service coverages. Moreover, increases in operating expenses have resulted in a steadily shrinking portion of total capital requirements which the utility companies have been able to raise through their internal cash generation. For example, the electric utility industry on a nationwide basis was able to provide internally an average of about 48% of its total capital requirements from 1965 through 1969; by 1970 this ratio was down to 28%.

The natural gas holding systems registered under the 1935 Act have fared considerably better than the registered electric utility systems on capitalization ratios and debt-service coverage. This is because, among other things, the capital requirements of the gas systems -- while large -- have in the past been not quite as pressing as the requirements of the electric systems. Now, however, the steady shrinkage of domestic natural gas reserves has confronted the gas industry with new and larger capital requirements. No longer able to obtain adequate gas supplies by the mere act of signing long-term contracts with their traditional domestic pipeline suppliers, the large gas utility holding company systems are putting intense effort into supplementing their traditional sources of supply through exploration and development programs of their own. Thus the

major gas systems -- Columbia Gas, Consolidated Gas, and American Natural Gas, among the registered holding companies -- have begun to participate substantially in joint ventures for lease acquisitions, exploration, and development with non-associated oil and gas interests. These activities embrace not only nearby areas such as offshore and onshore Louisiana and Texas but also distant sources as Alaska and Artic Canada. Nor is this all: The systems are also contracting for liquefied natural gas from abroad, involving the construction of storage and regeneration plants; they are conducting intensive research into obtaining natural gas from coal; and they are actively engaged in exploring the technical and commercial feasibility of synthetic gas. All of this, of course, puts large amounts of capital at risk in hope of future benefits, and intensifies financing problems.

Under the Holding Company Act, activities of the type I have just mentioned are not embraced within the meaning of "gas-utility business," which is defined simply as the retail distribution of gas. Rather, those activities come under the statutory class of "other business," prohibited by the Act unless they are reasonably incidental or functionally related to the utility business. The question has often been raised as to whether this prohibition should apply to the exploration, development, and research activities of the type I have mentioned. The Commission long ago concluded that such activities of the gas holding company systems are intimately and functionally related to their primary gas utility business of rendering retail gas service to their customers. The recent growing shortage of natural gas reserves has given fresh weight and validity to that conclusion.

Generally, the exploration and development activities of the gas systems are conducted through nonutility subsidiaries. Inevitably, these subsidiaries -- especially those newly established -- incur sizable tax losses in the early years of their activities. The losses are included in the consolidated tax returns of the holding company system when incurred, and have the effect of reducing, often substantially, the tax liability of the consolidated group. Since 1955, there has been a Commission Rule 45(b)(6) under the Holding Company Act, governing the allocation of consolidated taxes among the

companies making up a holding company system, the practical effect of which is that -- unless the Commission otherwise permits -- the benefits of tax savings arising from the tax losses of the exploration subsidiaries are distributed among the other subsidiaries having taxable income.

In most cases this means that the tax benefits flow to subsidiaries in the system other than the exploration company. The gas holding company systems stress that these subsidiaries do not assume any of the risks or provide any capital for the exploration and development which produce these tax benefits. Accordingly, a number of these systems have recently requested permission to deviate from the rule. Their objective is to allocate consolidated taxes so as to give the cash equivalent of the tax savings to the exploration subsidiaries and thereby aid their programs for the development of gas reserves.

Since its adoption, the Commission has only sparingly authorized exemption. In the beginning, there was no pressing economic need for frequent exceptions. Now recognizing the urgent need for developing new sources of gas supply in interests of consumers and investors, we have considered and granted some exemptions from the rule so that additional internally generated funds may be available for that purpose. I think the approach to these requests on a case-by-case basis preserves the regulatory intent of the law and at the same time provides enough flexibility to give appropriate recognition to the national policy favoring the development and exploration of reserves.

Let me turn now to the question of lease accounting. Despite what some critics have said, the Commission is not anti-leasing. We recognize the usefulness of leases as a financing device. Economic objectives -- including tax considerations -- of two parties are frequently better satisfied by a lease arrangement than a purchase or sale.

But leasing should not be made more attractive than it really is simply because of the way it is accounted for. Unfortunately, the burgeoning growth of lease activity during the past decade is partly a result of the fact that lease financing is not shown on the balance sheet. This has made such financing more attractive simply because its existence

is largely hidden from investors. Present disclosure rules only require a sketchy description of aggregate long-term lease commitments. This makes it virtually impossible for even a sophisticated analyst to make a meaningful comparison of companies who use different methods of financing the purchase of similar operating assets. Analysts have indicated that in many cases people are misled because a basic financing transaction is not shown on the financial statements. Also, accounting for a transaction as a lease, which is in substance an installment purchase, artificially increases income in the early years of the arrangement because aggregate interest expense is combined with all depreciation and charged to income on a level basis over the life of the asset rather than starting high and then declining as the outstanding debt balance is reduced.

The accounting profession has made considerable efforts to keep up with the phenomenal growth and complexity of lease arrangements -- but in the final analysis it ahs probably failed to do so. At this stage of the game, I believe the accounting profession should be concentrating on building new accounting principle bridges while reinforcing the old bridges with additional disclosure.

Accounting principles covering leases were established in Accounting Principles Board Opinion No. 5, which is now nine years old and whose spirit has been substantially eroded by a combination of “letter of the law” interpretations and competitive pressures in the financial and accounting communities. If continued, this erosion could have a deleterious effect on the concept of full and meaningful disclosure.

Now is the time for lease accounting to catch up with the “state of the art” of lease activity. The Commission has referred the measurement problems of accounting for leases to the newly established Financial Accounting Standards Board, which has replaced the Accounting Principles Board as the chief reulemaking body of the accounting profession. We expect expeditious action and are pleased to see that lease accounting is one of seven subjects on the Financial Accounting Standards Board’s initial

agenda. In the meantime, we at the Commission, and hopefully the accounting profession, will hold facts against further deterioration of lease accounting. This declaration of intention is evidenced by our recent publication of Accounting Series Release No. 132 which required capitalization of leases entered into with lessors without material economic substance; this is one area of deterioration which we intend to curb. In the near future, we expect to issue specific interpretations of this release which we expect to further constrain abuses in the lease accounting area.

Finally, let us return for a moment to the need to short up existing bridges while the new lease accounting principles are developed. Recently, the Accounting Principles Board announced the withdrawal of one of its last proposed opinions which was entitled "Disclosure of Non-Capitalized Lease Commitments of Lessees" and deferred the opinion along with the entire matter of lease accounting to the Financial Accounting Standards Board. We at the Commission were disappointed by this action. This opinion provided good lease disclosure that would help alleviate the gap between today's accounting practice and the complex world of lease activity. It provided for disclosure of lease rentals included in operations, future lease costs and the present value of non-cancelable leases. Unfortunately, this proposed opinion did not require disclosure of the impact on income of treating financing leases as a lease rather than debt. It is now likely that the Commission will propose similar requirements, including the principal omission I have just mentioned, as an amendment to our Regulation S-X, which prescribes the form and content of financial statements filed with the Commission.

Based on our course of action, coupled with our optimistic expectations from the accounting profession, we are hopeful that by the time 1973 financial statements are prepared, disclosure will be significantly improved, and by 1974 the gap will be permanently bridged and accounting for leases will be more consistent with economic reality.

Leasing also presents regulatory problems under the Holding Company Act. These problems stem from a rather new phenomenon, namely, the use of the lease device by some public utility companies to finance the acquisition of liquified natural gas facilities, gas storage tanks, turbines, generators, nuclear fuel, and the like.

In the typical leasing arrangement, financial or leasing institutions are owners of the leased facility, which, when installed, are integrated into the operation of the public utility company. Under the Act the law defines electric or gas utility companies as utilities owning or operating utility facilities. If the owner-lessor is a subsidiary of another company -- and this is not uncommon even for banking institutions -- the parent of each owner of the leased facility becomes "a holding company" under the law.

Obviously, banking or leasing institutions cannot undertake this type of financing if, as a result, the parent of the institutions is deemed to be a holding company subject to regulation under the 1935 Act. However, the Holding Company Act has provisions which permit the Commission to grant exemptions by rule and order. The Commission has granted some exemption applications by order. But it has become apparent that the specific exemptions were not designed for this new development. The burden on lessors has been excessive and examination of individual lease transactions is not an appropriate use of the Commission's limited resources. Applications filed with the Commission, some of which have been granted, cover leased facilities with an aggregate cost of over $500 million. Faced with these considerations, the Commission last January published proposed Rule 7(d). The object of the rule is to exclude lessors of such leases facilities from the definition of "owner". The rule proposes such exceptions, subject to certain safeguards which we deem necessary or appropriate in the public interest or the interest of investors and consumers. Comments, which the Commission invited, have been substantial and instructive.

The proposed rule reflects the Commission's recognition that lease financing is not an unmixed blessing, for it presents us with an operating utility integrated in physical

operation but not in legal ownership. We are sure that management and local utility commissions are not unaware of the possible consequences, in terms of operations or financing, that leasing could produce, if disproportionately used by a public utility. The rule is accordingly made subject to conditions in the hope of averting such detrimental effects. It is based on the assumption that local commissions will confine lease financing within appropriate limits. The rule thus presents a proper accommodation of the Federal regulatory system to bolster or support effective local regulation, and as such it is within the exemptive authority granted to the Commission under the Act.

Finally, I would like to share with you a few thoughts on a legal problem area that is of interest to us on a broad spectrum of issues: the relationship of judicial antitrust action to regulated public utility businesses. Your energy businesses face this problem most immediately, and this was evidenced by the decision of the Supreme Court last Monday in the Gulf States Utilities case, involving Federal Power Commission review of financing applications that were opposed by a group of municipalities claiming that the funds raised by the utility would be used for anti-competitive purposes.

Putting aside the substance of the antitrust allegations (which were not before the Court) two problems are raised by this and other cases:

(1) the extent to which the capital raising function, and its delicate timing, are to be dependent upon such regulatory problems, and

(2) the broader question of the interaction of the antitrust court and regulatory agencies with mandates to oversee businesses that the legislative branch has to varying degrees determined are sufficiently involved with the public interest to be granted quasi-monopoly status.

Turning to the first of these, my comments are limited by necessity since we are involved in pending litigation on this point. I would point out, however, that in our companion case to Gulf States in the District of Columbia Circuit, involving the same municipalities and a utility under our jurisdiction, rather than that of the FPC, the Court

decided that the Holding Company Act did not require the type of antitrust review that the Federal Power Act placed on the FPC. The distinction that the Appeals Court found in the two acts was that the Federal Power Act vested the FPC with jurisdiction over rate and regulatory problems of utilities in addition to the limited financing approval and disclosure provisions of our Act. As you know, the Holding Company Act applies to utilities whose rate and regulatory matters are subject to local state jurisdiction.

The financing issue is, however, only part of the large issue of the application of antitrust laws to monopoly-type, publically-oriented businesses.

The Supreme Court has treated this problem in varying ways this term. In Ricci v. Chicago Board of Trade the Court held that the Commodity Exchange Act, sanctioning control of the Board, required primary reference to an administrative determination of the anti-competitive issues raised in plaintiff's antitrust suit. The Hughes Tool Company opinion, issued concurrently with Ricci, looked at the specific exemption in the C.A.B. statute and found that antitrust jurisdiction was in effect ousted by its provisions. On the other hand, Otter Tail Power and Federal Maritime Commission v. Seatrain Lines, Inc., issued by the court Monday, examining the statutes involved, upheld the jurisdiction of the antitrust court in challenges claiming that the regulatory agencies should resolve anti-competitive complaints.

While complex antitrust principles underly this patchwork of rulings, the central thread running through the decisions is that the court will look at the legislative intent very closely and will not assume that exemption from the antitrust laws was intended unless there are fairly specific indications of such intent. I think it can be fairly stated that the Justice Department is strongly committed to this view.

I certainly cannot predict at this time the effect of unbridled competition on closely regulated industries such as yours. Legislative consideration of these problems is probably in the cards before a coherent policy can be established. In the meantime we will have to struggle with the problems and you will have to plan and run your businesses

in a climate of uncertainty. Hopefully a result, legislative or otherwise, will soon be forthcoming.