PUBLIC UTILITY FINANCING AND THE SECURITIES AND EXCHANGE COMMISSION

Address of

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Ever since the first English-speaking settlements on the east coast, the growth of this country has been toward the west coast. Since the turn of the century, however, the really phenomenal development has been taking place beyond the continental divide, in the states which are represented by the members of this Mountain-Pacific States Conference.

The great economic development of this area has, of course, been accompanied by a corresponding growth in financial activity. California now ranks first among the United States in the amount of interest received by its residents and is second only to New York in the amount of dividends received. Residents of California have also been leaders in the purchase of mutual fund shares, having purchased in the last five years over $100 million more of such shares than New York, the nearest rival. Corporations in the Mountain States and Western coastal areas have participated materially in the large volume of new securities registered with the Securities and Exchange Commission. Again taking California as an example, issuers in that state during the year ending July 1, 1957, filed registration statements covering $892 million in price. This was 6.1 per cent of the aggregate amount of all our business that year. A large part of these new securities has been issued by public utility companies. For example, in the fiscal year 1957, approximately two-thirds of the total amount of California financing was for the benefit of electric, gas, and telephone companies. This tendency is perfectly logical, being a natural concomitant of the growth in population in this area. There is every indication that at least approximately the present rate of growth will continue for some years to come.

In view of the increasing importance of this public utility financing, and since this field involves many aspects of joint interest to the Federal regulatory bodies in general and our own agency in particular on the one hand and the state commissions on the other, it seems particularly pertinent to discuss today with you the jurisdiction of our Commission in general and especially to touch upon two particular problems of current mutual interest, with respect to which we have either taken action or may take action in the near future. These two problems are the Commission's policy with respect to the free refundability of bonds issued by public utility companies subject to the Public Utility Holding Company Act of 1935, and the considerations governing the balance-sheet treatment to be given to the accumulated credits

arising from deferred tax accounting in respect of liberalized depreciation and accelerated amortization.

The Securities Act of 1933 was passed by the Congress in the realization that lax financial and ethical standards were undermining the integrity of our capital markets, destroying investor confidence, and leading the business and financial enterprises of this country to the brink of disaster. The decline in security values beginning in October, 1929, made clear the pressing need for the establishment and preservation of higher standards of business conduct if the American system of private capital was to survive. State "blue sky" laws, while most helpful, were found to be inadequate fully to meet the situation not only because of wide variations between states in their approach to this problem, but also because, with financial maturity, state lines were coming to be of less importance, and State authorities were unable to cope with the interstate activities of unscrupulous promoters.

The Securities Act of 1933 was the first of the several so-called Securities Acts passed by the Congress. Its two principal objectives were, first, to protect investors by requiring adequate and accurate disclosure regarding securities distributed to the public in interstate commerce or by use of the mails, and second, to outlaw fraud in the sale of all securities, whether or not newly issued. The 1933 Act was followed in 1934 by the enactment of the Securities Exchange Act, under which the Securities and Exchange Commission was established and which extended regulatory control to stock exchanges and broker-dealers. The next major legislation came in 1935, with the enactment of the Public Utility Holding Company Act. The balance of the Securities Acts, which are of less immediate interest to this particular group, are the Trust Indenture Act of 1939, the Investment Company Act of 1940 and the Investment Advisors Act of the same year.

While a very large number of other factors are, of course, also responsible for the tremendous expansion in our economy since the dismal days of the '30s, there can be no question but that the enactment of the Securities Act of 1933 and the other securities legislation has increased investor confidence and has thereby been of substantial assistance in enabling corporations to secure the vast amounts of capital they have required for their expansion. By 1933, approximately half of the $50 billion of new issues sold to American investors between 1920 and 1933 had become worthless. Since 1933, there have been effectively registered under the Securities Act, corporate securities of an aggregate issue value of about $161 billion. Not all of these securities, of course, are today worth the

issue price. Some of them have become worthless and others have increased enormously in value. There have been broad market price fluctuations over the years affecting these values, sometimes up, sometimes down, but there has been no major wholesale devaluation since 1933 to compare, even remotely, with that which took place prior to that time. In fact, many shrewd, observant economists are of the opinion that the Securities Laws, together with the substantial body of other regulatory legislation now on the books, have served and will serve to prevent any such phenemenon based on anything less than international disaster.

The confidence of investors in corporate investment today is such that new financing records are being made each passing year. The dollar amount of new securities registered with the Commission in the fiscal year ending June 30, 1958, totaled $16.9 billion -- the largest amount in the history of the Commission. The number of registration statements filed with the Commission and their value since July 1, 1958, have set new records. We expect that the value figure for the current fiscal year will be $18 billion, and that it will reach $22 billion in fiscal 1960. The number of registrations is currently running about 29 per cent over those filed in the comparable period last year.

The 1933 Act was premised on the principle that full disclosure of all pertinent financial data should be made to the prospective investor. The duty of the SEC under this Act is only to administer these statutory provisions. It has no power to evaluate any proposed security thereunder, nor to prevent its sale under a properly filed and fully frank registration statement. Strictly speaking, the SEC regulates only the sale of securities under this legislation, not the securities themselves. The Public Utility Holding Company Act of 1935, however, gives the Commission substantial regulatory power over the financial structure and activities of those electric and gas utility holding company systems which come under its jurisdiction. The underlying objective of the 1935 Act was to free operating electric and gas utility companies from the control of absentee and uneconomic holding companies, and to permit them to be effectively regulated by the States in which they were operating. At the same time, the 1935 Act contemplated the existence of such public utility holding companies as served a useful economic function and whose operations were limited to an integrated system. Such holding companies and their constituent operating companies were, however, to be subject to continued and detailed regulation designed to prevent the recurrence of the abuses which brought about the enactment of this law.

A principal mandate under the 1935 Act was to require the physical integration of public utility companies and functionally related properties of holding company systems and to compel the simplification of intercorporate relationships and the financial structures of holding company systems. While most of these problems as they existed at the time of adoption of the Act have been resolved, there still remain some important questions which must eventually be faced.

The second area of our jurisdiction under the 1935 Act covers the financing operations of the residual large holding companies and their subsidiaries, acquisitions and dispositions of securities and properties, accounting practices, servicing arrangements, and intercompany transactions. It is in this area that we are called upon to determine whether debt securities of utility companies should be freely refundable.

The redemption characteristic of senior securities has been a very much discussed and debated subject for years. I have in the past had occasion to restate the Commission's policy of insisting upon free refundability of such securities. I have been referred to no evidence which would alter our position in this respect and I should like to discuss with you one or two studies which have been made relatively recently and which I feel give it substantial support.

In order to put our position in proper focus, I should like to point out that our jurisdiction to pass upon these particular provisions of mortgage bond indentures stems only from the Public Utility Holding Company Act of 1935. We have no jurisdiction under this Act or under the 1939 Act to pass upon such indenture provisions of industrial corporations or of utility companies not subject to the 1935 Act. Our jurisdiction under the 1935 Act extends, in terms of assets, to roughly one-fifth of the privately-owned electric and gas utility industry. A number of provisions of the Holding Company Act give us specific authority to consider the question of free refundability of the senior securities of these companies. All of such provisions must be interpreted in the context of Section 1(b) of the Act, which declares that the national public interest and the interest of investors and consumers are or may be adversely affected by lack of economies in the raising of capital. We have considered that the Act thus directs the Commission to protect the consuming public against the imposition of excessive interest costs, and that it is necessary in order to obtain this result for us to insist that utility bond issues be freely refundable upon the payment of reasonable redemption premiums.

The Commission set forth its position on free refundability in two cases in 1953; Indiana & Michigan Electric Company (35 S.E.C. 321) and Arkansas Louisiana Gas Company (35 S.E.C. 313). The positions set forth in those cases were adopted in the Statement of Policy promulgated by the Commission on February 16, 1956, regarding first mortgage bonds subject to the 1935 Act. This Statement of Policy states in part that "the indenture . . . of the issuer . . . shall provide that the bonds can be called by the [issuer] for redemption at any time upon reasonable notice and with reasonable redemption premiums, if any." You will note that this Statement, while it requires a reasonable redemption premium, does not set forth any formula for determining the amount of such premium. The Commission has, however, adopted a rule-of-thumb formula under which the initial redemption price may not exceed the sum of the initial public offering price plus the interest rate. Thus, if bonds are offered to the public at 101 and bear a 5% coupon, the initial redemption price may not exceed 106, and the 6-point premium must thereafter be reduced pro rata to maturity.

Those who disagree with our policy of free refundability have advanced a number of arguments in favor of their position. They contend, for example, that an issuer of freely refundable securities is forced to pay higher interest rates in the market than it would have been required to pay if the security had a restriction on refundability. In the nature of things, it is difficult to isolate the evidence which would support or contradict such an argument or, for that matter, any similar argument. There are obviously many factors which enter into the pricing of any security of which refundability is only one. No two utilities are exactly alike, nor are any two issues identical in all respects. To date, however, the evidence which has been adduced in support of such a statement has not been substantial or convincing. On the other hand, the SEC has conducted certain internal studies which point unmistakably to the conclusion that the interest rate is not significantly affected by the absence or inclusion of a restriction on refundability. This conclusion was recently affirmed by certain studies made under the direction of Dean Willis J. Winn and Professor Arleigh Hess, Jr., of the Wharton School of Finance and Commerce of the University of Pennsylvania. These analysts stated at the annual meeting of the American Finance Association in Chicago, in December, 1958, that data accumulated on corporate bond issues offered between 1945 and 1958 indicated that the presence or absence of the call privilege appeared to have no significant effect on the interest rate.

A second argument made in this debate is that certain large institutional investors do not look with favor on the purchase of freely refundable bonds and that the Commission is, in effect, thus drying up or removing possible sources of capital available to the electric and gas utility industries. If our policy created any visible substantial difficulties with respect to the marketing of senior securities by utility companies, we would, of course, be seriously concerned and would reappraise our policy in the light of such evidence. In an effort to evaluate this contention, the Commission recently directed Mr. J. Arnold Pines, Chief Financial Analyst of our Division of Corporate Regulation, which administers the 1935 Act, to make a study of refundable and non-refundable issues to determine whether in fact there appears to be any significant difference in the marketability of the two types of issues.

In making this study, Mr. Pines secured data on all issues of electric, gas and utility bonds offered at competitive bidding between May 14, 1957, and November 30, 1958, specifically securing the number of bids which were made for each issue and information as to the market success or failure of the particular issue. A total of 137 issues aggregating $2,956,000,000 were studied. Of this total, the refundable issues numbered 109 and represented an aggregate face amount of $2,005,000,000. The non-refundable issues, each non-refundable for a period of five years, numbered 28 and totaled $951,000,000. While, as I have pointed out, a number of factors other than callability can affect the number of bids received and the market success of the particular issue, there is, statistically, a tendency for such factors to cancel out in a study of a relatively large number of issues. The median number of bids on both the refundable and non-refundable issues represented was four for each group. The weighted average number of bids received on the refundables was 4.46, while that on non-refundables was 4.11. In evaluating the marketing success of the particular issues, an issue was termed successful if at least 95 per cent of the issue was sold at the syndicate price. On this basis, 75.2 per cent of the 109 refundable issues were successful and 75.0 per cent of the 28 non-refundable issues were successful. We believe that the only possible conclusion is that there is no significant difference between the market acceptance of refundable and non-refundable issues, and that call privileges do not raise any serious impediment to the securing of capital by private utility companies.

Before coming out here, I asked Mr. Pines to review certain issues of western utility companies in the past six months since his

previous study was completed to see whether there appeared to be any significant evidence as to marketing results. He found six such issues put out by western issuers, of which two were refundable and four had a five-year restriction on refundability. Of the four non-refundable issues, three were successfully marketed by the selling syndicate. The selling syndicate on the fourth issue was broken up with less than one-third of the issue sold. With respect to the two refundable issues, one was successfully sold and the syndicate on the other was terminated with 20 per cent unsold. While no far-reaching conclusions can be made on the basis of a study of such limited data covering a relatively short period of time, this evidence of market performance would appear to be in accord with the previous study, and shows no significant difference between the market acceptance of refundable as against non-refundable issues.

Finally, one of the arguments we hear most often in opposition to the policy of the Commission is that it provides a "one-way street" in favor of consumers only and that it disregards the rights of investors. It is true that this particular provision favors the utility and its consumers, consistently with the expressed policy of Congress in adopting the 1935 Act. It seems to us, however, that the investor has a certain duty in these premises, and that this argument takes this portion of the Statement of Policy out of context and over-emphasizes its importance and effect. The Statement of Policy contains many provisions other than those which relate to refundability and which either give additional rights to or serve to protect existing rights of investors. For instance, it contains certain restrictions against the issuance of additional bonds, and provides for sinking and improvement funds, and for renewal and replacement funds. It provides further for restrictions on the declaration of dividends. All of these requirements provide substantial protection to the investor. In short, in drafting this Statement, the SEC did not favor either the investor over the consumer or vice versa, but rather sought to protect the interest of each in accordance with the policies declared in the Act.

At the time I first publicly discussed this situation about a year ago, I felt it proper to suggest to the State Public Utility Commissions that the adoption of a parallel policy in dealing with local issuing utilities might be of mutual benefit. I still feel this way, and urge reconsideration of the policies of such of your agencies as do not comport with our Statement in this regard. If there is universal acceptance of this viewpoint as between the Federal and the local agencies acting within the orbits of their respective jurisdictions, it seems patent to me that much of whatever

validity there may be in the contentions of those who advocate redemption freezing provisions will be negated. In the presence of the current increasingly high interest rates, it seems quite clear that such a cooperative program can have no result except to benefit the ultimate consumer in the rates which he will be required to pay for utility service.

I do not suppose that there is any subject in the field of utility law and accounting that has aroused as much and as bitter controversy in recent years as has the matter of deferred tax accounting. Although I could not be there myself, I note that the effect upon utility rates of this matter was the subject of its usual careful attention at the Phoenix convention of the NARUC last year. As was shown to you at that time, and as confirmed by an extremely detailed brief since filed with us, the large majority of State agencies has had occasion to consider this matter in one or another of its aspects as it affects either the accounting practices of operating utilities or their rates. The result is a singular lack of uniformity as between states. Practically every conceivable treatment of this problem has been authorized by one or more state commissions, and each method is stoutly defended by its proponents. The SEC now finds itself constrained by the growing importance of the problem to consider the accounting problems involved and whether they are affected by the various provisions of the Securities Acts.

To a sophisticated audience such as this, I will attempt only to sketch the background of our concern very briefly.

Section 167 of the Internal Revenue Code of 1954 authorizes the deduction of depreciation for tax purposes on fixed assets installed after December 31, 1953, on a more liberal basis than theretofore permitted through authorization of the use of the declining-balance and the sum-of-the-years-digits methods. Under Section 168 of the Code, the amortization was also permitted for tax purposes over a five-year period, under prescribed conditions, of specific emergency facilities installed after December 31, 1949. The larger depreciation or amortization deductions thus permitted for tax purposes in the earlier years of the life of the related fixed assets would be offset by the correspondingly smaller depreciation deductions available for tax purposes in the later years. As a consequence, income taxes in the earlier years would be expected to be less than they would otherwise be if traditional methods of depreciation were employed, while the converse would be true in the later years.

In the case of industrial companies, a substantial number of those which deduct liberalized depreciation in their income tax returns follow the practice of deducting an equal amount for financial accounting purposes. Other industrial companies deduct normal depreciation for financial accounting purposes and, where the current reductions in income taxes are material, make a charge to the income account for the tax effect representing a provision for future or deferred income taxes with a concurrent credit to a deferred tax account in the balance sheet. This concurrent charge and credit entry for the current tax reduction has come to be known as deferred tax accounting. A permissible alternative to deferred tax accounting, followed by various industrial companies, which has the same effect on current net income as deferred tax accounting, involves a charge to depreciation expense and a credit to the reserve for depreciation for the tax effect of liberalized depreciation. With respect to accelerated amortization, some industrial companies also provide in their books an amount for such expense equal to the amount of amortization deducted for tax purposes, but other companies which deduct accelerated amortization in their tax returns employ deferred tax accounting for financial accounting purposes. Such companies have invariably classified the deferred tax account in the balance sheet among the liability reserves or deferred credits, or analogous accounts, but in no event as a part of the stockholders' equity capital.

In the case of electric and gas utility companies, however, the financial accounting employed by companies which have elected to deduct liberalized depreciation or accelerated amortization in their income tax returns has, as I have pointed out, been marked by a remarkable lack of uniformity. Such different methods of accounting have respectively been certified by reputable accountants as being in conformity with generally accepted accounting principles. Most public utility companies have classified the accumulated balance-sheet credits to reserves or deferred credits or other non-equity accounts. Others have classified the accumulated amounts as a part of restricted earned surplus in the equity capital section of the balance sheet, while a few others, although identifying them as restricted earned surplus, have not included them in the equity capital section of the balance sheet. Still other utility companies have followed what has been called the "flow-through" method; i.e., they have not employed deferred tax accounting and have shown in the income statement normal depreciation charged and the actual current income tax provision, without provision for future income taxes.

The difference in treatment of deferred tax accounting as between industrial concerns and utilities is not surprising. Generally speaking, little real attention is paid by analysts to the debt ratio of industrial corporations and, in fact, most such companies do a large part of their financing by sale of equity securities or out of cash internally generated. None of these statements holds true for utilities, however, whose earnings, though very steady, are severely restricted by regulation. Here the debt ratio becomes of great importance. According to a study made by the Irving Trust Company, there are wide divergencies of views among securities analysts as to analytical treatment of accruals under deferred tax accounting, though they are practically unanimous in excluding from equity capital funds in computing debt ratios such accruals when placed in a special reserve. On the other hand, some of them give the same treatment to a restricted earned surplus account so generated.

After extended consideration of the problem of deferred tax accounting, the Federal Power Commission, on May 29, 1958, issued two orders -- one (No. 203) dealing with natural gas companies subject to the Natural Gas Act and the other (No. 204) dealing with electric utility companies subject to the Federal Power Act. Those orders do not make mandatory the use of deferred tax accounting for financial accounting purposes by those companies which elect to deduct liberalized depreciation or accelerated amortization in their income tax returns. Rather they provide that where the company does employ deferred tax accounting, the balance-sheet credit shall be classified in a new account (Account No. 266) entitled "Accumulated Deferred Taxes on Income." The Federal Power Commission by these orders also amended its applicable uniform systems of accounts to provide for this new account and related accounts.

Shortly thereafter, in July, 1958, the Committee on Accounting Procedure of the American Institute of Certified Public Accountants issued Accounting Research Bulletin No. 44 (Revised), dealing with the subject of liberalized depreciation for financial accounting purposes. The import and effect of this release are in considerable dispute with respect to the classification of the deferred tax credit.

Two months later, in September, 1958, a public utility subsidiary of a registered holding company filed with us a registration statement under the Securities Act of 1933 and a declaration under the Public Utility Holding Company Act of 1935 with respect to the proposed issue and sale

of first mortgage bonds at competitive bidding. In the financial statements submitted by the registrant company, which is also subject to the accounting jurisdiction of the Federal Power Commission, the balance sheet carried the accumulated credits arising from the use of deferred tax accounting in respect of both liberalized depreciation and accelerated amortization as restricted earned surplus and stated them as a part of the equity capital of the company. Our staff questioned the propriety of this classification in the light of Order No. 204 of the Federal Power Commission. It may be noted that an order of one of the State regulatory commissions to which this company is also subject as to a minor portion of its utility operations, authorized a restricted earned surplus classification. The other State commission having jurisdiction over the major distributing facilities had recently issued an order directing the company to transfer the accumulated credits from restricted earned surplus to a reserve account, from which order the company had initiated an appeal.

Rule 28 promulgated by the Securities and Exchange Commission under the 1935 Act prohibits a registered holding company or a subsidiary company thereof from distributing to its security holders, or publishing, financial statements which are inconsistent with the book accounts of such company or with financial statements filed by it with the Commission. One of the considerations raised by our staff in the case to which I have just referred was whether the applicability of Order No. 204 of the Federal Power Commission to the registrant rendered the publishing of any financial statement inconsistent therewith violative of the provisions of Rule 28.

After informal discussions between us and representatives of the company, we determined not to cite the company's classification as a deficiency in view of the great importance of this matter, not only to that particular registrant but also to a large number of other companies. Consequently, we permitted the registration statement to become effective and the securities to be sold on the basis of full disclosure in footnotes to the financial statements of the different positions taken by the several regulatory agencies concerned with this company's affairs.

Largely as a result of this particular matter and Accounting Bulletin No. 44 (Revised), and having in mind the very substantial amounts involved, the Securities and Exchange Commission, acting under the authority of the various Acts it administers, issued on December 30, 1958, a "Notice of Intention to Announce Interpretation of Administrative Policy."

The Notice stated that any financial statement which designates as earned surplus or its equivalent or includes as a part of equity capital (even though accompanied by words of limitation such as "restricted" or "appropriated") the accumulated credit arising from deferred tax accounting in respect of liberalized depreciation or accelerated amortization, would be presumed by the Commission "to be misleading or inaccurate despite disclosure contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material."*

A very substantial number of comments were received in response to the Commission's invitation for views and comments. Certain of the commentators agreed with the Commission's proposed policy and some even stated that the Commission did not go far enough. On the other hand, other commentators contended that the Commission should not adopt the policy statement for various reasons. I cannot, of course, undertake at this time to summarize all of these replies. I can say, however, that those who favor the Commission's proposal generally take the position that the deduction of liberalized depreciation or accelerated amortization in the income tax return does not result in aggregate deductions over the life of the related fixed assets in excess of the cost of such assets, but rather only in a shift in timing of the deduction resulting in a deferment of tax liability from the earlier years to the later years of the life of the related assets. Accordingly, it is their position that the accumulated balance-sheet credit is in the nature of a reserve or liability for the deferred income tax that will be payable in later years, and, consequently, it cannot be regarded as equity capital belonging to the stockholders.

Those opposed to adoption of the policy statement contend that the accumulated balance-sheet credit is properly classifiable as earned surplus, although restricted, since no current cost or expense to the corporation has been incurred by the charge to income for the current tax reduction. They contend that no presently existing liability to anybody exists and, therefore, the accumulated credit balance belongs to the stockholders. They also urge that public utility companies should be treated differently from industrial companies because of rate-making considerations involving consumers and because the State regulatory commissions have jurisdiction over rates. They also state that the consumers are benefited by the restricted earned surplus method since the equity capital ratios are

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* SEC Accounting Series Release No. 4.

thereby improved, and the utility company is free to issue correspondingly more debt securities for purposes of financing construction than it would otherwise be permitted to issue under regulatory standards, having in mind the deductibility for tax purposes of interest on the debt.

That we are not dealing with semantics, but rather with matters involving material sums of money, is evident from the fact that at the end of 1957, according to statistics put out by the Federal Power Commission, the aggregate amount of accumulated balance-sheet credits of Class A and Class B companies attributable to both liberalized depreciation and accelerated amortization totaled $694,433,000 in respect of electric utility companies (of which $402,969,000 was included in restricted earned surplus and $291,464,000 in reserve-type accounts) and $98,322,000 in respect of natural gas and pipe line companies (all of which was included in reserve-type accounts), or a grand total of $792,755,000. At the same date, the registered electric and gas holding company systems subject to the Public Utility Holding Company Act of 1935 had an aggregate amount of accumulated balance-sheet credits of $218,091,000, or 27.5 per cent of the national total. I might point out that one year later, at December 31, 1958, our registered holding company systems had increased their accumulated balance-sheet credits to $292,451,000. I do not yet have available the national total as of the end of 1958. It is also interesting to note that, whereas the registered holding company systems at the end of 1957 had classified 58.0 per cent of their accumulated credits outside the equity capital section of the balance sheet and 42.0 per cent in the equity capital section, the respective ratios at the end of 1958 were 68.6 per cent and 31.4 per cent.

Public hearings on the Commission's proposed policy statement were held before the full Commission on April 8 and 10, 1959, and we now have the matter under advisement. Some of your members appeared before us at this hearing and, as I recall it, took the position that we should not attempt to impose such a rule upon the entire industry, but should leave the matter to the states to regulate.

Unfortunately, with the situation in this unresolved state, I am unable to come to any very definite conclusions. I bring it before you today for two rather limited purposes: first, because I think you are entitled to a report on developments in a field in which you are officially

very much interested; and second, because this seems to me to be another field in which the SEC and the state utility commissions have mutual problems whose solution calls for sympathetic and cooperative mutual consideration and understanding.