Exhibit No. ___ (KLE-3)
Docket No. UE-050684
Witness: Kenneth L. Elgin

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PACIFICORP, d/b/a Pacific Power & Light Company,** **Respondent.**	**DOCKET NO. UE-050684**

EXHIBIT TO TESTIMONY OF

Kenneth L. Elgin

STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Excerpt from article: The Regulation of Public Utilities
By Charles F. Phillips, Jr.

January 27, 2006

The
REGULATION
of Public Utilities

Charles F. Phillips, Jr.

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different patents and owned by different concerns, were established in the same city."[10] Competition was relied upon to serve the public interest. Thus, in 1887, six electric companies were organized in New York City. Five electric companies served Duluth, Minnesota, prior to 1895, while Scranton, Pennsylvania, was served by four firms in 1906. In 1907, forty-five electric light firms had the legal right to operate in Chicago.[11]

> Introduction of the transformer in 1886 led to the use of alternating current, higher distribution voltages, and an expansion of the distribution area that could be served by an individual plant. Improvements in generators made possible larger outputs at lower unit costs, while other technical improvements made it possible to supply incandescent and arc lights as well as direct and alternating current motor loads from the same power source. The increasing economies of scale in power production and the standardization of equipment led to many consolidations of the small electric companies serving given communities or areas. The diminution of competition resulting from these consolidations of power production plants and distribution systems was one of the factors leading to government regulation of public utilities. In a number of cases the local government acquired ownership of the electric system in an effort to provide electric power at lower rates for local consumers.[12]

The Holding Company: Consolidation

The number of electric systems steadily increased until 1917, when a decline set in. The decline reflects the consolidation movement in this field during the late 1910s and throughout the 1920s. This movement took place through merger and lease, but consolidation by means of the holding company was paramount.[13]

A holding company is an enterprise that owns sufficient stock in another company or in a number of companies so that it may influence the management of the company whose stock it holds (see Figure 13-1). Sometimes the holding company is a stockholding firm only and operates no properties directly — a pure holding company. Other holding companies both hold securities and operate some properties in their own names — operating holding companies. By the early 1930s, many electric utility holding companies had assets of $1 billion or more. Further, by 1932, sixteen holding companies accounted for 76.4 percent of the energy generated, with three systems (United Corporation, Electric Bond and Share Company, and the Insull interests) accounting for 44.5 percent of the total electricity produced.[14]

Advantages of the Holding Company. The rapid growth of the holding company in the electric utility field was due to a variety of factors. In the main, two sets of forces were dominant. First, the holding company offered

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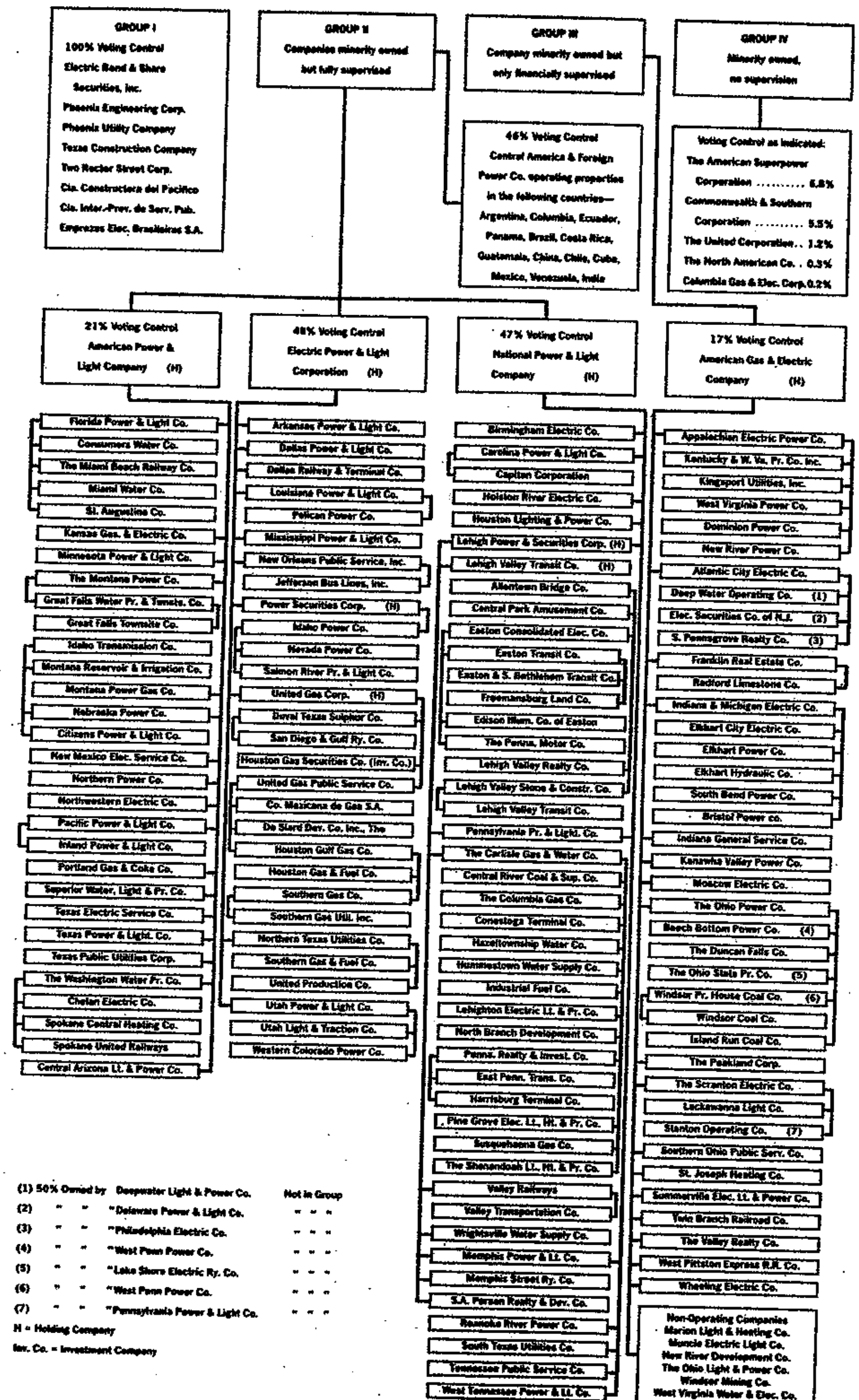

Source: Federal Trade Commission, *Utility Corporations,* 70th Cong., 1st sess., 1935, S. Doc. 92, Pt. 72-A. Chart II facing p. 88.

certain economies. Second, the holding company offered advantages to its owners that, while often producing effects harmful to the general welfare, encouraged its formation. Some systems were formed by electrical equipment manufacturers (the Electric Bond and Share Company by the General Electric Company) to find markets for their products. Others were organized by investment banking houses (United Corporation by J. P. Morgan and Company) engaged in the flotation of utility securities. Still others were promoted by engineering interests (such as Stone and Webster), which supplied technical services to operating utilities.[15] The basic motive, however, was profit.

Economies. The first advantage of the holding company arises from economies of large-scale generation. The introduction of alternating current made it feasible to generate electricity in large central stations and, thereby, to achieve lower costs. In turn, economical service could be rendered over wide areas. Interconnections further increased the service area.[16] In the second place, lower costs of financing were often possible through the holding company. Small companies usually are not well known; buyers for their securities are harder to find. A holding company can sell it own securities at lower rates of interest and use such funds to buy securities of its operating companies at a lower interest rate than if the operating companies were to try to find other buyers for their securities. As a result, by acting as fiscal agent, holding companies may offer a savings in the cost of money to their operating affiliates.

In the third place, holding companies can perform an engineering and construction service for their operating companies. When operating companies are small, they are unlikely to be able to afford an engineering staff. Construction jobs come at intervals, so that a small operating company cannot be expert in carrying them out. A holding company with a large number of operating companies under its control, however, can well afford to set up engineering and construction departments. Hence, if a local company wants to build a new plant, it can turn to its holding company's construction department and be assured that people with continual experience in that line of work will be in charge. Likewise, when an engineering problem arises that the staff of the operating company cannot solve, the issue can be taken immediately to the holding company's engineering department for resolution.

Large-scale buying of supplies and equipment has proven to be a fourth source of savings in many fields. A holding company offers an ideal vehicle whereby a number of small companies can pool their purchases. Instead of each company going separately to a supply house to buy equipment, the orders of all companies are forwarded to the purchasing department of the holding company, which can then afford to go directly to the manufacturers and obtain substantial discounts. Such discounts can be passed on to the operating companies. Finally, many operating companies were originally founded by individuals with little knowledge of the electric utility business. As the field grew, many of these individuals grew with it, and their plants were well managed. But a large number of plants were so small that they were unable to offer sufficient financial returns to attract capable managers. By combining a number of these poorly managed plants, a holding company can group them so that able management may be given to each group.

Profit motive. There can be little doubt that the formation of some holding companies was motivated by a desire to achieve economies. But the dominant motive arose from the profits that accrued to users of this system. By facilitating the pyramiding of control, the holding company affords an ideal means for those interested in controlling a large number of companies with a relatively small investment and, in addition, provides a large return on the money invested. Suppose that a holding company is constructed on the following assumptions (see Table 13-1):

1. There are twelve operating companies with a total capitalization of $48 million, divided in the following manner: 50 percent in 4 percent bonds, 25 percent in 5 percent preferred stock, and 25 percent in common stock.

2. The operating companies are divided into four groups of three each, with a father holding company over each of the groups. Each father company owns one-half of the common stock of its operating companies, requiring an investment of $1.5 million for each holding company, or a total of $6 million for the four. The total capitalization is divided into 50 percent in 4 percent bonds, 25 percent in 5 percent preferred stock, and 25 percent in common stock.

3. The four father companies are now controlled by two grandfather holding companies. Their total capitalization, consisting of one-half of the common stock of the father companies, is $750,000, of which 50 percent is in 4 percent bonds, 25 percent in 5 percent preferred stock, and 25 percent in common stock.

4. A great-grandfather holding company controls the two grandfather companies. Its total capitalization is $93,750, representing one-half of the common stock of the grandfather companies, and is divided into 50 percent of 4 percent bonds, 25 percent of 5 percent preferred stock, and 25 percent in common stock.

If an individual group owns one-half of the common stock of the great-grandfather company — an investment of $11,718.75 — it controls the entire structure. Fanciful? In the case of the Associated Gas and Electric System erected by H. C. Hopson and Associates, an investment of $300,000 at the

TABLE 13-1

Hypothetical Holding Company Pyramid

		Rate of Return and Its Distribution			
Company and Capital Structure	*Investment*	*6 Percent*	*Percent*	*4 Percent*	*Percent*
Operating companies:					
50 percent bonds, 4 percent	$24,000,000	$ 960,000	4	$ 960,000	4
25 percent preferred stock, 5 percent	12,000,000	600,000	5	600,000	5
25 percent common stock	12,000,000	1,320,000	11	360,000	3
Total	$48,000,000	$2,880,000	6	$1,920,000	4
Father holding companies:					
50 percent bonds, 4 percent	$3,000,000	$ 120,000	4	$ 120,000	4
25 percent preferred stock, 5 percent	1,500,000	75,000	5	60,000	4
25 percent common stock	1,500,000	465,000	31	—	—
Total	$ 6,000,000	$ 660,000	11	$ 180,000	3
Grandfather holding companies:					
50 percent bonds, 4 percent	$ 375,000	$ 15,000	4	—	—
25 percent preferred stock 5 percent	187,500	9,375	5	—	—
25 percent common stock	187,500	208,125	111	—	—
Total	$ 750,000	$ 232,500	28	—	—
Great-grandfather holding company:					
50 percent bonds, 4 percent	$ 46,875.00	$ 1,875.00	4	—	—
25 percent preferred stock, 5 percent	23,437.50	1,171.88	5	—	—
25 percent common stock	23,437.50	101,015.62	431	—	—
Total	$ 93,750.00	$ 104,062.50	111	—	—

top of the structure controlled a utility system having book assets in excess of $1 billion.[17]

The profit potential from the holding company structure also is illustrated in Table 13-1. If the hypothetical pyramid is permitted to earn 6 percent on its investment in the operating properties, then the corresponding return on the common stock of the great-grandfather holding company is 431 percent. Obviously, this is a fantastic rate of return! But large returns, in fact, were earned by several holding companies. According to the Federal Trade

Commission (FTC), the earnings on the common stocks of five leading holding companies for 1924 and 1925 were as follows:[18]

	1924	1925
American Power & Light Co.	34.8%	40.5%
National Power & Light Co.	16.5	—
North American Co.	28.2	—
Middle West Utilities Co.	19.0	21.5
Standard Gas & Electric Co.	55.2	37.6
Average	30.7%	33.2%

Even larger profits accrued to the holding companies from their service contracts with operating companies. Again, according to the FTC, the following figures are illustrative: (1) from 1924 to 1929, the Associated Gas and Electric System had net income of $6.5 million for management and construction services alone, representing 193 percent net profit on its service cost; (2) in the same period, Electric Management and Engineering Corporation (owned by National Electric Power Company) received a "minimum" net profit from servicing of $2.9 million, or 171 percent net on costs; and (3) from 1924 to 1927, W. S. Barstow and Company, Incorporated, and its subsidiary, W. S. Barstow Management Association, Incorporated, had a combined net income of $4 million, or 321 percent on expenses.[19]

Abuses of the Holding Company. While there were advantages to the holding company in the electric utility field, there were also important abuses. Three abuses stand out — pyramiding, write-ups and excessive service fees.

Pyramiding. Pyramiding itself turned out to be an evil. In the words of the FTC:

> The highly pyramided holding company group represents the holding company system at its worst. It is bad in that it allows one or two individuals, or a small coterie of capitalists, to control arbitrarily enormous amounts of investment supplied by many other people. In such a situation few men could be relied on to devote their attention to prudent management of the operating companies, because the speculative element is so overwhelming. It tends, apparently, to make them (1) neglect good management of operating companies, especially by failing to provide for adequate depreciation; (2) exaggerate profits by unsound, deceptive accounting; (3) seek exorbitant profits from service fees from subsidiaries; (4) disburse unearned dividends, because the apparent gains, so obtained, greatly magnify the rate of earnings for the top holding company; and (5) promote extravagant speculation in the prices of such equity stocks on the exchanges. Such concentration of control, even without that speculative pressure, appears objectionable as a matter of sound national welfare. . . . Finally, the exaggerated importance to the top holding company of compara-

tively small differences in the profit of the operating companies greatly enhances the incentive of the holding company to increase such profits, or to obtain a revenue through the exaction of service and other fees in addition to the ordinary revenue by way of dividends.[20]

The holding company structure is a fair-weather device. Consider again the data shown in Table 13-1. A 6 percent rate of return on the operating companies' investment would yield a 431 percent return on the common stock of the top holding company. But a 4 percent rate of return would not yield even enough revenue to meet the fixed obligations of the father holding companies. The entire structure, in other words, would collapse.

Write-ups. Closely connected was a second type of abuse — excessive write-ups, stock-watering and inflated capital assets. The FTC estimated that in 1935, write-ups exceeded $1.4 billion.[21] The Electric Bond and Share Company had total write-ups, for example, of $264 million. Sometimes write-ups occurred when property was purchased, but often they were the result of a revaluation of property already held. Thus, when the Cities Service Power and Light Company was established in 1924 to take over most of the securities held by the Cities Service Company, the former issued $99,999,000 of bonds, preferred stock and common stock against a total investment of $40,057,852, and then recorded the securities on its books at $106,104,403, or at 165 percent more than the amount formerly recorded on the books of Cities Service Company.[22]

Intracompany transactions. One of the major abuses of holding companies was charging excessive fees to their operating companies for services rendered. Usually, annual fees were collected in the form of a certain percentage of the operating company's gross revenue, and the resulting fees bore little relationship to the costs of the services furnished. Several examples of excessive fees are given above. Since they were hidden in the costs of the operating companies, excessive fees were covered in setting electric rates and thus paid by the consuming public.

Nor were excessive fees the only source of exploiting operating companies. The operating companies were weakened financially by inadequate depreciation charges, the payment of excessive dividends (sometimes out of capital) and the neglect of annual maintenance. Finally, it should be noted that since the holding company is a corporation separate from the corporation of the operating company whose stock it holds, it is not liable for the debts of the operating company. A holding company thus legally relieves its owners from financial responsibility toward its operating companies.

The Holding Company: Reorganization

State commissions were limited in their control of electric utilities in two specific ways: (1) by the interstate transmission of power and (2) by the