Regulation of Security Issues of Public Utilities By the New York Public Service Commission — 1929-1949

Lawrence L. Gray
Regulation of Security Issues of Public Utilities By the New York Public Service Commission — 1929-1949

Cover Page Footnote
Member of the New York Bar.

This article is available in Fordham Law Review: https://ir.lawnet.fordham.edu/flr/vol22/iss1/3
COMMENT

REGULATION OF SECURITY ISSUES OF PUBLIC UTILITIES BY THE NEW YORK PUBLIC SERVICE COMMISSION — 1929-1949

LAWRENCE L. GRAY†

I. INTRODUCTION

Twenty-four years ago, two young lawyers who were embarking upon notable careers in the field of public utility regulation were among the first to recognize the great importance of the power to regulate the issuance of public utility securities. For David E. Lilienthal and Irwin S. Rosenbaum in their study1 of the work of the New York Public Service Commission before 1929 in regulating security issues of utility companies emphasized the potential effectiveness of this method of control available to regulatory commissions. Since 1928, however, text writers and commentators have given little attention to this important means of regulating public utilities. There was a considerable amount of work published on this subject in the late 1920's and early 1930's1a when state legislatures began to perceive the need for regulatory action2 to cope with the abuses brought about by the wild financing and pyramidng of holding companies in the 1920's which culminated in the painful and often disastrous collapses of the depression era of the 1930's. The passage of the Securities Act of 1933,3 the Public Utility Holding Company Act of 1935,4 and the Federal Power Act of 19355 showed the concern of Congress over the abuses of interstate holding and operating utility companies in the issuance of securities, and by these statutes Congress now reaches utilities beyond the control of the regulatory power of the states.

Through its control over the issuance of securities, the New York Public Service Commission illustrates how the interests of the public, of consumers, and of investors can be safeguarded. By requiring that securities proposed to be issued be backed by properties exceeding in value the amount of those securities and capable of earning substantially more than the interest and dividend charges thereon, the New York Commission has done much to insure adequate and dependable service by the utilities. At the same time such a

† Member of the New York Bar.
1a. See, e.g., Barnes, Public Utility Control in Massachusetts (1930); Rosenbaum, Regulation of Security Issues by the Ohio Public Utilities Commission, 4 U. OF CEN. L. Rev. 321 (1930); Rosenbaum & Lilienthal, supra note 1; Waltersdorf, State Control of Utility Capitalization, 37 YALE L. J. 337 (1928).
2. Waltersdorf, supra note 1a, at 342.
policy, carried out by means of effective investigative powers to ascertain the state of the utilities’ properties and their earning power, protects the investors and owners against the evils of overcapitalization with its dangerous tendency towards reorganization, bankruptcy or foreclosure.

It is the purpose of this paper to examine the work of the New York Public Service Commission between 1929 and 1949 in the regulation of securities issued by New York public utilities. Emphasis will be placed on the electric and gas companies, but some attention will also be given to other utilities. The problems met by the Commission in determining what are security issues requiring the consent of the Commission under the statute, in handling petitions for the issuance of securities for the various purposes specified in the statute, in attempting to persuade the companies to provide for adequate depreciation of plant and equipment and for adjustment of inflated plant accounts by imposing conditions on the issuance of securities, are the chief topics considered by this paper. It is hoped that an examination of what the New York Public Service Commission has done in the regulation of security issues of public utilities since 1928 will provide some insight into the larger problem of utility regulation in general.

II. STATUTORY BASIS OF THE COMMISSION’S POWER TO REGULATE SECURITY ISSUES

The New York Public Service Commission was created in 1907 by statute when the New York Legislature abolished the Board of Railroad Commissioners, which had prior to that time regulated public utilities, and replaced the Board with the Public Service Commission. Before 1907 security issues were not effectively regulated. More extensive powers to regulate the issuance of utility securities were conferred on the Public Service Commission by the 1907 statute in substantially the same form as embodied in the present Public Service Law. The latter statute provides, in almost identically worded sections, for the regulation of security issues of common carriers, railroads, and street railways, of omnibus corporations, of electric and gas corporations, of steam corporations, of water corporations, and of telegraph and

6. For a discussion of the regulation of security issues by the New York Commission up to 1928, see Rosenbaum and Lilienthal, supra note 1.
7. N. Y. Laws 1907, c. 429.
8. See Rosenbaum and Lilienthal, supra note 1, at 717.
9. Jurisdiction of the Commission over telegraph and telephone corporations was conferred by N. Y. Laws 1910, c. 673; over steam corporations by N. Y. Laws 1913, c. 505; over omnibus corporations by N. Y. Laws 1931, c. 531; and over water corporations by N. Y. Laws 1931, c. 715. The 1907 statute (N. Y. Laws 1907, c. 429) had conferred jurisdiction over common carriers and over electric and gas corporations.
10. N. Y. PUB. SERV. LAW § 55.
11. Id. § 62.
12. Id. § 69.
13. Id. § 82.
14. Id. § 89f.
COMMENT

1953]

telephone corporations.\textsuperscript{15} The Commission has asserted jurisdiction over a
foreign corporation operating a gas plant in New York, and this has been upheld.\textsuperscript{16a} Similarly, the Commission has assumed jurisdiction over non-New
York telegraph and telephone corporations where the proceeds of security
issues are used in New York.\textsuperscript{16}

Since the provisions of the various sections of the Public Service Law as
to security issues are substantially the same, a brief summary of and quotations
from Section 69 of the statute pertaining to electric and gas utility companies,
will furnish a basis for the examination of the Commission's work that is to
follow. Section 69 provides that an electric or gas corporation—

"... may issue stocks, bonds, notes or other evidences of indebtedness, payable
more than twelve months after the date thereof ... for the acquisition of prop-
erty, the construction, completion, extension or improvement of its plant or dis-
tributing system, or for the improvement or maintenance of its service or the dis-
charge or lawful refunding of its obligations or for the reimbursement of moneys
actually expended from income or from any other moneys in the treasury ... not
obtained from the issue of stocks, bonds, notes or other evidences of indebted-
ness ...; provided ... there shall have been secured from the commission an order
authorizing such issue ... and that in the opinion of the commission the money,
property or labor to be procured or paid for by the issue of such stock, bonds, notes
or other evidences of indebtedness is or has been reasonably required for the purposes
specified in the order and that except as otherwise permitted in the order in the
case of bonds, notes or other evidences of indebtedness, such purposes are not in
whole or in part reasonably chargeable to operating expenses or to income. ..."

Section 69 of the Public Service Law goes on to include the sale of re-
acquired securities previously issued in compliance with Section 69 as a security
issue requiring commission authorization. Stock dividends cannot be authorized
by the Commission, and notes payable within twelve months may be issued
without the Commission's consent, but they may not be refunded by securi-
ties payable more than twelve months after date of issue unless authorization
for the refunding securities is first obtained from the Commission. Within ten
days after the issuance of all notes, bonds, stocks, and other evidences of
indebtedness, whether maturing more or less than twelve months after issue,
the corporation issuing securities must file with the Commission a notice of
such transaction.

These are the most significant provisions of Section 69 of the Public
Service Law. Before taking up the problems arising therefrom that have

\textsuperscript{15} Id. § 101.

\textsuperscript{15a} Matter of Penn-York Natural Gas Corp. v. Maltbie \textit{et al.}, 164 Misc. 569, 299

\textsuperscript{16} N. Y. PUB. SERV. LAW § 101; Re Western Union Telegraph Co., 69 P.U.R. (n.s.)
57 (1945) (Commission took jurisdiction where foreign corporation failed to show
the proceeds of securities issued were used wholly outside New York). Cf. Re Western Union
Telegraph Co., 51 P.U.R. (n.s.) 404 (1943) where the N. Y. Commission refused to
pass on the issuance of securities in the merger of two domestic telegraph corporations
previously approved by the Federal Communications Commission.
faced the New York Public Service Commission in the past two decades, brief mention should be made of the so-called Knight Commission which investigated the work of the Public Service Commission in 1930 and whose report recommended revisions in the Public Service Law. Most of the recommendations as to regulation of security issues were enacted into the present Public Service Law. However, the recommendation that Section 101 be amended so as to be uniform with the other sections as to the Public Service Commission's lack of jurisdiction over foreign utility companies has not yet been enacted into the statute. Nor has the Knight Commission's recommendation that the amount of notes maturing within twelve months be limited to five per cent of the stated value of securities outstanding been carried out by the New York Legislature.

Another gap formerly existing in the Public Service Commission's regulatory authority over security issues that was recommended for revision by the Knight Commission was closed up by the enactment in 1935 of an amendment to Section 38 of the Stock Corporation Law. By that amendment a utility corporation under the Public Service Commission's jurisdiction must obtain the latter's consent to a change in the corporation's capital stock under Section 36 of the Stock Corporation Law brought about by a reduction or increase in the number of shares or of their par value, or by a reduction of capital, or by the classification or reclassification of shares, before filing such change in the certificate of incorporation with the Secretary of State.

The foregoing are the most important provisions of the Public Service Law relating to the issuance of securities by utilities subject to the jurisdiction of the New York Public Service Commission. We shall now consider the more perplexing problems involved in the Commission's determinations as to what kinds of transactions constitute security issues within the meaning of the statute.

III. What Is a Security Issue Requiring Commission Consent?

A. Short term Notes

Since Section 69 of the Public Service Law requires Commission consent only where the stocks, bonds, notes or other evidences of indebtedness are payable more than one year after issue, the utility companies may obtain short-term loans for one year periods or less without having to secure authorization therefor from the Commission. The possibilities of abuse of such a privilege were recognized by the Commission in Patchogue Electric Light Co. case in 1948. There the Commission required as a condition to the authorization of a bond issue that the company submit a plan to retire

17. 1 REPORT OF COMMISSION ON REVISION OF THE PUBLIC SERVICE COMMISSION LAW (1930). See 40 YALE L. J. 17 (1931), for a contemporary analysis of the Knight Commission report.
18. N. Y. PUB. SERV. LAW § 101.
promptly $225,000 in notes maturing in one year or less. These notes had been renewed year after year for at least six years. The Commission declared that "the continuation of this form of indebtedness beyond the period of one year allowed by the statute merely by the substitution of one note for another is clearly a violation of the intent of the statute."21

The above noted case seems to be in accord with the general purpose of the Public Service Law. The total amount of the Patchogue Company's capital (including the notes in question) was only $725,000, and such an abuse of the short-term note exemption under Section 69 of the Public Service Law would seem to be within the Commission's power to strike down. However, whether the New York courts would sustain the imposition of such a condition as was required in the Patchogue case is not at all certain. The New York Legislature has not enacted into law the recommendation of the Knight Commission22 that short-term indebtedness be limited to five per cent of the stated value of total securities outstanding. The exemption from the Commission's jurisdiction of notes payable within one year is unambiguous; attempts by the Commission to by-pass the statute by using the effective weapon of withholding prompt consent to security issues unless the companies seeking authorization comply with conditions like those in the Patchogue case may not stand up on appeal to the courts. Legislative action is needed. Unless a check is imposed on unwise short-term loans, the Commission could be faced by a petition for a security issue to finance plant construction completed and paid for with short-term credit; in such a situation, the Commission might be forced to authorize security issues which it might have reasonably refused if requested for proposed construction.

B. Reclassification of Stock

A problem that confronts the Commission frequently is that of reclassification of common and preferred stock. Even before the 1935 amendment to the Stock Corporation Law mentioned previously,23 which empowered the Commission to give or deny consent to reclassifications of stock, the Appellate Division had held that the Commission had authority to deny or grant consent, under Section 69 of the Public Service Law, to a reclassification of voting common stock. In Public Service Commission v. N. Y. and Richmond Gas Co.24 the court held that a reclassification of 150,000 shares of voting common stock into 142,500 shares of non-voting preferred and 7,500

21. Id. at 133. Cf. Everett v. Phillips et al., 288 N. Y. 227, 43 N. E. 2d 18 (1942), where a minority shareholder sued to compel the directors of an electric utility to demand payment of loans made to another electric utility payable within one year, and renewed annually for several years. The court held that Section 69 of the Public Service Law did not make such repeated renewals illegal so as to require the directors to call in the loans.

22. 1 REPORT OF COMMISSION ON REVISION OF THE PUBLIC SERVICE COMMISSIONS LAW 38 (1930).

23. See note 19 supra.

shares of voting common stock, was an issue of securities within the meaning of Section 69 of the Public Service Law. The case is of more than academic interest despite the amendment to Section 38 of the Stock Corporation Law in 1935 following the decision for the court construed Section 69 of the Public Service Law broadly so as to carry out the Legislature's purpose to give the Commission "extensive powers of regulation and supervision to protect not only utility corporations and their stockholders but primarily the investing public."25 The court interpreted Section 69 to mean that "no gas or electric corporation may issue stock for any purpose without the consent of the Commission."26 Thus the court refuted the company's contention that Section 69 conferred jurisdiction on the Commission only as to securities issued for purposes specified in the statute. The court cited a Court of Appeals case27 of the previous year to the effect that Section 69 should be liberally construed to empower the Commission to look into the purpose to which the proceeds of notes payable within one year were put where the company sought to refund the notes by issuing long-term bonds.

In 1940 the Court of Appeals affirmed an Appellate Division opinion upholding the power of the Commission under Section 38 of the Stock Corporation Law to withhold consent to a proposed reclassification by a gas and electric utility of $3,000,000 of stated capital into a "Contingency Reserve."28 The Appellate Division said that the power conferred on the Commission by Section 38 of the Stock Corporation Law to give "consent and approval" to a reclassification of capital did not mean that giving such consent was merely a formal matter. Rather, the Commission has power to consider the interests of the bondholders and preferred shareholders who would suffer from an impairment of assets caused by the payment of dividends charged to the Contingency Reserve created by the transfer from the common stock capital account. The Commission was upheld in this case notwithstanding the fact that the amount sought to be transferred from capital to the reserve account had been itself transferred from surplus to capital by a resolution of the board of directors in 1930.

The Commission has, however, in a 1945 case involving the Staten Island Edison Corporation,29 declined to assert its power to deny authorization of a reclassification of common stock where the stock had originally been reclassified without the consent of the Commission and, therefore, in violation of the statute. The stock had passed through at least nine different owners since 1930, the year of the unauthorized reclassification. The Commission

25. Id. at 401, 279 N. Y. Supp. at 827.
26. Ibid.
stated that it would not be feasible to declare the original reclassification void and restore the status prior to 1930. The Commission accordingly approved the company's plan to decrease the number of shares outstanding and reduce the stated value of the stock from $14,600,000 to $7,400,000.\textsuperscript{29}

Through its power to regulate the alteration of stockholders' rights by reclassification of capital stock of utilities, the Public Service Commission has been able to more closely integrate its regulatory authority. By means of this power the Commission can prevent unwise attempts to alter the rights of shareholders and thereby help to bring about confidence in the securities of public utilities by strengthening the financial position of the companies and increasing their ability to provide service to the public.

C. Other Types of Security Issues

The Commission has also asserted its power to authorize security issues in another situation not specifically covered by the statute. In a 1938 case\textsuperscript{31} the Commission made a determination that notes or agreements payable more than one year after date of issue and intended to be delivered to customers by an electric and gas corporation for contributions made by the customers to line extensions had to be authorized by the Commission. The company was told that it must apply to the Commission for authority to issue these notes (which were to be paid within ten years out of revenues earned by the line extensions) in accordance with Section 69 of the Public Service Law.

A case arose in 1937\textsuperscript{32} involving an electric and gas corporation where the Commission, after an investigation of the practices of the company, declared illegal the dealing in its own securities through a subsidiary company. Chairman Maltbie, declared for the Commission, that the utility company had violated Section 69 of the Public Service Law by selling its own securities without the consent of the Commission after reacquiring such securities.

IV. Purposes for Which Securities May Be Issued

A. Refunding

1. General

One of the purposes for which a utility company may issue securities is the "discharge or lawful refunding of its obligations."\textsuperscript{33} Because of the huge amount of refunding that has occurred in the past two decades to

\begin{itemize}
  \item In re New York State Electric & Gas Corp., 19 P.U.R. (n.s.) 122 (1937), the Commission declared null and void the attempted reclassification of common stock into two classes of common and preferred, and an attempted redemption of the preferred thereby created was declared void. Cf. Re New York Power & Light Corp., 63 P.U.R. (n.s.) 318 (1946) where the company was allowed to change preferred stock to common so as to avoid payment of a substantial tax levied on the issuance of new common shares.
  \item Re New York State Electric and Gas Corp., 23 P.U.R. (n.s.) 286 (1938).
  \item Orange & Rockland Electric Co., 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 883 (1937).
  \item N. Y. PUB. SERV. LAW §§ 55, 62, 69, 82, 89f, 101.
\end{itemize}
take advantage of lower interest and dividend rates, the Public Service Commission has encountered many problems in handling petitions seeking authorization for refunding outstanding securities. The Commission encourages such financing and requires that all bonds issued be callable. In fact the Commission has gone so far as to warn the utility companies that it will, in rate cases, consider the fact that refunding at lower interest or dividend rates has not been availed of when proceedings to determine the proper rate of return are in process.

2. Use To Which Proceeds of Refunded Obligations Were Put

It is the policy of the Commission to make a careful investigation of the use to which the proceeds of the obligations to be refunded were put before authorizing the refunding securities. The Commission has refused to authorize the issuance of securities where the refunded obligation was incurred and the proceeds applied to purposes not authorized by the statute. Thus, an electric utility has been denied permission to refund bank loans with bonds where the proceeds of the bank loans had been used to buy stock of a subsidiary company. In 1934 the Court of Appeals had previously upheld the power of the Commission to look into the purposes to which the proceeds of open account indebtedness and notes payable within one year were put where the utility sought to refund such obligations. In that case the company had not adduced satisfactory evidence as to the use to which the proceeds of the loans had been put, and the Commission denied permission to issue refunding bonds. It appeared that the Staten Island Edison Corporation had purchased bonds of an affiliate with the proceeds of the 364-day notes sought to be refunded. The court construed Section 69 of the Public Service Law liberally to close up "the wide gap which would be left for evasion" if the statute were narrowly interpreted so as

34. See 1 Annual Report of the Public Service Commission 49 (1948). For statistics on refunding by utilities in the United States, see 41 P. U. Fort. 248 (1948).

35. 1 Annual Report of the Public Service Commission 32 (1946). Cf. Re New York State Electric & Gas Corp., 61 P. U. R. (N.S.) 577 (1945) (abstract) where the Commission denied the company permission to refund 3½% bonds with 4% preferred stock because of the higher fixed charges. But cf. Orange & Rockland Electric Co., 1 Annual Report of the Public Service Commission 883 (1937) where the company was not allowed to refund securities bearing a higher dividend rate because there were funds available to redeem the old securities.

36. 1 Annual Report of the Public Service Commission 38 (1940).

37. 1 Annual Report of the Public Service Commission 33 (1946).

38. 1 Annual Report of the Public Service Commission 68 (1939).


40. Staten Island Edison Corp. v. Public Serv. Comm., 263 N. Y. 209, 188 N. E. 713 (1934). Cf. Re Central Maine Power Corp., 130 Me. 28, 153 A. 187 (1931) where the Supreme Court of Maine upheld the Maine Public Utility Commission's denial of a refunding petition for short-term notes where proceeds of latter were used to cover the discount on bonds issued to acquire property.

to allow utility companies to refund short term obligations not requiring Commission consent without first obtaining authorization for the refunding securities.

The Commission has also given permission to refund obligations where the proceeds of the obligations had been used to buy common stock of another electric utility and where the proceeds had been used to buy the company's own bonds. The authorization, in the former case, for the refunding of bonds originally issued to buy common stock of another company was justified by the Commission on the ground that the refunded bonds had been authorized in 1925 and at the date of the case (1942) the Commission was in no position to compel the sellers of the stock to repay the petitioning utility. The Commission did, however, require that the new debentures be subject to annual sinking fund provisions to retire the bonds.


It is the policy and practice of the Commission to require that securities issued be supported by asset accounts, which, at fully depreciated values, exceed the amount of the refunding securities and other outstanding obligations. Accordingly, the Commission has denied permission to refund where the property accounts failed to support the new securities. But where the properties are inadequate to support the refunding securities, the Commission may yet authorize their issuance on condition that sinking funds be set up to amortize the securities.

The Commission's power to deduct accrued depreciation from property accounts in order to ascertain if refundings are to be allowed seems clear, although the courts have not yet had occasion to review such action by the Commission. In rate cases the courts have upheld the Commission's power to make its own finding as to accrued depreciation to be deducted from the property accounts in determining the rate base. In Matter of Consolidated Edison Co. v. Maltbie, a temporary rate case, the Court of Appeals has held that the Commission may ignore the company's retirement reserve account and make its own finding as to accrued depreciation which is to be deducted from the original cost of properties in computing the rate base. That case arose under Section 114 of the Public Service Law which empowers the Commission to deduct accrued depreciation from the

45. 1 Annual Report of the Public Service Commission 70 (1939) and 1 Annual Report of the Public Service Commission 48 (1948).
47. See Long Island Lighting Co., 1 Annual Report of the Public Service Commission 616 (1941).
original cost of properties used and useful in the public service in fixing temporary rates so as to allow a five percent rate of return on the rate base. In the Matter of the Application of Long Island Lighting Co. v. Maltbie, a permanent rate case, the Appellate Division has upheld the Commission’s finding of accrued depreciation based on the straight-line method where such finding had support in evidence submitted by the Commission.

Such a policy of allowing only capitalization of depreciated plant value is consistent with the Commission’s practice in rate cases of deducting observed depreciation in computing the rate base, and, it is submitted, is correct. The refunding of securities based on properties carried at higher valuations than those in the rate base would mean that rates would not be sufficient to meet the fixed charges of the securities. If the Commission were to allow utilities to refund securities without requiring that the stocks or bonds be backed by sound property values, then a company could issue securities, refuse to make adequate depreciation provisions on property backing the securities issued, pay out dividends to the amount of accrued depreciation and then refund the old securities, forcing the Commission to resort to sinking fund requirements to protect the investors and consumers.

4. Unamortized Debt Discount and Expense

An important problem arising in refunding operation is the disposition of the unamortized portion of discount and expenses of refunded security issues. The Commission has adopted as its policy the immediate write-off to surplus of such unamortized amounts. This rule, applied rigorously, can have a serious impact on a company whose surplus account cannot absorb the full amount of the charge. This was the situation in the New York State Electric and Gas Corporation case in 1941. There, a $3,000,000 charge to earned surplus of unamortized discount required by the Commission created a deficit which was made up by a transfer from the common stock capital account of an amount equal to the deficiency. The utility company had maintained a policy of paying common stock dividends without taking, as the Commission thought, adequate charges for depreciation over a period of years.

In view of the fact that the United States Supreme Court has authorized amortizing the old discount and expenses of issuance and call premiums over the life of new bonds for income tax purposes and since there is authority to amortize those items over the unexpired portion of the refunded

---


50. 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 44 (1941).

51. New York State Electric & Gas Corp., 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 45 (1941).

52. Great Western Power Co. of California v. Commissioner of Internal Revenue, 297 U. S. 543 (1936).
bonds,\textsuperscript{53} the New York Commission's insistence on an immediate write-off to surplus may work a hardship and defeat one important purpose of a refunding operation, namely, lower interest charges, through the lowering of the sales price of the new issue due to impairment of surplus.\textsuperscript{54} However, in most cases the amount of the unamortized discount and expense will not be large enough to cause difficulties of the kind mentioned. Since there is support for the Commission's position in the Federal Power Commission,\textsuperscript{55} it is difficult to deny the validity of that position in such a matter of accounting practice. The New York Commission's attempt to require that the expenses of a new security issue be charged in whole to surplus has been held to be confiscatory by the New York courts.\textsuperscript{56}

5. Call Premiums and Selling Prices of Securities

The Commission maintains a close supervision over the call premiums on refunding securities as on other security issues and in addition requires that all securities issued be callable or redeemable.\textsuperscript{57} In many cases the Commission has determined that call premiums on preferred stock\textsuperscript{58} and redemption premiums on bonds\textsuperscript{59} were too high. In addition the Commission regulates the interest and dividend rates of security issues and attempts to insure that the lowest possible rates are obtained by requiring competitive bidding in most cases.\textsuperscript{60} However, the Commission has in a recent case

\textsuperscript{53} Re Jersey Central Power & Light Co., 33 P. U. R. (n.s.) 207 (1940) (New Jersey Board of Public Utility Commissioners). See 28 P. U. Forr. 360 (1941) for the view that if an original cost rate base is used, then to be consistent the Commission should allow the write-off of unamortized discount and expense over the life of the refunded bonds or a later period so that a historical cost of money is obtained.

\textsuperscript{54} See Dahl, Some Comments on Public Utility Refunding Operations, 12 J. Land & P. U. Econ. 256 (1936) for a discussion of the effect of such a situation on the marketing of new bonds where no surplus exists to absorb the unamortized discount and expense to be charged off.


\textsuperscript{57} 1 Annual Report of the Public Service Commission 38 (1940).


\textsuperscript{59} Re New York State Electric & Gas Corp., 67 P. U. R. (n.s.) 321 (1946) (3 points maximum premium); Re New York State Electric & Gas Corp., 74 P. U. R. (n.s.) 424 (1948) (3 points maximum premium).

\textsuperscript{60} 1 Annual Report of the Public Service Commission 47 (1949). The Commission in this report emphasizes the need for exceptions to the policy of required competitive bidding in cases where market conditions are unstable, where the expenses of sale through underwriters would be too high, and where the expense of filing fees payable to the SEC would make public sale unwise.
not required competitive bidding where the company could sell a security issue to an insurance company and save the expense of filing fees that would have to be paid to the Securities and Exchange Commission were the securities publicly offered.61

B. Other Purposes for Which Securities May Be Issued

1. Operating Expenses

In two cases decided in 1948, the Commission authorized the issuance of three-year and five-year obligations to pay operating expenses.62 But these authorizations were indicated to be most unusual and were only made because of the serious credit position of the utilities involved. The Commission required that the securities issued be amortized by means of sinking funds to preclude the use for other purposes of funds obtained from income. In the same year an electric utility was denied permission to issue securities to pay income taxes of prior years and also the expenses of a cycle change-over.63 These cases illustrate the Commission's sound policy that security issues must be backed by properties capable of earning the charges on the securities. Only in extraordinary situations has the Commission abandoned that policy.

2. Refunding Expenses

The Commission has allowed an electric company to issue fifteen-month notes to pay the call premiums and out-of-pocket expenses of a refunding operation on condition that the securities be amortized by a sinking fund.64 Monthly payments were required to retire the notes. The reluctance of the Commission to allow costs of refunding to be spread over a period extending beyond the date of refunding is consistent with the policy requiring an immediate charge-off to surplus of unamortized discount and expense in a refunding operation. But it is arguable that the cost of new securities includes the cost of calling in the old obligations, and in many cases the refusal of the Commission to allow refunding costs to be capitalized can work a severe hardship on a company wanting to take advantage of lower interest and dividend rates.

3. Security Issues as Collateral for Other Securities

In a recent case a utility company was denied permission to issue first mortgage bonds as collateral for a promissory note65 where the note provided for the sale of the bonds pledged. The Commission said that because the pledgee could sell the collateral without permission of the Commission

on default of payment on the note, such a provision would give the pledgee control over the sale price of the bonds which is a matter for the Commission to regulate.

4. Capitalization of Earnings

Nor does the Commission allow the capitalization of earnings as a basis for the issuance of securities.\(^6\) Securities must be backed by properties of sound value, and the properties must earn more than enough to pay all operating expenses and the cost of the capital hired. Fixed charges must be earned by a comfortable margin.\(^6\) But the Commission has allowed the parent company to guarantee the bonds of a subsidiary although the subsidiary earned its fixed charges only 1.25 times.\(^6\) In that case the parent had earned its fixed charges 2.98 times and for that reason, and also because the bonds to be issued and guaranteed by the parent were subordinated to a general mortgage, the Commission allowed the parent to guarantee the issue.

V. MISCELLANEOUS PROBLEMS

The Commission attempts as much as possible to keep the proportion of bonds and fixed interest obligations in the capital structure below 60 per cent.\(^6\) Accordingly, the Commission has denied approval of the proposed capital structure of a reorganized electric utility where the ratio of debt to net assets exceeded 60 per cent.\(^7\) But the Commission has authorized the issuance of fixed-interest obligations where, because of its poor credit position, the company could not sell stock\(^7\) and the sale of debentures instead of stock meant that 67 per cent of the total capital would be indebtedness as against a previous 46 per cent. Likewise the Commission has authorized the issuance of first mortgage bonds prior to an issuance of preferred stock proposed by the company even though the effect was to make the debt temporarily in excess of the 60 per cent limit.\(^7\) The Commission refused to permit the simultaneous issuance of the securities even though this would have had the effect of keeping the debt below 60 per cent of the total capital, and, therefore, might have been a factor in helping the utility to obtain a better price for its bonds.\(^3\) The objection that the

---

\(^{6}\) Re Kings County Lighting Co., 68 P.U.R. (N.S.) 296 (1947).
\(^{9}\) 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 46 (1949).
\(^{10}\) Re Long Island Lighting Co. et al., 73 P.U.R. (N.S.) 266 (1947).
\(^{11}\) Rochester Telephone Corp. et al., 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 54 (1948).
\(^{12}\) Re New York State Electric & Gas Corp., 74 P.U.R. (N.S.) 424 (1948).
\(^{13}\) Cf. Re New York State Electric & Gas Corp., 61 P.U.R. (N.S.) 57 (1945) (abstract) where the Commission denied permission to issue refunding 4% preferred stock in redemption of 33½% bonds even though such an issue would decrease the proportion of debt in the capital structure.
preferred stock investors would not know of securities having prior claims could not be made where bonds and preferred stock are issued simultaneously. However, if sufficient publicity had been given to both proposed issues before the securities were offered, the Commission's action would seem unobjectionable in requiring the bonds to be issued first, followed by a ten day interval before the preferred stock could be sold.

VI. THE "ROCHESTER GAS & ELECTRIC" PROBLEM

A. Imposition by the Commission of Conditions on the Authorization of Securities

One of the most powerful and effective weapons of regulation available to the Public Service Commission in the past two decades has been its use of conditions attached to its consents to petitions for security issues. By exchanging prompt authorizations of security issues for the utilities' agreements to carry out the Commission's wishes in write-down of plant accounts, and in setting up adequate depreciation reserves, the Commission has succeeded in correcting to a great extent the overcapitalization of the 1920's with the attendant write-ups of plant accounts and payment of large dividends from funds that should have been set aside out of depreciation provisions and used for plant replacement.

As an illustration of what the Commission has accomplished since 1930 in persuading the utility companies to set up larger depreciation reserves, in 1930 the electric and gas corporations in New York City showed an average of 1.54% of book cost of fixed capital carried in depreciation reserves compared with 14% in 1944, and gas and electric corporations outside New York City carried on their books an average of 5.5% of fixed capital in 1930 and 15.5% in 1944 in depreciation reserves.

This achievement by the Commission is all the more remarkable because in 1935 the New York Court of Appeals affirmed a decision of the Appellate Division that the Commission had no statutory power to prescribe a straight-

74. See 2 BENJAMIN, ADMINISTRATIVE ADJUDICATION IN THE STATE OF NEW YORK 104 (1942).
75. See e.g., New York Power & Light Corp., 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 515 (1945); Central N. Y. Power Corp., 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 61 (1944) (write-down of common stock required with credit to unearned surplus to absorb plant write-down to original cost).
77. See 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 36 (1941) and Long Island Lighting Co., id. at 642, for examples of such practices where dividends of 34% per year were paid on common stock when almost no provision for depreciation was made. Between 1924 and 1934 $11,000,000 in dividends was paid on the common stock of the Long Island Lighting Company when the investment in the common stock amounted to $3,000,000.
78. 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 102 (1945).
line method of depreciation or any other method of depreciation. The Commission had circumvented this judicial prohibition by means of the conditions imposed on authorizations for security issues previously. Because of the nature of the securities market, it is highly important to companies seeking to issue bonds and stocks on the most favorable terms to be able to time their offerings to take advantage of temporary market conditions. This factor has given to the Commission the means of driving hard bargains in the ways indicated above, and the companies have been almost helpless, practically speaking, to contest this assertion of Commission power. Because of the factor of market timing for proposed financing, it is futile for a utility company to litigate the cases where the Commission has imposed conditions on plant write-downs and increases in depreciation charges and reserves.

But in 1949, in Rochester Gas and Electric Corporation v. Maltbie, the New York Court of Appeals affirmed the Appellate Division which had held that the Commission had no power to require, as conditions to the granting of consent for security issues, that the company adopt the straight-line method of depreciation, write-down plant accounts and apply out of earnings annually amounts to make up the deficit created by charges to surplus required by the conditions. The Appellate Division said that it could not be maintained in the case before it "that a requirement dealing with future increase of surplus for depreciation will presently add anything to the marketability or stability of the securities which petitioner seeks to issue." The court went on to say:

"Should adjustments appear to be necessary in connection with surplus for depreciation after a legal and proper inspection and appraisal as to observed depreciation has been made, the Commission has full power to act."  

This decision would seem to have struck a serious blow at the Commission's power. Since it cannot prescribe the method of depreciation to be followed by a utility company either directly or by means of conditions attached to security authorizations, the Commission is powerless to prevent a company

---

80. See Donnelly, Relation of Security Regulation to Market Timing, 42 P. U. Forr. 28 (1948) in which the author points out how utility companies have to pay higher interest and dividend rates in many cases where the regulatory commissions fail to act speedily on petitions for financing. See also Barron's, Mar. 14, 1949, p. 40, where the statement is made that the delays from the litigation in the Rochester Gas & Electric case cost the company ten to fifteen yield points more after the case was decided than would have been necessary had the securities been approved for issue promptly.
82. See Donnelly, Relation of Security Regulation to Market Timing, 42 P. U. Forr. 28 (1948) in which the author points out how utility companies have to pay higher interest and dividend rates in many cases where the regulatory commissions fail to act speedily on petitions for financing. See also Barron's, Mar. 14, 1949, p. 40, where the statement is made that the delays from the litigation in the Rochester Gas & Electric case cost the company ten to fifteen yield points more after the case was decided than would have been necessary had the securities been approved for issue promptly.
83. Id. at 121, 76 N. Y. S. 2d at 677.
from paying dividends out of funds which are in actuality a return of capital and which should be set aside for plant replacements. The dilemma confronting the Commission is one that can only be resolved by the New York Legislature. That body has consistently failed to act on recommendations made to it by the Commission, year after year, requesting that the Public Service Law be amended so as to allow the Commission to prescribe a method of depreciation.  

The requirement that utility companies annually set aside out of earnings adequate depreciation reserves so that plants may be replaced is a sound one and so widely recognized by non-utility industries and the accounting profession that even in tax cases, depreciation is recognized as a legitimate operating expense by means of which the full cost of plant properties may be amortized. Even after the Rochester Gas and Electric Corporation case, the utility company involved agreed, in 1949, to set up depreciation reserves and provided for annual charges for depreciation on the books substantially in accordance with the Commission's original condition that was struck down in the main case. This almost universal acceptance in principle of the validity of adequate depreciation charges related to the using up of plant property over its life remains beyond the Commission's power to apply until statutory authority is conferred on the Commission.

Theoretically the utilities can continue to rely on the retirement reserve system and pay dividends out of a surplus that is in fact partly made up of a depreciation reserve. When the time comes to replace plant properties which have become useless the Commission, faced with such a situation, must authorize security issues to pay for new plant. An effective check may remain available to the Commission in its assertion of power to require sinking funds to amortize securities issued under such circumstances. Whether the courts will uphold this assumption of power by the Commission is not clear in view of the Rochester Gas and Electric case. That the payment of dividends to equity owners of funds which rightfully should remain untouched as a cushion for bondholders and other prior security holders who rely on plant and similar assets for security endangers the securities held by the two latter groups seems indisputable. The connection between inadequate depreciation charges and impairment of the assets that provide adequate service to the public is direct and real. Surely, such a matter comes within the scope of the "public interest" to be protected by the Commission's regulatory power. But it is not only

84. See 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 74 (1939); 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 190 (1941); 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 208 (1946).
85. INT. REV. CODE § 23 (1).
86. 1 ANNUAL REPORT OF THE PUBLIC SERVICE COMMISSION 172 (1949); see also id. at 175, describing the adjustments agreed to be made by the Staten Island Edison Corporation in its plant and depreciation reserve accounts preparatory to reorganization.
the consumer and investor who are injured by this lack of authority in the Commission—the companies themselves will suffer when wholesale replacements are necessary and the funds for them are unavailable except at the great risk of overcapitalization. Expensive interest and dividend charges will have to be paid for the speculative securities issued under such circumstances.

It seems anomalous that the Commission in rate cases \textsuperscript{88} has power to deduct its own estimate of accrued depreciation in computing the rate base, and the utility companies, for income tax purposes, may deduct annual depreciation charges on the straight-line method, but the Commission has no power to require the companies to set aside annual amounts in a depreciation reserve so as to preclude the disbursement of excessive dividends.\textsuperscript{90} Such a situation can only tempt the Commission to plan new devices and resort to methods of regulation not within the spirit or the letter of the Public Service Law. In an era of cheap money rates, coupled with the important tax advantages of debt securities, the huge pressures for debt financing point up a serious lack in the Commission's regulatory power over security issues and over the utilities' activities in general.

VII. SUMMARY AND CONCLUSION

The work of the New York Public Service Commission in regulating security issues of public utilities in the period from 1929 through 1949 indicates, on the whole, a fairly effective regulatory agency. The Commission has recognized during that period the relation between security issues and operating efficiency. A utility plant that must meet interest and dividend charges beyond the earning capacity of the property devoted to the public service cannot operate at full effectiveness under the threat of recapitalization, reorganization, or bankruptcy at more or less frequent intervals.

By making certain that securities issued are backed by properties of sound value, successful service to the public and protection to the investor are at least made possible, provided, of course, management is otherwise efficient and the consumers buy the services available. In attempting to correct the situations resulting from past overcapitalization by requiring plant writedowns, adjustments in depreciation reserves, and sinking funds to amortize "watered" securities, the Commission has pursued what it seems to have regarded as its primary duty, albeit at the expense of stretching the meaning of the Public Service Law to its farthest extent.

The Commission, in meeting the many problems arising in the regulation of security issues, has sought to safeguard the interests of the consumer, the bond and preferred stock investor, and the utility owner. It has, for example,

\textsuperscript{88} See notes 48 and 49 supra.
\textsuperscript{90} See 1 \textit{Annual Report of the Public Service Commission} 95 (1939) where the Commission complains that the companies in rate proceedings resist reductions in annual depreciation allowances but at the same time insist that accrued depreciation estimates deducted from plant accounts in computing the rate base be kept at minimum amounts.
perceived the attempted evasion of the statute as to obligations maturing within one year by holding repeated renewals of such notes to be securities requiring Commission consent. It also has successfully persuaded the companies to provide for plant replacements by recouping the funds required for such purposes out of earnings rather than out of security issues which bear little relation to the value of plant properties backing such securities, i.e., to the earning power of properties dedicated to the public service.

Its record during the twenty years following 1928 indicates that the Public Service Commission will carry out its statutory duties in the regulation of security issues satisfactorily, provided that statutory amendments are enacted to close up the gap in the Commission's authority revealed by the cases arising since 1928. With the added statutory authority recommended, the Commission will help the utility companies to achieve sound financial structures, to the greater benefit of the consuming public, the stockholders and other investors without whose capital government regulation in our society would be meaningless.