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THE ENGINEER'S INTEREST IN SOUND CORPORATE FINANCIAL POLICY

ADDRESS

of

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before

THE AMERICAN INSTITUTE OF ELECTRICAL ENGINEERS

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THE ENGINEER'S INTEREST IN SOUND CORPORATE FINANCIAL POLICY

The Securities and Exchange Commission has been in operation for a little more than ten years and now administers six statutes having to do with certain of the financial activities of our business enterprises which include duties under Chapter X of the National Bankruptcy Act, in the nature of advisory services to the various federal courts. All the laws that we administer were designed for the protection of the public and investors. The powers that we exercise in the public utility field are, however, somewhat different from those under the other statutes entrusted to our administration. The Holding Company Act makes us a sort of public service commission for holding and operating companies in the electric and gas utility fields. Under that Act we regulate the various activities of holding companies and their subsidiaries, including not only the issuance and sale of securities but various other system relationships and activities. Our powers here are not limited to requirements of disclosure. They include regulatory authority and duties the most important of which is the duty of requiring geographic integration and corporate simplification of public utility holding company systems.

In administering this statute we have been bending our efforts to the development of compact and efficient operating systems with conservative corporate and capital structures. I am going to talk about those things tonight, because the engineers and technologists who conceive and supply the method of operations of our industries have deep interest in the development and maintenance of prudent corporate financial policies.

The growth and the development of the electric utility industry in America represent an unparalelled achievement from an engineering standpoint. It would be presumptuous of me to suppose that I could describe those advances to you. They are the accomplishment of the men of your profession and have been set forth and discussed in the technical papers of your Society. Unfortunately, however, the financial and corporate practices of many of the public utility holding company systems stand -- or once stood -- in striking and unfavorable contrast to their technical and operating methods and standards. Because the Congress recognized that imprudent and improvident financial policy could impede and had impeded the use of sound techniques in the development of the industry, it directed the Securities and Exchange Commission to do a financial engineering job in the public utility holding company field. The magnitude of the assignment, as you know, is tremendous. It involves reshaping the corporate structures and control relationships in the various holding company systems. Its completion will result only from long and painstaking effort of ours and of the companies subject to

the Act. But even though the job is a long-protracted and difficult one, I believe that the benefits that will flow from it are more than worth the effort and will survive long after it has been completed.

To a large extent the conditions that we have been directed to correct resulted from the mushroom growth of holding company systems in the '20's, when holding company promoters, sometimes working on a shoestring investment, used the public's money to acquire properties, frequently at highly inflated prices. Insofar as holding company control brought about the coordination of capacity and the formation of strong, interconnected regional power systems, it very definitely served the public interest. During the boom, however, a substantial part of the empire-building was in direct conflict with sound principles of engineering efficiency and regional power planning. In their eagerness to accumulate properties, holding companies vied with each other in acquiring operating utility companies all over the country -- and even in foreign countries. This extension of holding company control had little or no relation to economy of management and operation or to the integration and coordination of economically related operating properties.

A casual glance at the National Power Survey Map, published by the Federal Power Commission in 1935 which shows the service areas of the principal electric systems in the United States at that time, will reveal the extent of the scatteration of holding company operating properties. It shows how these properties, owned by separate holding companies sprawled across territories in a veritable crazy quilt with no relation to regional power needs or other basic elements of electric power economy. For instance, look at the State of Ohio. In 1935 you could count on the map close to fifty different islands of operation properties controlled by holding companies. As many as 15 holding companies controlled properties in Ohio, and in several other states the local utilities are controlled by as many as 10 or 12 holding companies. The properties of one system are often separated by the properties of another system, with the result that the power requirements of many areas are not planned or served as efficiently and cheaply as basic economic conditions fully realized upon would permit. Such apparent uneconomic developments flowed from the strategy of immediate expediency, nurtured by individual system rivalries. We can understand how they happened without accepting the necessity of their indefinite continuance.

Congress determined that they should not continue and, in the Holding Company Act, directed us to limit each holding company system to a single integrated public utility system, with provision for the retention of additional utility systems and related incidental businesses under appropriate circumstances. We are also directed to require the simplification of holding company structures, including the elimination of unnecessary holding companies and the reorganization of holding companies which are unduly complicated and over-capitalized.

In accordance with these Congressional mandates the Commission has proceeded to rearrange the holding company systems and to effect needed reorganizations. Initially every effort was made to encourage the companies to file voluntary plans. However, the companies by and large neglected the opportunity to follow the route of voluntary compliance and chose instead to play a waiting game. They responded to the Commission's invitation by submitting tentative plans which on examination appeared to be impractical and not in conformity with the statute. In general their plans amounted to little more than attempts to justify retention of existing scattered holdings. It thus became clear to the Commission that compliance with the Act could be achieved only through the institution of affirmative proceedings to compel compliance. Accordingly, in the spring of 1940, the Commission instituted its first Section 11 proceedings. Since that time most of the hearings to determine the nature of the Section 11 questions in the various systems have been held, problems of interpretation have been settled, procedural patterns have been established, and many of the more important orders, particularly as regards divestment of properties, have been issued. Time is running on those orders and now it may be supposed that the stream of applications by holding companies to give effect to the terms of those orders will continue and perhaps grow in volume. From the progress so far made, it seems clear to me that the end of the job of integration of holding company systems is in sight.

Even though it may be an old story to some of you I would like, because others of you may not have heard it, to give a brief description of what has occurred under the Holding Company Act. The Commission described it in its last annual report to Congress and I call your attention to that report. In that report we listed the electric, gas and non-utility properties which had been divested by the various holding companies. The list has expanded considerably since then and at the end of June 1944, 266 separate companies, with total assets in excess of 3-3/4 billion dollars, had been divested. Let me summarize a few of the more important cases to illustrate to you the practical operations of the statute in the way of divestment of properties by holding companies. In November 1943 Cities Service Power & Light Company sold its entire common stock interest in Public Service Company of Colorado to an underwriting syndicate for $20,453,000. Public Service Company of Colorado, with consolidated assets of $105,000,000, in good financial condition, is now an independent operating unit, and is no longer subject to the Holding Company Act. In September 1944 Cities Service Power & Light Company also sold its entire common stock interest in Empire District Electric Company to an underwriting syndicate under competitive bidding for $4,711,000. The company which was sold resulted from a merger of separate operating units in the Power & Light system. Substantial contributions by the parent company, together with operating advantages arising from the combination, produced a company which was stronger financially and better able to serve consumers than any of the constituent parts.

In April 1943 the Commission approved a voluntary plan providing for the recapitalization of Puget Sound Power & Light Company. The plan became effective by court decree in September 1943, leaving the parent, Engineers Public Service Company, with less than a controlling interest in the company; and Engineers subsequently sold that remaining small interest. Puget, with consolidated assets of $130,000,000, is no longer subject to the Act.

The State of Texas furnishes two examples of a somewhat different nature. The first is Houston Lighting & Power Company, with total assets of $67,000,000. The parent, National Power & Light Company, exchanged part of its common stock interest in Houston for its own outstanding preferred stock under a voluntary exchange plan; and, in May 1943, sold the balance to underwriters for public distribution, and thereupon Houston was no longer subject to our jurisdiction. Naturally, we at the Commission were gratified to observe that Houston, although it was no longer subject to the Holding Company Act, nevertheless chose, as an independent company, to invite competitive bids for a recent issue of bonds, and to select a Texas bank as trustee under the bond indenture. The second Texas example is San Antonio Public Service Company. The parent, American Light & Traction Company, sold its common stock interest in this company to the City for $10,000,000 in October 1942.

Another method of divestment is illustrated by The North American Company's distribution of its common stock interest in Detroit Edison Company as dividends to its own common stockholders in the years 1941-1943. The same holding company is now distributing its common stock holdings in Pacific Gas & Electric Company. A somewhat similar method was used by The United Gas Improvement Company when it distributed its common stock interest in Delaware Power & Light Company to its common stockholders in August 1943. Previously, in March 1943, the same holding company distributed most of its common stock holdings in Philadelphia Electric Company and Public Service Corporation of New Jersey to its stockholders as a partial liquidating dividend.

Beyond the methods I have mentioned there have been others which figured in the attainment of the Holding Company Act's objectives. These have taken the form of acquisitions of property by one holding company system from another. Among them was the exchange between The United Gas Improvement Company and the Associated Gas and Electric Company system, involving Eastern Shore Public Service Company and Erie County Electric Company. There was a similar exchange of properties between Southwestern Public Service Company and Continental Gas & Electric Corporation, involving properties in the Panhandle of Texas and in Kansas. The sale by Illinois Iowa Power Company of its interest in Des Moines Electric Light Company and Iowa Power & Light Company to Continental Gas & Electric Corporation is another example. Another important instance of integration resulting from Section 11 was the merger of Virginia Public Service Company, a subsidiary in the Associated Gas & Electric Company system, with Virginia Electric and Power Company, a subsidiary of Engineers Public Service Company, which occurred a few months ago.

Likewise, progress is being achieved in rearranging and correcting the complicated capital and corporate structures of the various holding company systems. In a number of systems there are holding companies which are merely pyramiding devices and perform no useful function. Many of these as a consequence of proceedings under Section 11 (b) (2) have been ordered to liquidate or dissolve. This is so with three of the large sub-holding companies in the Electric Bond and Share system — American Power & Light Company, Electric Power & Light Corporation, and National Power & Light Company — and ten or eleven others.

The reorganization plan of Standard Gas and Electric Company, which we recently approved, is an excellent illustration of the use of the Section 11 procedures to accomplish recapitalization, involving retirement of nearly $60,000,000 of debt securities, and the conversion of $87,000,000 of preferred stock, on which dividend arrearages of more than $68,000,000 had accumulated, into common stock. An interesting feature of this plan is that the notes and debentures will be paid off partly in cash and partly in common stock of the operating subsidiaries. The plan as filed and approved eliminated the present common stock from participation in the recapitalized company. Our order in this case has been submitted to a Federal District Court for enforcement. This case, as well as many others of a similar nature, illustrates the fact that, with the cooperation of management, it is possible to work out fair and equitable plans of reorganization for the most complicated situations. It also illustrates the type of case in which steps taken for the purpose of corporate simplification will serve to carry out the divestment of properties which are unretainable under Section 11 (b) 1.

It is perhaps unnecessary for me to say that in our procedures and decisions under Section 11 we have exercised extreme care to accomplish the objectives of the statute without impairing values. That is not to say that we can create values where they do not exist, but it does mean that the job is being done with careful attention to the preservation of genuine interests of investors and the public.

Before I comment on the significance of this program, let me say a few words about the measures that have been taken in the last few years to improve the financial policies of the operating utility companies. By the end of June 1944, the Commission had passed upon the issuance of more than $6,000,000,000 of securities of registered holding companies and their subsidiaries. The major part of this financing was for refunding purposes, to take advantage of lower interest rates. This large amount of refinancing afforded the opportunity to improve the financial structures and policies of the utilities. We, like the State Commissions and the Federal

Power Commission, have required the elimination of write-ups from the plant accounts, either by direct write-off or by an amortization program. In this connection the operating utility subsidiaries of registered holding companies wrote-down their property accounts by more than $500,000,000 in the seven years ended December 31, 1942. The process has continued since then at an accelerated rate as the companies' original cost studies have been completed.

We have also used every legitimate means to reduce debt and establish conservative debt ratios. The effect of that program is reflected in the comparative financial statistics of the electric utility industry for the years 1937-1943. There were gross property additions of nearly 2-1/2 billion dollars during the period and there was a net increase in plant account of more than a billion dollars after allowing for retirements and the elimination of inflationary items. Yet total outstanding debt decreased by more than $200,000,000. A substantial improvement in depreciation policy contributed to this result. In this period depreciation reserves increased by more than $1,000,000,000 and the annual depreciation accrual increased by over $100,000,000. Substantial improvements have also been incorporated in the protective provisions of bond indentures and preferred stock contracts. As a result of these policies, coupled with a steady increase in the use of electric energy, the electric utility industry today is in the strongest financial condition in its history.

The provisions of the statute which are perhaps of most interest to your group are those which establish standards for the regulation of system service companies and, in lesser measure, independent service companies. Service companies figure prominently in the history of the use of the holding company form of organization in the public utility field. The origin and history of service companies was so varied both as to their aims and practices that generalizations would be unwise. Yet, in many instances, the service company was as much an instrument of control and exorbitant profit as it was of service and, unfortunately, its potentialities of service to operating utilities were reduced because of its subservience to purely holding company concerns and aims. Aside from the factors which brought about the establishment of the service company in holding company systems, its use was widespread, and the final result was the suppression of competition. Competitive forces could not and did not have free play.

The non-independent character of system service companies was a matter of deep concern to the Congress. Congress learned in the course of its study of public-utility holding company systems that the system service company had become largely a control medium and a device to extract from the operating companies compensation and payments which could not have been taken off in any other manner. These practices were detrimental to consumers and investors of the operating companies.

Therefore, Congress concluded that services to operating companies by system service companies should be rendered at cost. The standards governing the kind and character of services which may be rendered, the nature and scope of the relationship, and the methods of making reports concerning such services and relationships, are expressed in Section 13 of the Holding Company Act.

The Commission has required substantial modification of the service contracts which were in effect at the time the statute was adopted. In a number of cases the Commission has stated the principle that the compensation and collateral expenses of holding company officers and employees must be borne directly by the holding companies and not be shared by their controlled service companies and thus passed on to the operating companies. The Commission has also ruled that each service company should confine itself to functions and services which the operating subsidiaries cannot perform as efficiently and economically for themselves.

The administration of Section 13 is closely related to the enforcement of Section 11. The problem resulting from the joint impact of Section 11 and Section 13 upon a holding company system is one to which the Commission, the public utility industry and engineering firms generally have given considerable thought and study. The view has been repeatedly expressed to us by representatives of the industry and members of engineering firms that service companies have a real role to play in the operations of the public utilities industry after operating companies have been separated from holding company systems. Here I shall address myself to that question as distinguished from the functions of service companies within holding company systems. It is pointed out that one of the great benefits which flowed from the existence of service companies in their early days was their ability to make available on a wide basis technical knowledge and know-how which would have been enjoyed by only a few companies if the technicians had been distributed on an operating company basis. There were not at that time an adequate number of trained men to go round. Frankly, I do not know whether the use of service companies, in light of the number of technicians which have since been trained, would have expanded or contracted if the closed type of economy represented by holding company systems had not occurred. It is only through the administration and enforcement of the Holding Company Act, particularly Section 11, that the answer will be supplied.

I believe there is an area -- and I make no effort to describe it here except to point out that the size of the operating company may itself be a major factor -- in which engineering and technical services may properly and economically be furnished to operating utility companies by outside service companies. But it is essential that holding company influence not permeate service relationships if the real economic value of such services is to be tested. In light of the fact that service companies have been an important medium for exercise of control, the problem of achieving an effective severance is an

exceedingly troublesome one. Nevertheless, where real independence can be achieved there is no barrier in the statute against the continuation of these enterprises operating in a free competitive market and selling their services at arm's length as their economic usefulness may be demonstrated.

While our experience to date is insufficient to serve as a ground for a positive prediction, one or two situations which we have had occasion to consider tend to point their future. The first, and really the only case of this kind that we have had before us formally, involved the system service company of the Associated Gas & Electric system. In connection with the Section 11 (b) (1) proceedings directed against the trustee of Associated Gas and Electric Corporation, the Commission in its notice of and order for hearing tentatively concluded that no interest in Atlantic Utility Service Corporation could be retained.

In order to resolve the problems created by the administration of Section 11 and for the purpose of making available to the system operating companies if desired the services of the technical staff already familiar with their requirements a program was submitted which resulted in the formation of a new independent service company by the former employees of the system service company. The ownership of Gilbert Associates, Inc., the new service company, was vested in certain of the employees of the system service company.

This new company proposed to purchase the necessary office and other equipment from the system service company and to take over the technical staff of the service company. When the proposal came before the Commission it was recognized that one serious problem presented, in view of the past relationship of employees of Gilbert Associates to the Associated system, was the question of the maintenance of competitive conditions in connection with the contracts to be entered into between the various companies in the Associated system and Gilbert Associates. Accordingly, the Commission set the matter down for a public hearing and made that question one of the specific issues to be considered. At the hearing at which, of course, other service organizations were entitled to appear and be heard, it was disclosed that system operating companies were to be free to negotiate to their best interest as to required services from Gilbert Associates, Inc. or any other independent organization desired. Further, Gilbert Associates, Inc. stated that it intended to compete in the general market for non-Associated business and it was contemplated that business from the present system companies would eventually furnish but a small part of the business of the organization.

In this particular case, the fact that none of the employees of the former service company, who were to become owners of Gilbert Associates, had been in managerial positions in the Associated system and the further fact that the Associated system was being administered by Court appointed Trustees, made it quite clear that Gilbert Associates did not contain the seeds of a control device.

From all indications these changes have been very constructive both from the standpoint of the former employees who have been able to establish their own business in the field of servicing all types of companies and from the standpoint of the operating companies who can now obtain necessary services in a free and open market.

At the time the Commission considered and disposed of the plan of Standard Gas and Electric Company for divestment of five of its subsidiary companies, jurisdiction, upon the request of Standard Gas and Electric, was reserved by the Commission to consider the service company problem at some later date. We were advised by Standard Gas and Electric that it was then in process of working out a plan of disposition of its service company, Public Utility Engineering and Service Corporation, to that company's employees. We have been recently informed that negotiations to that end are presently under way, and that the definitive proposal will be submitted to us.

Now, what are the effects of the overall program that I have outlined and what does it mean to the engineers and the operators of the utility properties? The first effect will be to convert most of the subsidiaries of holding companies into independent operating companies. It will release these companies from remote holding company control and permit the local management to be more responsive to the needs of the communities served. Moreover, by increasing the responsibility and autonomy of local management officials it will promote their self-reliance and sense of responsibility. They will have better and more attractive jobs because they won't have to take orders from a high-salaried supermanagement.

Now let me say a few words about the financial effects of the Section 11 program. When we began administering the Holding Company Act the common stocks of utility operating companies, comprising about 75% of the electric utility industry, were in the portfolios of the holding companies. In turn, the holding companies had issued their debentures, preferred, and common stock, sometimes in a bewildering variety. Very few of the holding companies were in good financial condition and the securities of most of them were severely depressed and yielded no income to the investors who owned them. As I have said, under the Holding Company Act these situations are being cleaned up. Complex capital structures are being replaced by simple capital structrures. Holding company debts are being paid off, risky holding company preferred stocks, with their huge accumulation of dividend arrearages, are being converted to common stock so as to permit once again a flow of income to the security holders. But what is more important, the holding companies are going through a shrinking process. They are being reduced in size because they must slough off their scattered holdings and their security holders are receiving, either in exchange or as liquidating dividends, the common stocks of sound operating companies. This is a factor of great significance both to the operating companies themselves and to the investors who thought they had

an equity interest in the utility industry but found that all they had was a speculative interest in a holding company. Under these conditions in the years to come, the operating utility industry will have a greater ability to raise equity capital on a sound basis to finance its ever growing needs; and the investors who furnish that capital will receive their dividends directly, without being subjected to the expense and the risk of supporting an outmoded holding company organization.

In my view these developments in the public utility field have real significance for the engineer. They will have important effects on the maintenance, expansion, commercial policies, and the public position of the companies. There is ample evidence that routine financial decisions such as the adoption of construction and maintenance budgets are more soundly and intelligently arrived at when an overburdened capital structure with its attendant pressures does not force a cramped judgment upon the managers. The ability of any business unit to adjust itself to the everchanging circumstances of our economy rests in substantial degree upon a conservative financial and corporate structure which will permit a free choice of action based upon considerations of the well being of the enterprise rather than one of expediency which is compelled by financial stringency. The gains that have been made in improving the financial structures and policies of the industry must be maintained. Groups like yours have the responsibility of exerting your influence to insure a continuance of sound corporate financial policy. I believe you will discharge that responsibility.