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INTEGRATION AND UTILITY INVESTORS

By

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What the SEC says about the already accomplished benefits of the Holding Company Act to investors and the growing well-being of the public utility industry under the Commission's administration of the Act might be discounted as colored by institutional pride. But you need not rely on our assurances, for you can turn to conservative investment advisers who have no possible bias in favor of that Act or of the SEC. Note, for instance, the comments of the Standard Statistics Company in its publication, "Bond Outlook", for March 2, 1940. After surveying the effects of SEC regulation on earnings, depreciation charges, protective indenture provisions write-ups, excessive valuations, and other matters (including the allegedly "radical" action of the SEC in the case of Consumers Power Company) it concluded:

> "Regulation under the Holding Company Act has strengthened materially the position of operating company bonds, and added many safeguards thereto. As an example, the SEC decision on the Consumers Power case, in reality, was favorable to the company's bondholders, since it necessitated equity financing of future capacity expansion which would widen earnings and asset protection of the bonds."

The experience of almost five years with the Public Utility Holding Company Act has demonstrated the soundness

of the standards of the Act and the benefits to investors and consumers which grow out of the provisions relating to the issuance of securities, the acquisition and sale of assets and securities, the requirements that servicing and management contracts with associated companies be based on cost, and similar requirements. So I believe that the standards of the Act relating to the integration of public utility properties and the elimination of "scatteration" among public utility holding company systems will, in the next few years, achieve a comparably wide acceptance and prove their fundamental wisdom.

The argument is still advanced -- though I think with considerably lessening conviction -- that integration of holding company systems means widespread dumping of securities upon markets unable to absorb them, with the consequent collapse of security prices. A reading of Section 11 will indicate that nothing in it requires dumping of securities and that only a reckless administration of the Act by a Commission, an industry, and underwriters, all suddenly deprived of all common sense, could lead to such a result. Indeed, the Commission would be violating its specific duty under the Act if it approved the sale of utility securities or utility assets by holding companies at less than adequate consideration.

Let me refer once more to conservative financial opinion. In the March 4th issue of "Barron's", H. J. Nelson, after pointing out the initiation of integration proceedings by the Commission, concluded that "there are no indications of a determination to destroy legitimate values. In fact, a good many utility authorities believe that in the process of unscrambling the holding companies various senior securities will emerge stronger." Last month the following appeared in "Standard Trade and Securities Service" of Standard Statistics Company:

> "There seems little justification for any fear that holding companies will be forced to dispose of properties at inadequate prices or to take any action that would adversely affect true values. In short, holding company securities should still be appraised on the basis of their real earning power. Where such earning power is adequate, there is no reason to fear that it will be destroyed merely because the properties of a particular system may not be physically integrated."

Actual experience in the administration of the Act up to the present time serves to confirm this judgment. In the Utilities Power & Light Corporation case, the Commission was confronted with a holding company system in its own death throes because of wild purchases of utility securities in the 1920's and which, on its own motion, went into bankruptcy. This system has been described by Floyd Odlum (president of the Atlas Corporation, the largest individual security holding in Utilities Power & Light) as violating "practically every basic provision of the Holding

Company Act, the company's subsidiary properties being mostly single 'utility islands' entirely surrounded by major systems, belonging to other major groups". Yet Utilities Power & Light (now the Ogden Corporation) -- perhaps one of the most extreme cases with which Section 11 will be called upon to deal -- is achieving compliance with Section 11 not only at no loss of previously existing values to its security holders but with gain: Debenture holders, whose debentures touched as low as 12-1/2 in 1932 and whose 1938 price range was from 45 to 67 will, it now appears, receive full payment of their principal plus accrued interest.

It is interesting to note the pattern of compliance with Section 11 selected by Utilities Power & Light and the officers of its successor corporation. Two successful sales of the common stock of its operating companies -- Newport Electric Corporation and Indianapolis Power & Light Company -- to the public were effected through underwriters.

In each of these cases the holding company obtained a price very advantageous to it and its investors. Some question was raised, indeed, as to whether the price was not too high, and the Commission met that objection by requiring an unusually full disclosure of the facts bearing on the price. Cash received from the sale of these common stocks is being used to retire senior securities. The proceeds of the sale of Indianapolis Power & Light Company

common stock alone were sufficient to redeem all of the new outstanding debenture issue of the successor Ogden Corporation, and nearly half of Ogden's new preferred stock. The net effect of these transactions, which were essentially refundings as far as investors were concerned, is to replace holding company securities with sound operating company securities -- a result which cannot be but beneficial.

The Ogden Corporation is presently considering two other proposals which serve to indicate the variety of techniques available for compliance. In one case, the common stock of an operating subsidiary is proposed to be sold to a single individual purchaser, and in another case, it is contemplated that two small subsidiaries will be consolidated into one larger company whose securities will then be able to command a favorable price in the market. A comparable plan is being developed by another major holding company system owning thin common stock equities in certain subsidiaries but also owning a portion or all of such subsidiaries' senior securities. The holding company is planning to convert its holdings of the latter securities into common stock, thus creating a greatly improved capital structure for the subsidiary and a much more readily marketable asset. Section 11, therefore, will accomplish in this case not only the termination of the absentee holding company control but also will improve substantially the credit position of the local company and

its ability to serve consumers. In many other cases, similar readjustments of undesirable security structures of operating companies or of sub-holding companies prior to sale or exchange of their securities will result in higher prices to the selling company, will enable the investing public or the acquiring company to estimate with greater accuracy the value of the securities sold, and will rehabilitate the reorganized company on a permanently sound basis.

The instances of Newport Electric Corporation and Indianapolis Power & Light Company -- and the further recent instances of Washington Gas Light Company and West Penn Power Company -- demonstrate that common stocks of public utility companies are finding a ready and enthusiastic market. Investors who, heretofore, have, for the most part, been restricted to investment in the utility industry either in the form of very low interest bearing bonds, preferred stocks, or in the more speculative holding company securities, are obviously welcoming the opportunity to invest in such operating company common stocks close to the actual income producing assets. This method of compliance alone insures that Section 11 can be enforced without present loss to investors in holding company securities where actual equities in the earnings and assets of operating properties exist.

A variety of other methods of compliance (plainly contemplated by Congress as disclosed in the Congressional

debates and Committee reports) are open to holding company managers. The capital structure of many systems will readily permit the holding company to exchange its underlying assets for its own outstanding securities. A system with several integrated utility systems which cannot be retained by the holding company because of failure to prove compliance with the "A-B-C" standards of Section 11 can, in accordance with a fair plan of reorganization, distribute the common stock of such integrated systems to investors in the holding company, in exchange for their debentures, preferred stock or common stock. This method can be employed even where the holding company's securities are pledged under collateral trust indentures or are otherwise not usually available for distribution. Securities of the holding company are thus converted into securities of the specific integrated systems in a manner comparable to those successful readjustments in industrial securities accomplished pursuant to judicial decrees under the Sherman Act. If the plan of reorganization is equitable, the investor in the holding company can suffer no loss not already long since incurred since his single claim is merely divided into a number of units, all of which are distributed back to him. Many variations of this technique are possible.

Another method of compliance is the exchange of utility securities or utility assets with other holding company

systems where the exchanged property is capable of physical integration with the adjacent properties of the acquiring system. Multilateral trades of this nature may be possible. In situations where one property is more valuable than the other, sufficient common stock of the more valuable utility may be sold publicly or privately so as to bring the properties to a relatively even exchange basis. In some cases, it will be possible (as was recently done successfully by Federal Water Service Corporation) to dispose of a particular property -- utility or non-utility -- which cannot be retained under Section 11 -- by a sale either to the public or to an adjacent system -- and then to acquire a property, disposed of by still another holding company, which can be integrated with the integrated system or systems permitted to be retained. In general, however, the method of exchange of properties is perhaps more difficult than other methods to accomplish and may involve some dangers to investors and consumers. In the long run, it may be economically sounder to achieve regional integration by operating companies voluntarily integrating with each other, because of established economies, rather than superimposing combinations of properties by holding companies which may be motivated by a desire to control as large an aggregation of properties as possible.

Still another method of compliance is the conversion of

the holding company into an investment trust.* This course can be effected by the abandonment of control by the holding company of its subsidiary operating companies. Under the Act, a holding company is a company controlling operating electric or gas utility companies and a subsidiary company is a company controlled by a holding company. Absent control, the holding company-subsidiary relationship ceases to exist. Thus, it is possible for a holding company to retain all of its present investments merely by making legal arrangements which will effectively deprive it of control. Such legal arrangements may be made by enfranchisement of the bondholders and preferred stock of the operating company or by voiding a portion of the voting rights of the common. In some cases, it may perhaps be desirable to sterilize the voting power of the holding company's common stock as long as the holding company retains it. When the holding company disposes of the stock, voting power would revive. In all such cases, however, the Commission should require definite proof that the holding company relationship has actually been severed and not merely converted into more subtle channels of control or controlling influence.

Mr. Justice Douglas pointed out in 1938, when he was Chairman of the SEC, that the record of "scattered" public

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* This method may, in some cases, raise problems which I shall not here discuss.

utility holding company systems, as compared with systems of a more integrated nature, indicates, on pragmatic tests of operating results, that investments in the more integrated systems are considerably more safe. The securities of holding companies which were the most "scattered" -- such as, for instance, Associated Gas and Electric, Insull's Middle West, Standard Gas and Electric, and Utilities Power and Light -- have proved, as many an investor knows, the poorest risks.

Inertia, as such, is not to be desried; but inertia can be a stupefying drug. There should be a presumption in favor of the existent. But that presumption is subject to rebuttal by a showing that old modes of behavior are importantly harmful. Accordingly the defense of the status quo is not always conservative.

In saying that, I have in mind those who defend the status quo in the utility field, the retention, intact, by the utility holding companies of their existing portfolios. Those persons are not, in truth, conservative investment advisers. They strive to appear so, when they deny the benefits of Section 11's integration program on the ground that it interferes with "diversification of investment". Now true investment diversification is indeed conservative. But investment in an unintegrated utility holding company does not yield true diversity. Those who maintain that it

does are confusing "diversification" with "scatteration". It is not conservative to invest in a holding company which owns nothing but junior securities in a large number of scattered subsidiaries all of which are engaged in the utility business.

Real diversity of investment, moreover, may require diversity of management so as to avoid linking too much of one's capital with the integrity and judgment of one man or a single group of men. Every investment involves investment in management. The public investment in Insull's Middle West, or in Hopson's Associated, clearly went into one managerial basket.

There is another argument which needs analysis: I refer to the contention that utility holding companies are an aid to expanding and economically employing power facilities in furtherance of national defense. That may well be true of integrated systems. But scatteration is the antithesis of integration. Coordination in the use of sources of electric power is not best achieved through the mere paper unification of control of operating utility companies having no rational or geographic relation to one another.

As a result of the incentives provided by the integration provisions of the Act, the utility industry in the United States will, in private hands, gradually rearrange itself into compact regional operating systems rather than to continue to consist of the present uneconomic and

inefficient scattered empires, which, paradoxically, have Balkanized the physical operating facilities of the industry. Mobile and flexible administration of the other provisions of the Act by the Commission -- together with the growing consciousness of public service on the part of an increasing number of progressive utility officials -- should contribute substantially to the financial condition of public utility companies and enable them to meet, with an efficiency of operations not now attainable, the increasing demands of our economic system for adequate power at the lowest costs consistent with an attractive return to the investor.

Some months ago, we began proceedings to bring about integration of all the major holding companies. Recently, one such company, United Gas Improvement Company, asked us tentatively to specify, in the proceedings affecting it, our views concerning the action which it must take in order to comply with Section 11. We issued an opinion in which we said we would do so. And we are willing to do likewise as to other companies. Of course, our views, thus expressed, will not be final; any company which disagrees with them, in whole or part, will have a full opportunity to present evidence and to be heard in opposition, before we make any final decision. And any such decision, if considered erroneous, can be appealed to the courts. Such expressions of our views will serve to narrow the areas of disagreement.

The New York Times has described that move as "a constructive one on the part of the Commission" which "should go far . . . in clarifying the issues" and "in establishing guideposts for the future"; and The Wall Street Journal commended it as helpfully cooperative governmental administration.

I am confident that, as a result of the continued sensible administration of that Act by the SEC, the utility industry, under private ownership and management, will be assured a promising future highly beneficial to its investors and to the nation.

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