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"SOME ASPECTS OF PUBLIC UTILITY FINANCE DURING THE WAR"

ADDRESS

of

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SOME ASPECTS OF PUBLIC UTILITY FINANCE DURING THE WAR

All of us know that the coming of war has materially affected the economic status of utility operating companies and that it will strongly influence the course of development in the industry. The next step of measuring and analyzing the effect of the impact of the war upon utilities is, of course, much more difficult and requires, I think, somewhat prophetic gifts. I do not claim, in undertaking this discussion, possession of such gifts. Indeed, I realize keenly the difficulty of recognizing the controlling factors and ascribing to each the weight of influence it exerts in shaping the composite development. Nevertheless, I would like to explore with you certain trends in the industry which appear discernible at this time. You and we have an interest in the creation and maintenance of strong utility operating companies, and so we can approach these problems from a common point of view.

As a point of departure, let me briefly sketch some highlights of the decade prior to the war. During the 1920's, many holding company systems were assembled on a promotional, speculative basis that resulted in distorted financial structures, complex and top-heavy capitalizations, and discordant and uneconomic groupings of utility properties. Consequently, operating companies in holding company systems, by and large, were in a decidedly weakened condition at the beginning of the pre-war decade. I do not want to talk about the details of these abuses and evils -- but I do want to note, in passing, the accomplishments within the industry in the last decade in strengthening operating companies, in eliminating corporate complexities, and in ameliorating the harmful effects of the holding company super-structure above the operating companies.

Charles W. Kellogg of the Edison Electric Institute pointed out recently that during the six years ended 1930, approximately 75% of the total funds for construction in the electric utility industry came from the sale of "new money" securities and only 25% from depreciation reserves and the reinvestment of earnings. Since 1930, the figures show a revolutionary change in the methods of financing new construction in the utility industry. Our records indicate that, for the years 1930 to 1941, the total volume of securities sold for "new money" purposes was equal to less than 20% of gross expenditures for new construction, while over 80% of such expenditures was financed by funds retained in the business through depreciation accruals, undistributed net income, amortization of debt discount and expense, and similar internal items. Stated another way, gross additions and betterments in the electric utility industry exceeded "new money" security issues by approximately \$3,000,000,000. Concretely, this means that investors in utilities securities enjoy greatly increased asset and earnings coverage. In many cases, assets in the form of new generating or transmission equipment are now reflected on the books in substitution for "watered" assets which provided only the illusion of coverage.

In other important respects, the financial practices followed by utility operating companies improved considerably in the 1930's. Depreciation accruals and depreciation reserves have gone up sharply, although there still are instances where improvements should be effected. There has been marked progress in the elimination of inflationary items in asset accounts

of utility companies. Our staff has estimated that operating utility subsidiaries of large holding companies squeezed out over one-half billion dollars of "water" in the years 1936 to 1940, and in addition, set up reserves for future write-downs of more than one-quarter billion dollars. Likewise, many companies have simplified their corporate structures. Service charges by holding companies to their controlled subsidiaries -- which in the boom days drew over \$60,000,000 a year from operating companies -- are now reduced to less than \$20,000,000 a year.

Another important factor that was responsible for improving the financial condition of electric and gas utility companies in the past decade was the industry-wide refunding program which began in 1935 and continued through 1941. In those seven years electric and gas utility companies issued seven billion dollars of securities, the bulk of which were issued for refunding purposes. Most of the refunding issues were sold to take advantage of lower interest rates and extended maturity dates. While investors in these securities received lower returns, reflecting general trends, they gained from the fact that in the refunding process indentures were modernized, conflicts of interest affecting indenture trustees were eliminated, and numerous other improvements were made in the economic and protective covenants of the mortgage. In some instances of high debt ratios, however, the outstanding debt should not have been perpetuated in entirety but some portion of it should have been converted into common stock. This point of view was strongly urged by the Commission in the well-known El Paso case, where the Commission also pointed out that over one-half of the total fixed debt of the industry falls due in the decade 1961-70 and almost forty percent falls due from 1965 to 1969. Experts have suggested that this may constitute an undue concentration of maturities and a possible future source of trouble to the utility industry.

During the thirties, there was also a continued growth in the demand for electric energy and continued improvement in efficiency of operations. Despite rate reductions, gross revenues for a group of companies, representing substantially the entire private electric industry, increased at the rate of about 4% compounded annually in recent years. For the same group of companies, depreciation accruals increased from \$161,000,000 in 1932 to \$279,000,000 in 1941, and taxes increased from \$201,000,000 in 1932 to \$511,000,000 in 1941. Gross corporate income after taxes remained relatively stable, varying from a low of \$762,000,000 in 1934 to \$889,000,000 in 1940; interest and amortization of debt discount and expense declined steadily from \$358,000,000 in 1933, the high point for the period, to \$303,000,000 in 1941; net income was \$508,000,000 in 1932 from which it declined to \$391,000,000 in 1934 and then gradually rose to \$557,000,000 in 1940. That was equivalent in 1940 to a return after preferred dividends of about 7.5% on the book value of common stock and surplus. Composite figures for 1941 are not yet available, but it may be assumed that there was a decline in that year in the amount earned on common stock. It should be noted that the figures as to return on the book value of common stocks have not been adjusted to eliminate write-ups or amounts paid in excess of original cost, but do reflect charges to income for the amortization of some of such items. Chairman Olds of the Federal Power Commission recently estimated that write-ups and excess cost items approximate 27% of the total asset carrying values. This suggests that, at least from the consumer's point of view, utilities, by and large, in the past have been permitted to earn a generous return on the actual sums invested in productive property.

The statements I have made, while general in character, indicate that a substantial portion of the industry by the end of the decade of 1930 had made definite progress toward the achievement of a stable condition or had adopted practices and policies which promised to bring about that result. The force of international events, which in turn affected the economy of this Nation, was commencing to be felt by the utility industry by 1940. It became clear that it was essential for the Nation to marshal its productive capacity in the way best adapted to meet the threats and dangers surrounding us. The recognition of this need brought about extensive consideration of the adequacy of the capacity of the operating utility industry. As you recall, there were those who were convinced that the capacity of the industry had been revealed as inadequate as the emergency program gathered momentum. On the other hand, some took the point of view that the capacity of the industry was not only adequate, but adequate with a safe margin, to accommodate increased demands brought on by a broadened production program for industry generally. At the same time, utility companies, like all other business units and citizens, were paying higher taxes. The indications then were that taxes would increase and net income decrease as the crisis deepened. Relatively current figures prepared by our staff with respect to 190 operating subsidiaries of registered holding companies show that combined gross revenues for the first six months of 1942 were approximately 9.7% higher than for the same period last year. The gross income of these companies, after taxes, was down 6.6%; their net income was down 10.5% and the balance available for common stock after deducting preferred dividend requirements was down 15.1%. Of course, these are aggregate figures, and different companies show varying results.

Federal tax accruals of 170 companies (the other twenty were not available) were \$122,203,000 for the first six months of 1942 as compared with \$70,755,000 in the same period in 1941, or an increase of 73%. Many of the companies stated that their 1942 accruals were based on 1941 rates plus additional amounts to allow for higher rates. In the first six months of 1942, more than half of the companies were accruing excess profits taxes. In considering these figures, it should be borne in mind that these tax accruals have not yet been adjusted by the various companies for accelerated amortization deductions -- which I will discuss in a moment. The increase in taxes was a particularly significant element in the operations of holding company systems, comprising, as they frequently do, several strata of companies each of which originated out of a leverage pattern.

At all events, the combination of admittedly required construction whatever its extent, and the impact of increasing taxes upon utilities, presented a question as to how the cost of that construction could be financed without resorting to excessive debt with its attendant dangers. Events not then generally anticipated seem to have minimized the significance of the dispute over adequacy of capacity and to have presented means to the utilities of defraying the costs of constructing additions in harmony with sound financial policy. To some degree, the same events have introduced new, and perhaps substantial, elements to be reckoned with in connection with any consideration of the impact of taxes upon the industry.

The events I have in mind are the presently existing shortages of critical construction facilities and materials which have resulted in priority restrictions. The effects of these priority restrictions permeate every phase of our

subject of public utility financing during the war. About a month ago, the War Production Board announced the issuance of a series of orders to effect a readjustment of the power expansion program. This was based on a comprehensive review by the WPB of the power supply and requirements situation in the light of the over-all war production program. The orders involved an extensive revision of existing priority ratings on public and private power projects throughout the country. All utility projects regarded as urgently necessary were assigned ratings high enough to assure their completion on schedule. Work on generating projects totaling 2,200,000 kilowatts scheduled for operation in 1943 and 1944 was stopped, as well as work on a number of transmission line projects. The effect of the curtailment program upon capital expenditures for substations, transmission lines and distribution facilities is more difficult to measure. It is possible, however, that the scarcity of copper and other critical materials will greatly curtail expenditures for these facilities in 1943 and 1944.

Speaking broadly, the effect of the orders of WPB is to classify the industry into two groups consisting of those who must postpone construction until priority restrictions are lifted and those who will undertake large construction programs and must find the money to defray the costs involved. This classification holds only in a broad sense, because some companies will fall somewhere in between. Accordingly, I do not want to stress too much the classification of the industry on this basis as a key to an understanding of existing financial problems. I do think, however, that while the financial factors that are common to both groups of companies outweigh their distinctive aspects, it is nevertheless worth while to discuss their financial problems from the standpoint of certain of the contrasting influences affecting each category.

First, let us consider the situation of those companies which will construct additions to plant. How will they finance their capital requirements? Is it likely that the tax incentive to issue debt securities will inevitably lead to their over-bonding? Will war tax levels impede this financing? These questions are best discussed with reference to the rather generous provisions made by Congress for the construction of facilities needed in the conduct of the war.

In describing the effects of these provisions, I shall necessarily talk in general terms and outline what appears to be their impact upon a number of companies at this time. I realize, of course, that there are many variables inherent in each company's situation which may make my general remarks inapplicable in some cases. Furthermore, economic changes not now apparent or other present unknowables may later serve to invalidate some of my observations. Consequently, I would like to have you regard the following comments as exploratory rather than as definitive conclusions on my part.

Congress has provided means whereby, in many cases, new construction can be financed on a self-liquidating basis either without any, or with only a temporarily, increased debt. One of these is through direct government

financing in the form of revenue advances for facilities built for the specific purpose of serving Government owned plants or other Government properties such as army cantonments. A typical contract provides for construction of the facilities with funds provided by the Government to be repaid in the form of credits on the power bills for service rendered. From the standpoint of the utility company, the revenue advance is advantageous because it shifts both the burden of raising the money and the risk of its investment to the Government. Moreover, no interest or other capital charge is paid by the utility company for the funds so advanced.

Another avenue that Congress has opened to the utilities for financing war-time construction has important implications. I refer to Section 124 of the Internal Revenue Code, which was originally enacted in the Second Revenue Act of 1940. That section of the tax law authorizes the Secretaries of War and Navy to issue necessity certificates with respect to capital expenditures which are directly related to war needs. The granting of these certificates entitles the company to amortize its investment in war-time facilities over a five-year period in lieu of ordinary depreciation, thereby decreasing the amount of its taxable income in this period. A taxpayer who has elected to take accelerated amortization may discontinue such deductions with respect to the unamortized balance at any time simply by notifying the Commissioner of Internal Revenue.

Let me illustrate the workings of accelerated amortization with respect to a large utility operating company. It applied for and received a necessity certificate early in 1942 to accelerate the amortization of new construction in the amount of seven and one-half million dollars. Current income statements of the company show that it accrued Federal income and excess profits taxes for the first six months of 1942 in the aggregate amount of \$2,770,600. Of that amount, the excess profits tax accrual was \$2,109,100. These accruals, according to the company, were based upon 1941 tax rates plus an additional amount of \$975,000 in anticipation of higher rates. Assuming that the company's level of earnings continues, the accelerated amortization deduction of one and one-half million dollars yearly for five years will fall entirely in the excess profits rate bracket. At an assumed excess profits tax rate of 90 percent, this would enable the company to retain earnings equivalent to the greater part of the cost of the new facilities over the five-year period. Thus, accelerated amortization may provide a major source of funds for the financing of new utility construction during the war.

The case I have cited is not unusual, for up to August 1942, seventy-five different electric or gas companies had applied for and obtained necessity certificates for the accelerated amortization of approximately \$200,000,000 of new construction, and there is a steady flow of new applications each week. Moreover, an examination of the current income statements that are filed with the Securities and Exchange Commission by about 190 electric or gas utility companies reveals that a large proportion of the companies with substantial construction programs have taxable excess profits sufficient to absorb accelerated amortization for all or the greater part of their war construction expenditures.

One conclusion, I believe may be ventured at this point. That is -- the problem of financing necessary additions will not cause much trouble. It is now clear that, in one way or another, the facilities needed for war purposes will be financed. It is equally clear that accelerated amortization affords constructing companies benefits and opportunities which they would not otherwise have had. The bothersome question is not one of obtaining money to defray construction costs. It is, rather, one of the selection of policy and method governing the use of cash generated internally so as to achieve the best results for the company, the consumer and the investor. In times and circumstances like the present, anything other than a very conservative policy jeopardizes the future of the company and the interests of all persons dependent upon it.

In general, the needs of the industry require such conservative financial practices. The objective should be to finance the cost of war-time facilities out of internal resources to the greatest degree possible and to amortize any debt incurred for the remainder of expenditures over as short a period of time as circumstances permit.

An example will illustrate my thought here. Take the case of a utility which constructs generating equipment or other facilities which are expected to have a continuing usefulness after the war. Here, characteristically, the revenues derived from their use are based on the normal industrial rates charged by the company and will not be sufficient to pay for the cost of the facilities over a relatively few years. Other sources of financing will be required. It appears to me that, in many cases, the cost of such war-time facilities can be financed from funds retained in the business through the non-cash items charged to income and also out of the "tax savings" resulting from accelerated amortization. These "tax savings", as I have noted, will be substantial in numerous instances.

There is a real danger, however, which must be avoided, that some companies will engage in a "big week-end" and pay out in dividends that part of their net income which represents "tax savings" arising from the accelerated amortization deductions and let the years following the five-year period take care of themselves. Such a policy, particularly if accompanied by debt-financing, would be an invitation to trouble and perhaps distress for the enterprise. It must not be overlooked that after particular assets have been fully amortized for tax purposes, no further deductions with respect to them will be allowed in future tax returns. This means, of course, that taxes -- after the five-year period -- will be larger than they otherwise would have been. To a large extent, the gains in present "net income" as a result of accelerated amortization during the five-year period may be considered illusory, since they will be offset to a considerable extent -- depending on tax rates and other factors at the time -- by correspondingly greater taxes subsequent to the five-year period. These circumstances require that management make the "tax savings" unavailable for dividend distribution at this time.

If the management does this, it can, in many cases, use the "tax savings" in addition to funds retained through depreciation accruals, etc., to finance a substantial part of the cost of construction of emergency facilities with at most only temporarily increased debt. If, however, management pays the "savings" out in dividends, the needed war construction would probably have to be financed in part by borrowed capital, and at the end of the five-year period the company would be faced with both increased taxes and the necessity of servicing and paying off the increased debt.

I want to turn now to the companies who will not be permitted -- by virtue of priorities -- to expand their plants in this war period. These companies no longer have the outlet of construction expenditures to absorb the large amounts of cash accumulated from depreciation accruals, amortization charges and the retention of earnings within the business. Of course, the division of the industry into two broad categories should not obscure the fact that many companies with a construction project entitled to the highest priority rating will face similar problems of utilizing surplus cash arising from the fact that other, less vital, construction projects of the same company have been stopped by the WPB. In 1941, of approximately \$592,000,000 spent for new construction, approximately \$279,000,000 was raised through depreciation accruals, and approximately \$216,000,000 from other internal sources.

Utility companies that have an excessive amount of debt securities outstanding should, without question, use available cash to reduce their debt even though the reduction of the debt eliminates a tax deduction for interest charges. In my view, the advantages of debt reduction for these companies overshadow its disadvantages from a tax standpoint. Unless debt is reduced, or an equally acceptable alternative is adopted, bondholders will find their position deteriorating. In normal times, the use of depreciation and other internal funds for capital expansion results in the maintenance of asset coverage for the bonds and offsets the depreciation of the existing plant and equipment.

In some cases, it may be desirable to invest surplus cash funds (to the extent indentures permit) in Government securities. U. S. Treasury Notes, due December 1946, yield approximately 1.46% and are exempt from state income taxes. U. S. Treasury 2-1/2s, due 1967-72, sell on a yield basis of approximately 2.45%. Since the income from these securities are subject to some Federal income taxes, the average utility will save a little more by reducing debt rather than adopting this alternative. Nevertheless, investing in government securities has some important advantages. In the first place, it helps finance the war. Secondly, it places the utility in a highly solvent and powerful position at the end of the war, enabling it to finance necessary property additions wholly out of its own funds. After the war, the power industry as a whole may well need a substantial expansion of present facilities in view of the present curtailment of normal capital additions.

Another alternative, and one that should have considerable appeal to the management and to the common stockholders, is the use of idle cash to retire preferred stock. In this way, the common stockholder can fatten substantially his equity in the company by eliminating a fixed obligation security whose existence renders his security a far less desirable and stable investment. There is little doubt that a substantial reduction in outstanding preferred stock will be greatly beneficial to all investor groups and to consumers.

In cases where preferred stock arrears exist, cash can be used to pay them and to retire the preferred stock. If the arrears are substantial, cash payments to preferred stockholders can be used in a reorganization plan under Section 11 (b) (2) of the Holding Company Act directed toward paying off the arrears and converting the preferred stock into common stock. Such cash payments will make the reorganization much more desirable to the preferred.

An important caveat must be noted, however, in the use of cash to retire preferred stock. In cases where debt is above the ratios of conservatism and safety outlined in the El Paso case, it would be unfair to the debt holders and in some cases illegal to retire a junior security and possibly leave an inadequate margin for the safety of the debt. In such cases, management, generally speaking, must first retire debt or invest in government bonds.

There is no formula for determining the proper use of excess funds for all companies. Each company has its own particular problems, including debt maturities, estimated capital requirements after the war, the proportion of senior securities in its structure, its past and present dividend policy and so forth. In general, a balanced program, varying with the needs of individual companies, consisting of debt reduction, elimination of preferred stock, or the accumulation of cash resources in the form of government bonds, will be desirable. The rewards of a wisely planned use of the cash accumulations which can no longer find an outlet in new construction will be substantial.

Another aspect of utility operations during war which indicates the desirability of retention of substantial amounts of cash, or its equivalent in government bonds, is the possibility of breakdowns in equipment which may result from the quite general overloading of facilities made necessary by current demands. This overloading portends a shortened life for certain utility assets. Likewise, the factor of inadequate maintenance arising out of priority restrictions or manpower shortages points in the same direction of accelerated depreciation of facilities.

In closing -- it appears to me that the financial problems facing utilities in war-time can be met successfully provided management follows prudent financial practices. But the job is largely up to management. That management which is improvident in its use of available resources will heavily penalize its security holders and its consumers. On the other hand, management which takes advantage of the opportunities open to it will be better prepared to meet whatever conditions the post-war future may bring.