THE REGULATION OF PUBLIC UTILITY FINANCING

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before

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Introduction

It is indeed a pleasure to have this opportunity to discuss with you the subject of the regulation of public utility financing. I shall deal mainly with regulation by the Securities and Exchange Commission not only because that it is what I am most familiar with but also because our jurisdiction is in a sense complementary to that of other regulatory agencies and because we cover a relatively broad segment of the utility financing field.

Jurisdiction over the regulation of electric and gas utility financing is shared by the S.E.C. with the Federal Power Commission and thirty-three State agencies. This aspect of sharing jurisdiction has always been regarded by the Commission as an opportunity for cooperation with these other agencies not only in matters where jurisdictions tend to converge but in all other matters where such cooperation is desirable and appropriate in the case under consideration.

The S.E.C. was created by Congress in 1934. It is an independent regulatory body of five members, appointed by the President with the advice and consent of the Senate. Not more than three of its members may be from the same political party. We hold staggered terms of five years.

In a general sense, the Commission is interested in public utility financing because all of the laws administered by it relate to the field of securities and finance and provide certain protection for investors and the public in their security transactions. These laws cover dis-

closure requirements on new security offerings and on securities traded on a national exchange. They also embrace qualification of trust indentures, the regulation of investment companies and investment advisors as well as broad jurisdiction over public utility holding companies and their subsidiaries. The Commission also performs various functions as an advisor to the Federal courts in corporate reorganization proceedings. I shall discuss the details of our jurisdiction over utility financing later; it is sufficient at this point to mention that our administrative responsibilities in this field stem mainly from the provisions of the Securities Act of 1933 and the Public Utility Holding Company Act of 1935.

Characteristics of the Utility Industry

The nature of public utility financing in the United States is in many ways as different from other corporate financing as the utility industry itself is different from nonregulated segments of the American productive economy. Put somewhat differently, utility financing is a reflection of the economic characteristics of the industry from which it derives. I would like therefore to review briefly some of these characteristics and note the manner of their effect upon the pattern of financing.

A. Regulated Monopoly.

The public utility industry is a regulated monopoly, early experience having demonstrated the error of duplicating facilities for competitive reasons. As long as demand for its product continues unabated, such a monopoly is assured of its income, though the amount may be limited by

governmental controls and very somewhat with business conditions. Collaterally, utility companies, at least at the operating level, have a relatively low mortality rate and the element of entrepreneurial risk is at a minimum. It is because of these circumstances that utilities may properly function with a capital structure which includes within reasonable limits a sizable proportion of mortgage debt. However, even under circumstances of long life expectancy and income stability there are of course reasonable percentage limits which in terms of debt financing should not be exceeded. This pattern of corporate capitalization for utilities differs sharply from the preponderance of non-regulated industrial corporations which are financed primarily with stock equity.1/

1/ Capitalization ratios derived from summary statistics of non-utility and utility companies are presented in the following tabulation as of December 31, 1949:

Per cent of total capitalization and surplus represented by	Manufacturing Concerns (a)	Electric Utilities (b)	Natural Gas Companies (c)
Long-term debt	12.1%	49.3%	52.0%
Preferred stock	( )	13.8%	3.8%
Common stock and surplus	(87.9%)	36.9%	44.2%

(a) From Quarterly Industrial Financial Report Series - For All United States Manufacturing Corporations (F.T.C. and S.E.C.)
(b) From Statistics of Electric Utilities in the U. S. (F.P.C.)
(c) From Statistics of Natural Gas Companies (F.P.C.)

B. Public Interest Factor.

Utility companies must provide service to all who apply and at reasonable and non-discriminatory prices. Such service must generally meet certain tests of quality and adequacy. The effect of this factor is readily apparent. In order to justify their existence, companies affected with this public interest aspect must program their construction well in advance, and be prepared to undertake financing operations promptly and regularly to assure that operating capacity will always be adequate to handle the public demand. When a customer flicks a switch, the electricity must be there. When a new house is constructed, or a new community developed, the electricity must be there. Thus, in the absence of serious economic adversity, large scale utility financing must be a continuing process as the companies are called upon to meet the requirements of a growing nation in peace and war.

C. High Invested Capital.

A third factor, to some extent related to the previous ones, is the unusual relationship of gross revenues to the amount of total capitalization and surplus in the utility business. The electric industry for example, during 1949, took in about 30 cents in gross revenues for every dollar of investment. This may be compared with about $1.80 to every dollar for private manufacturing concerns. This high ratio of invested capital to revenue makes it necessary that a fairly large proportion of revenues be available as return on invested capital. It also demonstrates an important reason why the utilities in periods of rapid expansion can not rely on retained earnings as the primary source to finance new plant, but must of necessity come again and again into the capital markets for additional funds.

D. Bigness.

The last element I shall mention is the factor of size in the industry. There are of course numerous small utilities including electric, gas, water and transit companies. Nevertheless, utility operations in general are characterized by bigness; large plant investment, large scale generation, long distance pipe lines of tremendous carrying capacity, etc. This bigness has its foundation in technological developments which have made large scale operation the most economical. In the electric industry, over 60 percent of the class A and class B electric utility companies, reported by the Federal Power Commission, have total assets, after deduction of reserves for depreciation and amortization, of more than $10 million dollars and more than half of this group exceed the $50 million dollar mark.

This bigness may also be demonstrated by a sample listing of the dollar size of construction programs recently announced by several of the larger companies.

American Gas & Electric Co.	$290,000,000	('51 - '53)
Carolina Power & Light Co.	50,500,000	('51 - '53)
Cleveland Electric Illuminating Co.	125,000,000	('51 - '55)
Columbia Gas System, Inc.	68,000,000	(1951)
Commonwealth Edison Co.	370,000,000	('51 - '54)
Consolidated Edison Co. of N. Y., Inc.	305,000,000	('51 - '55)
El Paso Natural Gas Co.	83,000,000	('51 - '52)
Kansas City Power & Light Co.	57,000,000	('51 - '53)
Long Island Lighting Co.	137,000,000	('50 - '54)
New England Electric System	60,000,000	('51 - '52)
Public Service Co. of Indiana, Inc.	90,600,000	('50 - '53)
The Southern Co.	73,886,000	(1951)
Tennessee Gas Transmission Co.	47,000,000	(1951)
West Penn Electric Co.	82,000,000	('51 - '52)

Extent of Utility Financing

To measure the scope of utility financing against the background of overall financing in the United States, I have made some extracts from data prepared in the Division of Trading and Exchanges in the S.E. C. Table I offers summary information on all new security offerings for cash by corporate issuers during the period, 1948-1950. The figures include public sales of securities and private placements. Table II sets forth the expenditures on new plant and equipment by business firms in the United States over the same three year period.

TABLE I

NEW SECURITY OFFERINGS FOR CASH BY CORPORATE ISSUERS
(1948 - 1950)
(Gross Proceeds in Millions of Dollars)

Type of Issuer	1948 Amount	1948 % Total	1949 Amount	1949 % Total	1950 2/ Amount	1950 2/ % Total
Manufacturing	$2,226	31.5	$1,414	23.4	$1,189	18.9
Railroad	623	8.8	460	7.6	593	9.4
Real Estate and Financial	594	8.4	599	9.9	625	9.9
Commercial and Miscellaneous	414	5.8	347	5.7	547	8.7
Electric, Gas and Water	2,187	30.9	2,320	38.4	2,686	42.7
Other Transportation 1/	132	1.9	340	5.6	252	4.0
Communication	902	12.7	571	9.4	400	6.4
Total Corporate Issues	$7,078	100.0	$6,051	100.0	$6,292	100.0

1/ Includes street railway and bus companies
2/ Preliminary figures

TABLE II

EXPENDITURES ON NEW PLANT AND EQUIPMENT BY U. S. BUSINESS 1/
(1948 - 1950)
(Millions of Dollars)

Type of Company	1948 Amount	1948 % Total	1949 Amount	1949 % Total	1950 2/ Amount	1950 2/ % Total
Manufacturing	$8,340	43.4	$7,250	40.0	$7,950	43.8
Mining	800	4.2	740	4.1	690	3.8
Railroad	1,320	6.9	1,350	7.4	1,140	6.3
Commercial and Miscellaneous 3/	5,390	28.0	5,120	28.3	4,700	25.9
Electric and Gas Utilities	2,680	13.9	3,140	17.3	3,220	17.8
Other Transportation	700	3.6	520	2.9	430	2.4
Total	$19,230	100.0	$18,120	100.0	$18,130	100.0

1/ Excludes agriculture
2/ Estimates based on anticipated capital expenditures of business
3/ Includes trade, service, finance, communication, etc.

Table I, you will note, shows that electric, gas and water financing has increased dollar-wise from $2,187,000,000 in 1948 to $2,686,000,000 in 1950. On a percentage basis, this segment has advanced from 30.9 percent to 42.7 percent of all corporate financing. The next ranking segment in terms of size is the manufacturing classification but the trend here is in sharp contrast. The dollar total has declined substantially during the three year period and the percentage of total offerings has contracted from 31.5 to 18.9. If communications and non-railroad transportation financing are added to the electric, gas and water category, thus embracing the broad field of utilities, there is represented 45.5 percent of total corporate financing in 1948, 53.4 percent in 1949 and 53.1 percent in 1950 with a dollar figure exceeding 3 billion

in each year.2/

Data contained in Table II offers an interesting comparison with Table I. In terms of aggregate plant expenditures, the figure for electric and gas utilities is large (over 2½ billion in 1948 and over 3 billion in 1949 and 1950) but it is not the largest category. Companies identified under the headings "manufacturing" and "commercial and miscellaneous" are spending far greater sums than the utilities which accounted for only 13.9 percent of total expenditures in 1948, 17.3 percent in 1949 and 17.8 percent in 1950.

Making allowances for the somewhat different classification of companies in the two tables, it is still clear that the non-utility enterprises are capable of installing very large amounts of new equipment while they seek relatively small amounts of outside capital.

2/ Net proceeds of security offerings have been employed chiefly for new money purposes; that is, either for construction of plant equipment or to increase working capital. However, the proportion of financing undertaken for refunding purposes has been on the up swing. Percentages of new money financing, 1948 - 1950, are as follows:

	1948	1949	1950 *
Manufacturing	79.2	61.2	59.7
Railroad	88.5	96.7	59.0
Real Estate and Financial	82.6	74.3	57.6
Commercial and Miscellaneous	75.3	67.6	51.1
Electric, Gas and Water	87.1	80.7	66.7
Other Transportation	96.6	89.3	95.3
Communication	97.6	89.1	79.2

* Preliminary

This heavy internal generation of funds allows an amount of freedom from the security markets which, since the close of World War II, has been unknown to the utility industry. For electric and gas utilities, large scale expansion in recent years has been geared directly to large scale financing and the end, certainly is not yet in sight.

At this point, I should like to narrow the field somewhat and consider in some greater detail two classes of utilities which have displayed phenomanal post war growth and have contributed heavily to the financing totals we have discussed. I refer specifically to the electric utility industry and the natural gas transmission group. These are certainly dissimilar segments in the utility field but this contrast will provide an opportunity to discuss some of the underlying factors which in each segment have affected the course of corporate financing.

A. Financing the Electric Utilities

In July 1947, I had occasion to observe in an address before the National Association of Railroad and Utilities Commissioners in Boston, that private electric utilities were going through a period of unprecedent growth and were expected to add some 11 million kilowatts of generating capacity during the period from 1947 to 1950. Actually that figure was exceeded and the four year increase amounted to over 13½ million kilowatts. New data assembled in the recent statistical issue of "Electrical World" demonstrated that the pace is not slackening. Many companies have in fact raised their sights and further capacity increases by the private companies in the next four years may total more than 16 million kilowatts.

This continuing up-surge is likewise reflected in increasing energy production, larger gross revenues and expanded budgeting for construction of facilities. Translated into dollars of capital expenditures, the figures appear as follows:

Annual Capital Expenditures for New Construction
Electric Light and Power Industry

1947	-	$1,372,145,000
1948	-	2,078,088,000
1949	-	2,517,614,000
1950	-	2,347,171,000
1951	-	2,557,810,000 (planned)

(Source: Electrical World Surveys, rural cooperatives and federal projects not included)

Here is indeed a staggering need for capital funds by an industry which at the end of 1946 showed total net utility plant of about 11½ billion dollars.

Part of these capital requirements have of course been derived from internal sources which consist mainly of depreciation and amortization reserve accruals and retained earnings. In total, however, these amounts have fallen far short of overall requirements. Percentage wise, we can say that such internally generated funds contributed some 30 to 35 percent of total construction needs. 3/ The balance of monies required has come from outside sources through the medium of debt and equity financing.

How the electric industry proceeded to meet its financing needs can

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3/ This proportion is in sharp contrast to the situation existing from 1935 to 1946 when the industry's construction program was on a reduced scale and was financed largely from internal sources.

be demonstrated by the following table:

NEW MONEY FINANCING BY ELECTRIC UTILITIES
(1947 to 1950) *
(thousands of dollars)

	1947	1948	1949	10 Mos. to October 31, 1950
Long term debt	$ 442,895	$ 981,609	$ 861,395	$ 586,024
Preferred stock	98,505	167,493	210,150	210,952
Common stock	95,067	120,015	328,715	255,243
Total	$ 636,467	$1,269,117	$1,400,260	$1,052,219

* Extracted from reports on public utility security issues prepared by Ebasco Services Incorporated.

You will note that the proportion of long term debt financing in the years 1947 and 1948 was extremely high. It is true that general market conditions during this period were relatively depressed and the demand for equity issues rather limited. Nevertheless, this situation caused the Commission considerable concern at the time. As I shall describe later, much effort has been expended under the Public Utility Holding Company Act of 1935 to pull the industry out of the morass of financial distress into which it had fallen in the '30's, and the Commission has been extremely anxious that operating companies develop sound capital structures. That is to say, capital structures containing a sufficient cushion of equity investment underlying the debt. This is the so-called "balanced" capital structure with which the Commission is very much concerned. Adequate equity in the capital structure is the best assurance against insolvency, and it is also the key to low cost financing. The Commission has frequently spoken of this in its orders

and decisions and we commissioners have discussed the need in a number of addresses. Others too have given attention to it. 4/

It is indeed gratifying to note that the electric industry has been responsive to this need. Common stock financing in 1949, for example, was more than twice as large as the 1948 figure and for the 10 months in 1950 the total of preferred and common offerings represented almost 45 percent of the aggregate for all classifications.

B. Financing Gas Utilities

In some respects the post war development of the natural gas industry has been even more spectacular than that of the electric industry though not its equal in dollar size. Production, transmission, and distribution facilities have been expanded since 1946 at a record breaking pace and the so called "wonder fuel" is gradually finding its way into all sections of our country. Natural gas customers have increased in number from 9 to 14½ million in the last 5 years; revenues from sales to ultimate customers have gone up from 713 to 1,363 million dollars; and these totals can be expected to climb much higher.

Essentially the explanation of this spectacular growth is that natural gas, always a fuel of superior quality and great convenience,

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4/ In an address made by Winthrop W. Aldrich, Chairman of the Board of Directors, The Chase National Bank of New York, to a group of utility executives in February 1949, he stated in part "A reasonable proportion of debt in the form of commercial bank loans and long term bonds is desirable. But it is essential that the capitalization of your companies should include substantial equity capital which actually provides a measure of protection for the debt. You must not be complacent about overloading your companies with debt even at prevailing low interest rates."

has also become one of the least expensive sources of energy. Cost increases in both coal and oil have led to a trememdous demand for gas only partially satiated by the present capacity to deliver. In some jurisdictions, for example, regulating authorities have been forced to restrict the installation of natural gas home heating equipment for lack of adequate fuel supply.

This challenge of demand has been accepted by an aggressive program of development and construction which is forging a great link between gas reserves of the Texas, Louisiana area and the concentrated industrial and residential markets to the North and West. In addition to the activities of the older systems which have expanded their facilities, looped their lines and stepped up carrying capacity, there has come into being a whole new group of pipe line enterprises most of them projected, financed and constructed since the close of World War II. Each of these has been a large scale promotion involving the investment of sums running into the hundreds of millions of dollars and involving pipe laying operations for distances as great as 2,000 miles. Typical of this trend was the opening last December of the Transcontinental Gas Pipe Line Corporation system which is now bringing the first large scale flow of natural gas from Texas to the country's largest city.

Aggregate dollar expenditures, past and projected, for transmission line construction are reflected in the following industry statistics. No breakdown on transmission facilities alone is available for those years prior to 1949.

	Total Natural Gas Utility Construction Expenditures	Expenditures for Transmission Facilities
1946	$236,800,000	NA
1947	623,600,000 1/	NA
1948	629,200,000	NA
1949	848,100,000	$567,700,000
1950	954,300,000 2/	645,600,000 2/
1951	890,800,000 2/	564,700,000 2/

1/ Includes $143,127,000 cost of Big Inch and Little Big Inch pipe lines purchased for conversion to transmission of gas.
2/ This amount is a forecast.
(Data from Gas Facts - 1949)

While regulation of this segment of the utility industry is more directly within the orbit of the Federal Power Commission, the S.E.C. has had to deal with problems related to its expansion in several systems, including Columbia Gas System Inc., Consolidated Natural Gas Company, Northern Natural Gas Company, Southern Natural Gas Company, American Natural Gas Company and United Gas Corporation. We have jurisdiction over these companies because they are either registered utility holding companies or subsidiaries of such holding companies. We also review other situations in connection with their filings under the Securities Act and the Securities Exchange Act.

Our contact with financing of this industry has been sufficiently extensive to cause us to note with some concern the continuing tendency, particularly among the newer enterprises, to rely very heavily upon debt financing for their capital requirements. The publication "Business Week" in its issue of November 25, 1950 offered some concrete evidence

of this situation in the form of a table covering security offerings over a 6 year period of 10 of these companies. Set forth below is summary of these data together with some percentage calculations which we have added.

NEW MONEY FOR NATURAL GAS

How 10 Companies Raised It 1/

	Debt		Stock	
	Amount (000,000)	% of Total	Amount (000,000)	% of Total
1945	$25.0	54	$21.0	46
1946	125.0	81	30.0	19
1947	219.5	84	42.5	16
1948	278.0	84	54.6	16
1949	281.5	86	47.2	14
1950	352.3	90	38.2	10

1/ Companies included: Columbia Gas, El Paso, Lone Star, Northern, Panhandle, Tennessee Gas, Texas Eastern, Texas Gas, Transcontinental, United Gas.

The trend which is evidenced by these figures is certainly clear. But it must be interpreted in the light of characteristics peculiar to the industry.

When the S.E.C. in 1948 approved the initial 88 million dollar capitalization of Michigan-Wisconsin Pipe Line Company, a newly formed subsidiary of American Light and Traction Company (now American Natural Gas Company), that capitalization was in the ratio of 75% debt and 25% common stock. It was realized at the time that the nature of the company's business particularly in its earlier stages required a debt proportion higher than our usual maximum of 60 percent. The indenture covering the bond issue set forth that additional bonds could also be issued on the basis of 75 percent of net bondable value of property additions required to complete the later intermediate and few development phases of the pipeline. The Commission noted however in its approval of the initial security offering that "By permitting the 75 percent provision to remain in the indenture we are not, in any sense, authorizing the company at this time to issue bonds to the full extent permitted by the indenture. Each particular security issue of the company submitted to us in the future will be required of course to meet the applicable standards of the Act."5/ Thus it was indicated that the 75 percent proportion would continue to require reexamination in the light of later circumstances.

The heavy proportion of debt financing in the pipeline companies does not, of course, have the same dangerous aspects as a like proportion

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5/ HCA Release No. 8600, footnote 6.

would have for electric utilities, where debt is of long term and treated as a permanent part of the capital structure. Sinking fund provisions for pipeline debt are very heavy and generally provide for a program of repayment which will fully retire the issue by its maturity date. The funding is, in fact, geared to the factor of available gas reserves. The limited gas reserves give the pipeline a fixed life which necessitates a definite, fairly rapid payout. As a result, the initial debt heavy capital sturcture can be improved as time goes on.

The reexamination of capital structure in the light of statutory standards is of continuing importance to us. Among the other gas systems which are subject to our jurisdiction we have given repeated encouragement to the idea of strengthening equity whenever possible because we know from experience that excessive "trading on the equity" is in fact treading on thin ice and is unsuited to an industry affected so importantly with the public interest. We are not oblivious, of course, to the fact that the debt offerings of the pipeline companies are highly regarded as an investment medium by the insurance companies. Primarily through the method of private placement, they have absorbed almost 1 billion dollars of natural gas pipe line bonds since 1945 and indicate a hearty appetite for more. Among other factors which have enhanced the appeal of these offerings are (1) the general growth prospects of the industry; (2) the long term stability of earnings coverage and (3) the strength of cash sinking fund requirements to which I have referred.

It is well to remember, however, that this pipeline expansion program has become a long term undertaking and there are indications that the aspect of heavy debt financing with each passing year becomes less of a temporary and more of a permanent characteristic of the business. Even the newest companies are scheduling additional construction for the years ahead to achieve further increases in capacity. Demands of the new defense program serve to spur this effort. Debt financing is of course highly essential to the success of this development but the base of corporate structure must also be strengthened by the infusion of sufficient common stock equity and we believe that present stock market conditions offer strong incentive for such action.

These aspects of post war expansion which I have been discussing with you demonstrate that utility financing is a tremendous undertaking, and indeed, its regulation in this period is certainly no small responsibility for the S.E.C. or for the other regulatory bodies concerned with the problem. In order to serve America adequately the utilities must grow and to grow they must finance. But we can not allow this procurement of capital to be accompanied by any repetition of the razzle-dazzle financing of the previous generation.

Let us take a little closer look at just how the Commission stands guard against any such threat.

Although all of the statutes which we administer, as I mentioned earlier, are related directly or indirectly to problems of financing it is primarily the administrative responsibility conferred upon the

Commission in the Securities Act of 1933 and the Public Utility Holding Company Act of 1935 which make it one of the nation's most important utility financing regulators.

Financing Regulation Under The Securities Act of 1933

A. Scope of Regulation.

The Securities Act of 1933 affords to investors the protection of full and fair disclosure of information by all companies whose securities are being offered for public sale.[6/] Under its provisions a utility company (or any other company making a public offering) must file with the Commission a registration statement containing material facts dealing, among other things, with the character, size and profitability of its business, its capital structure, the uses to which the company intends to put the proceeds of the sale, remuneration of officers and directors, underwriting commission, and pending or threatened legal proceedings. There must also be included certified financial statements. The statute also requires the seller of the registered security to use and deliver a prospectus summarizing the information on file with the Commission to all persons solicited or sold the securities. There are specific prohibitions against misrepresentation, deceit and other fraudulent acts in the sale of

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6/ In general, government and municipal securities, issues of banks, railroads and cooperatives are exempt from provisions of the Act. Private placements, intrastate offerings and certain limited size offerings are also exempt from registration requirements.

securities under penalty of fine or imprisonment and subject to the risk of possible suit for damages by investors.

It is important to note that, assuming proper disclosure, the Commission is powerless to deny registration or otherwise bar the issuance of securities for lack of merit. Our task goes solely to the point of assuring an adequacy of information.

B. Volume of Registrations.

Since the major portion of utility financing is accomplished through the medium of public security offerings the Commission's responsibility under this statute is a substantial one. As a matter of fact the total dollar volume of registration by electric, gas and water companies exceeded $2,000,000,000 during the twelve months from July 1, 1949 to June 30, 1950.

C. Results Achieved.

Our examination of registration statements often brings to light deficiencies which if undiscovered would be published and furnished to investors. Generally speaking, registration statements of the utility companies are now characterized by a high degree of accuracy and completeness. Deficiencies, if and when they occur, are generally of a minor nature and readily corrected by amendment. It should be remembered, however, that the adequacy and coverage of the modern utility prospectus is in marked contrast to the scanty one-page presentations and "puffing" sheets which purported to provide the investor with his information needs in the twenties. The modern

prospectus makes possible informed, intelligent investment. It has brought with it a restored public confidence in our securities markets and our corporate institutions.

D. Private Placement of New Issues

There is one segment of utility financing which stands outside the jurisdiction of the Securities Act of 1933. It consists of those transactions generally referred to as private placements, where the security seller and the buyer deal directly with each other both in establishing the terms and in passing title to a security issue. Participation of underwriting firms in such transactions is limited to the role of intermediaries or finders. The buyers or buying group in such transactions are almost always institutional investors. During 1950, private placements represented approximately 27% of all security offerings by electric, gas and water companies. If the calculation is limited to debt offerings, the figure is higher, running to 34%.

The substantial amount of utility bond issues placed privately in recent years has been attributed by some critics of the Securities Act to a desire on the part of issuers to avoid the burden of its registration requirements. These critics overlook one important thing, and that is that the growth of private placements is related directly to the growth in recent years of the institutional investor - the insurance companies which are repositories for billions of dollars of individual savings. These institutional investors are interested largely in debt securities of which utilities are a chief source. There has

also been in recent years a substantial reduction in bond interest rates which has taken the general public, for the most part, out of the bond buying market. The concentration of capital places a limited group of buyers in an excellent position to deal directly with security sellers, to negotiate tailor-made terms and to offer commitments on further lending. Obviously, these features hold a strong attraction for any utility management.

While we might expect that the private placement procedure would permit some reduction in the time and expense of preparation by the issuing company, the Commission feels that the procedure does not necessarily result in the lowest cost of money. We believe that minimum costs can best be obtained through full competition between security buyers in the best American tradition. Furthermore under the Holding Company Act, the Commission has a responsibility to see to it that competitive conditions are maintained in connection with the issuance of securities by registered holding companies and their subsidiaries. The direct negotiation between an issuer and either the investment banker or the institutional investor does not afford this result. We are convinced that sale of securities through competitive bidding is the best answer. The merits of this procedure are also recognized by the Interstate Commerce Commission, Federal Power Commission and 15 State regulatory agencies.

One relatively recent instance serves to illustrate very graphically the benefits to be derived costwise from competitive bidding. In December 1948, Duke Power Company proposed to sell

privately to 7 insurance companies $40,000,000 of 30 year First and Refunding 3-1/8% Mortgage Bonds. The original price was 100.89 to yield 3.08%. This price was later amended to 101.47 to yield 3.05%. This issuance came under the jurisdiction of the Federal Power Commission and application was made to that agency for approval. After some further consideration, the company revised its application and submitted the issue to competitive bidding. The winning bidder offered to purchase the bonds at a price of 100.803 with a coupon of 2-7/8% representing a cost of money of 2.835%. Initial offering price was 101.31. The difference in interest cost over the life of the bond issue, comparing the amended private placement rate and the successful competitive bid, was $2,580,000 on a basis book method of calculation or $2,734,274 using a net interest cost comparison. These include no adjustment for differences in the size of expenses of issue.

Comparisons of this type are not too numerous because it is not often that data on the two methods of sale can be assembled for comparison on one offering. However, the Commission does have in its files several other instances which serve to demonstrate that the bidding procedure does afford lower cost to the issuer.

Financing Regulation Under The Public Utility Holding Company Act of 1935

A. Scope of Regulation.

Regulation of utility financing under the Public Utility Holding Company Act of 1935 is but one aspect of the broad jurisdiction conferred upon the Commission in this statute over public utility holding companies

and their subsidiaries. Enactment of this legislation by the Congress had been preceded by an extensive investigation begun by the Federal Trade Commission in 1926 and lasting into the early '30s. The results of that study showed conclusively that public utility holding companies and their subsidiaries were subject to serious and widespread abuses which were adversely affecting the national public interest, the interest of investors in their securities, and the interest of consumers of electric energy and natural and manufactured gas. Among these were control with little or no investment, pyramiding, tremendous overcapitalization, abuse of management prerogatives, excessive fees and charges, financial mismanagement, etc., etc.

Because of the interstate character of the systems and the corporate labyrinths created, the problem was completely outside the power of individual states.

The statute therefore established broad Federal jurisdiction over all such holding company systems. It imposed requirements for the physical integration and corporate simplification of these systems. This is the famous Section 11 of the Act which was one of the most controversial pieces of legislation ever enacted by the Congress. I will have more to say about this important provision later. In other sections, the Commission is given jurisdiction over security transactions, acquisitions and divestments, dividend payments, solicitation of proxies, intercompany loans and intra system transactions. There are provisions on servicing, sales and construction contracts and on the supervision

of accounting practices. In a word, the Holding Company Act is a statute designed to create the character of the utility industry and that is what has been done.

The characteristically broad jurisdiction afforded by the Holding Company Act is clearly reflected in the scope of tests which must be applied by its provisions before any security issue can be approved by the Commission. We must find the security to be reasonably adapted to the security structure of the issuer and of other companies in the same holding company system; the security must be reasonably adapted to the earning power of the issuer; it must be necessary and appropriate to the economic and efficient operation of the company's business; the fees, commissions and other remunerations paid in connection with the issue must not be unreasonable; finally, the terms and conditions of the issue or sale of the security must not be detrimental to the public interest or the interest of investors and consumers.

B. Results Achieved.

Under these standards, the Commission has had not only an opportunity but a mandate to use its authority as a means of achieving a marked improvement in the financial structures of the operating utilities. To achieve this result, the Commission has enforced the elimination of inflationary items from company plant accounts to assure that assets behind securities to be issued were not of the character of "wind and water". In some cases the effect of this elimination has been so drastic upon the equity accounts of the operating company that it has

been necessary for the parent holding company to improve the relationship of equity to debt by making a cash contribution or by contributing to the subsidiary a portion of its security holdings in that company.

Considerable attention has also been given to the strengthening of bond indenture provisions, covering matters of additional bond issuance, sinking funds, maintenance and depreciation requirements, and restrictions on the payment of common dividends.

In respect to preferred stock offerings, the Commission has insisted that the company's articles of incorporation contain a number of protective provisions which permit that class of stockholders to elect a majority of the board of directors in the event of default on four quarterly dividends and increase its voting rights in respect to certain types of corporate action. There has also been added the so-called A B C clause which has the effect of automatically restricting the payout of common dividends if common stock equity is or becomes less than 25 per cent of total capitalization and surplus. Through these steps each financing became a vehicle for improvement in corporate organization and served to prepare many of the subsidiaries for eventual divestment by their parent holding company and subsequent independent operation.

The problems of maintaining sound capital structure must, of course, be met with a degree of flexibility of administration. What may be a permissible ratio of debt to equity under one set of circumstances may not be appropriate under another. For example, just recently the Commission approved on an interim basis the acquisition of stock by five electric utilities in a new generating company, Electric Energy, Inc. The new company was to be formed to construct and operate a 500,000 KW generating station to supply energy requirements of a project of the Atomic Energy Commission.

The proposal presented some serious problems under the acquisition standards of the Holding Company Act. Furthermore, the total common stock investment of $3,500,000 was to be accompanied by debt borrowing of $66,500,000. The circumstances in this application were unique. The applicants had entered into an arrangement with the Atomic Energy Commission which was to be formalized by a 25 year contract to supply firm capacity to the Paducah project. The rates to be charged the Federal Government and its additional guarantees assure the servicing of debt and its substantial amortization as well as a return on the common stock.

The heavy debt ratio permitted in this application does not, however, set a pattern for other transactions. It is a feature of a very singular situation. Any attempts to justify other proposals involving the creation of top heavy capital structures, through the organization of separate generating companies or through lease-back arrangements, on the basis of

attributed defense needs will necessitate the most careful scrutiny by this Commission. The Commission has stated that for analytical purposes the capital structure of the special purpose company will be considered as though it were part of the structure of the parent company so as to reflect full the obligations which have been assumed. We know that the nation's defense needs can best be served by soundly organized, soundly capitalized operating companies and this principle cannot be ignored.

C. Competitive Bidding.

In dealing with its statutory responsibilities in connection with utility financing under the Holding Company Act the Commission, as I have indicated, must find by the terms of the statute that such offerings are sold under "competitive conditions" and that the amount of fees and expenses accompanying each sale are reasonable. Because no other procedure met these requirements effectively, the Commission, in April 1941, adopted its Rule U-50 requiring competitive bidding in the sale of securities by registered utility holding companies and their subsidiaries. During the subsequent nine year period to June 30, 1950 some 435 issues totalling in amount more than $6,200,000,000 have been sold pursuant to its requirements. The success story of this procedure over the past years can not be detailed in this treatment but its operation has done more than just enable the Commission to meet a statutory need. It has achieved a lowering in the cost of security flotations and through diversification of underwriting management has done much to eliminate the detrimental influence of preferential relationships between particular investment banking houses and public utility companies.

D. Extent of Financing Jurisdiction.

As the programs of integration and simplification under the Holding Company Act are consummated and the extensive program of divestment nears an end the Commission's jurisdiction over financing transactions is also undergoing a parallel contraction. It may be noted, however, that despite this continuing trend security issues of electric and gas utilities approved under the Holding Company Act during the fiscal year from July 1, 1949 to June 30, 1950 totalled $764,000,000 and during the same period the Commission also approved issuances by holding companies totalling an additional $300,000,000.

Section 11

Now let us consider the important provisions of Section 11 of the Public Utility Holding Company Act of 1935. In this section the Congress empowered the Commission to undertake a thoroughgoing overhauling of electric and gas utility holding company systems, the like of which has never been seen in this country. Section 11 may be termed the key provision of the statute. It requires that holding companies be limited to one (or in certain situations, two) integrated system and only such other businesses as are directly and closely related thereto. It also requires that corporate structures be simplified and voting power equitably distributed among security holders.

A. Need For Legislation.

To appreciate the meaning of this extreme legislation, it is necessary to recall a few facts about the utility industry as it existed prior to 1935. In the first place, it should be noted that the very bad financial condition of the industry did not have its origin at the operating level of the underlying utility companies. It can be demonstrated, for example, that net operating income of the electric utilities held up quite well during the depression years following 1929. Yet no less than 128 companies, including 52 operating companies, were forced into bankruptcy, receivership and extension plans between September 1, 1929 and April 15, 1936. Arrearages on preferred stock of holding companies reached 282 million dollars by the end of 1938 and operating company preferred stocks had arrearages of another 140 million. Most of these difficulties were not traceable to any substantial decline in operations but rather to top heavy, highly leveraged capital structures with little real underlying equity. They were also a reflection of uneconomic combinations of property and the result of extensive investor exploitation.

B. Program of Enforcement.

The constructive program of rehabilitating and simplifying the corporate structures of holding company systems has been a long and arduous one. Although the statute went into effect in 1935, enforcement did not begin until the Supreme Court upheld its constitutionality in 1938. The Commission at first afforded the companies opportunity to submit their own plans for compliance with statutory requirements before applying the compulsive

provisions. However, it became apparent that this means would be interminable, and accordingly, in the spring of 1940, proceedings were instituted by the Commission against the major holding company systems out of which came a series of findings, opinions and orders, based on extensive hearings, which set forth the pattern, but not the method, of achieving compliance with the standards of the Act.

The Commission has continued to encourage the companies to come forward with their own plans of reorganization and almost without exception, enforcement of the statute ultimately has been accomplished by means of plans filed by management and reviewed by the Commission and the courts for fairness to security holders and compliance with statutory standards.

C. Application In Two Systems.

To demonstrate the results being achieved in the enforcement of Section 11, let me discuss briefly the impact of its provisions on two of the major holding company systems.

At the time of its registration as a public utility holding company in March 1938, the Commonwealth & Southern Corp. controlled a holding company system consisting of some 43 companies. Its principal subsidiaries were 11 public utility companies all of which rendered electric service and some of which also furnished gas, transportation, and other services. These companies conducted their operations in five Northern and six Southern States. Although some of the electric properties in the south were interconnected, the northern electric properties for the most part were situated in separate and distinct areas. The publicly held securities of the sub-

sidiaries, consisting primarily of bonds and preferred stocks, aggregated about $711,000,000 while Commonwealth's own debt securities and preferred stock totaled about $52,000,000 and $150,000,000 respectively. Thus the system had outstanding an extremely large amount of senior securities ranking ahead of Commonwealth's common stock. Dividends on this common stock had not been paid since March 1932 and dividends on the cumulative preferred stock had been paid at a reduced rate for several years resulting in dividend arrearages of about $18,000,000.

Divestments from time to time eliminated from Commonwealth's holding company system all the transportation companies and nearly all the small non-utility companies. Commonwealth also sold its interests in three utility subsidiaries operating in Tennessee, South Carolina and Indiana, and transferred its interests in the public utility companies which conduct integrated electric operations in Georgia, Alabama, Florida and Mississippi to The Southern Co., a newly organized public utility holding company.

The final Section 11 plan of Commonwealth resulting in the distribution of its remaining stock holdings became effective in October 1949. With its consummation, the original system of 43 companies has been resolved into a number of independent operating companies, and two integrated regional holding company systems which are expected to continue under the jurisdiction of the Commission. One of these systems consists of Ohio Edison Co. and its subsidiary, Pennsylvania Power Co.; the other is composed of The Southern Co. and its four interconnected public utility subsidiaries.

This process of integration and simplification did not destroy legitimate investment values but resulted in the accrual of substantial benefits to investors. The market value of the outstanding securities of the Commonwealth & Southern Corporation on August 26, 1935 was $190,854,000. On October 11, 1949 the total amount received for such holdings either in cash or in other security values at that date was $414,664,000, a 117 percent increase. During the same period, the Dow Jones Utilities Average had gone up 49 percent and the Industrial Average 45 percent. In most instances it was possible here, as it has been in other holding company reorganizations, to distribute to shareholders the actual securities of the underlying companies, rather than to resort to cash sales with consequent danger of dumping large amounts of securities on the market. In place of their holding company securities of questionable value and little if any earnings or dividends, investors have obtained sound securities in good operating companies or in holding companies which have been integrated and reorganized on a sensible, sound basis.

The Middle West Corp., successor in bankruptcy to Middle West Utilities Co., registered under the Act in December 1935. This was the Insull system. At that time, it had 152 subsidiaries, including 62 electric or gas utility companies and 15 subholding companies; 16 of the 152 subsidiaries were themselves in process of reorganization under the Bankruptcy Act, and these, in turn, controlled an additional 74 of the system companies. In contrast, Middle West has now divested itself of every subsidiary company except United Public Service Corp. and is presently in liquidation.

As a result of proceedings under Section 11(b)(1) of the Act, Middle West was ordered in January 1944 to sever its relations with all properties, operations and companies except Central Illinois Public Service Co. and its subsidiaries, and Kentucky Utilities Co. and its subsidiaries, jurisdiction being reserved to consider the retainability of these companies. In 1947, however, the management of Middle West decided to dissolve the corporation and a resolution was presented to stockholders who voted in favor of the dissolution. Pursuant to this decision, Middle West distributed to its stockholders its principal assets, consisting of the common stocks of Central Illinois Public Service Co., Kentucky Utilities Co.; Public Service Co. of Indiana, and Wisconsin Power & Light Co. Many of its smaller properties were sold or merged into other companies in the system.

In April 1946 the Commission approved the creation of the Central & South West Corp. system which is comprised of four electric utility companies of substantial size. The new system was formed by merging two subholding companies which between them had four outstanding issues of six and seven percent preferred stock with dividend arrearages totaling about $16,000,000. These shares were retired at the redemption price plus accrued dividends. The merger also resulted in increasing the combined common equity from 8.5 percent of total capitalization and surplus to 29.5 percent. The new Central & South West Corp. continues to be subject to the Act as a registered holding company controlling an integrated electric utility system.

D. Continuing Holding Companies.

You will note from these examples that the process of integration and simplification does not result in the elimination of all holding companies though their scope and pattern of operation have been drastically altered. It is expected, therefore, that some 20 odd utility holding company systems with assets of six or seven billion dollars will continue under Commission jurisdiction as streamlined, regional, operating combinations which will meet the rigid requirements of Section 11. Holding company management in these systems will retain the responsibility to plan and secure adequate system financing and the Commission through its continuing jurisdiction will review each step to insure that statutory standards are maintained and system construction is accompanied by balanced growth in the consolidated capitalization. In this respect it is gratifying to be able to report that registered holding companies have sold during the last three years almost $200,000,000 of their own common stock and have reinvested most of the proceeds in equity securities of their subsidiaries. Securities of these new regulated holding companies are beginning to take on a new investment quality which is reflected in the resurgence of investor interest.

E. Divested Utilities.

A greater segment of the industry however has been completely removed from the jurisdiction of the Holding Company Act. In the period from December 1, 1935 to December 31, 1950, 396 electric and gas utility companies have been divested from holding company systems and are no longer

subject to its provisions. An additional 363 non-utility companies have also been removed. Insofar as regulation is concerned, the utility companies are now subject to the State and local regulatory authorities, unhampered by interstate corporate complication which would bar effective regulatory control. For the most part, these companies are now separate operating enterprises though some have been merged into other organizations. Their managements are independent with important local representation on the board of directors. They are down-to-the-rails and alert to the power problems of their service areas. Generally their common stock is widely held and often traded on a national exchange. In a number of companies it has been discovered, however, that residents of the communities in which the utilities operate are acquiring larger proportions of their common shares so that there is a tendency toward the merging of consumer interest with investor interest. 7/

Most significant of all the characteristics, however, is the success which these divested companies have had in raising both debt and equity capital. Mortgage interest rates have been at or below three percent and debt offerings have consistently encountered ready marketability. Offerings of preferred and common stock have been more difficult, but these securities are being sold, and, with respect to common offerings, in great quantity. These common stock sales have been featured by extensive and successful employment of the rights offering procedure. This ability of managements to go back to their stockholders, not once but several times, for additions to equity capital is, in a sense, a tribute to the financial strength and investor confidence which they enjoy.

7/ Charles E. Oakes, "The Customer, The Investor and You", Edison Electric Institute Bulletin, July 1950.

F. Conclusion.

It is difficult to find a means of guaging the over-all effect of the Holding Company Act upon the utility industry because the ramifications of its influence have been so extensive. If the test be the ability of the industry to meet the country's power needs and to finance its heavy capital requirements successfully, there can be no doubt that the Act has had a most beneficial effect. The industry may be faced with serious problems of materials scarcity in the months ahead, but these hardships will not be compounded by any major difficulty in raising capital. American utilities have an abundance of muscle and vitality; they are growing as America is growing in peace and war; and we, at the Commission, are glad to report that they have also become a sturdy segment in the financial structure of American private enterprise.

To me, this is the most important test of the value of the Holding Company Act. If this legislation or some similar statute had not been passed in 1935, and had not been followed by a decade of active enforcement, I believe that the financial condition of the utility industry would not have permitted the successful financing of its post-war construction program nor enabled it to meet the heavy demands for service.

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