Securities and Exchange
Commission
Library

SOME COMMENTS ON THE CURRENT UTILITY SCENE

ADDRESS

of

DONALD C. COOK

Commissioner, Securities and Exchange Commission

Before the

NEW YORK SOCIETY OF SECURITY ANALYSTS

New York City
Wednesday, March 29, 1950

SOME COMMENTS ON THE CURRENT UTILITY SCENE

I am glad to have the opportunity of meeting you and exchanging views on the utility industry. While I know that cross-fertilization of this kind is mighty good for me, I am not sure that a group as sophisticated in utilities as this one will get reciprocal benefits this afternoon.

As all of us know, the electric utility industry was first subjected to intensive Federal regulation about 15 years ago, largely because this basic industry had been severely victimized by the "high and low" finance of the '20s. The numerous bankruptcies and preferred stock arrearages among both electric operating companies and holding companies in the '30s were primarily, if not exclusively, attributable to these financial practices, for the operating electric utility industry showed remarkable stability in the great Depression. I think it is easy to prove this statement. Kilowatt hours generated declined only 15 percent from 1929 to 1932, while in the same period, for example, the Federal Reserve Board index of industrial production fell 47.3 percent. We know, too, that the net operating income of private utility companies, before depreciation and taxes, was greater in every year during the '30s than it was in 1928--a year which itself was better than previous years. The industry's gross income was actually higher in 1932 than it was in 1928. This great industry was too important to the nation's economy to permit it to remain ensnared in the tangled web of frenzied finance.

The Holding Company Act, one of the great and enduring New Deal reforms, was soon forthcoming. The statute, drafted in the finest traditions of New England conservatism, was bitterly fought by interests standing for radical finance. Oddly enough, the Act, which demonstrably was a bulwark of our system of free enterprise, was branded as the handiwork of wild-eyed and impractical Washington visionaries, or--and even worse--college professors! But that was before the professors built the Bomb.

Primarily, the Holding Company Act was intended to perform two major surgical operations upon the utility industry: First, to break up the non-integrated holding company systems and to create an industry pattern of (a) operating companies returned to local control or (b) regional integrated holding company systems most of which, because of their interstate nature, would remain subject to the Holding Company Act; and, second, drastically to simplify corporate structures by eliminating pyramided holding companies, trick securities, and excessive leverage. As you know, the ideal in this latter respect was a simple, understandable, and well-balanced capital structure which would inspire investor confidence and permit public utilities to attract, on economical terms, the vast sums of new capital needed by them to finance their uninterrupted growth.

But in a relatively short time, as these things go, remarkable results have been achieved. The prophets of confiscation and ruin were confounded as one holding company system after another emerged from the integration and corporate simplification process with demonstrable

benefits to investors and consumers. Finally confidence was restored to a point where even corporate managers were investing in their own securities. Let me quote some late figures as to the extent of the progress made. From December 31, 1935 to December 31, 1949, 696 companies with assets of $9,106,000,000 have been removed from the jurisdiction of the Act through divestment. For the most part, these were properties and securities of companies found by the Commission to be non-retainable by holding company systems. Some of the properties divested were sold to neighboring utilities who integrated them with their own operations. In addition to the figures just cited, 250 companies with assets of $5,470,000,000 have been divested by holding companies but remain subject to the Act by reason of their relationship to another registered holding company.

While it is too early to determine precisely which companies or systems will remain subject to the Commission's jurisdiction, it is estimated that some 6 or 7 billion dollars of assets (including electric, gas, and retainable non-utility assets) may remain subject to the Act after integration proceedings have been completed. Present indications are that the following systems, among others, are likely to continue under the Act:

American Gas & Electric Company
American Natural Gas Company
Allegheny Gas Company
Central & Southwest Corporation
Columbia Gas System, Inc.
Consolidated Natural Gas Company
Delaware Power & Light Company
Derby Gas & Electric Corporation
General Public Utilities Corporation.

Interstate Power Company
Middle South Utilities, Inc.
National Fuel Gas Company
New England Electric System
Northern States Power Company
Ohio Edison Company
Philadelphia Electric Power Company
The Southern Company
Union Electric Company of Missouri
Utah Power & Light Company
West Penn Electric Company
Wisconsin Electric Power Company

Comparable results have been achieved under the corporate simplification section. As you know, many unnecessary holding companies and other useless but expensive corporate entities have been eliminated, and the pyramided holding company system is becoming as archaic as the Pyramids of Egypt.

Practically all pertinent ratios reflect the tremendously improved financial health of this industry since 1935. More than $1,300,000,000 of sheer wind, or, as it is sometimes referred to, "balloon juice", has been eliminated from utility property accounts. Ratios of depreciation and amortization reserves to gross property went up from 10.8 percent in 1937 to 21.7 percent at the end of 1948. Coverages of all fixed charges and preferred dividends went up from 1.9 times to 2.7 times. While total debt and preferred stock have increased about 10.3 percent since 1937 to December 31, 1948, generating capacity of privately owned utilities has increased by 42 percent and generation is up by 107 percent. Of course, much of this progress must be ascribed to better economic conditions. But I have seen too many of these improvements emerge

from conferences at the Commission not to ascribe some of the accomplishments to the operation of the Holding Company Act. The cleaning up of the industry's accounts and the corporate simplification which has taken place are, of course, of major importance to you in your day-to-day work as securities analysts, and I want to say more about that later.

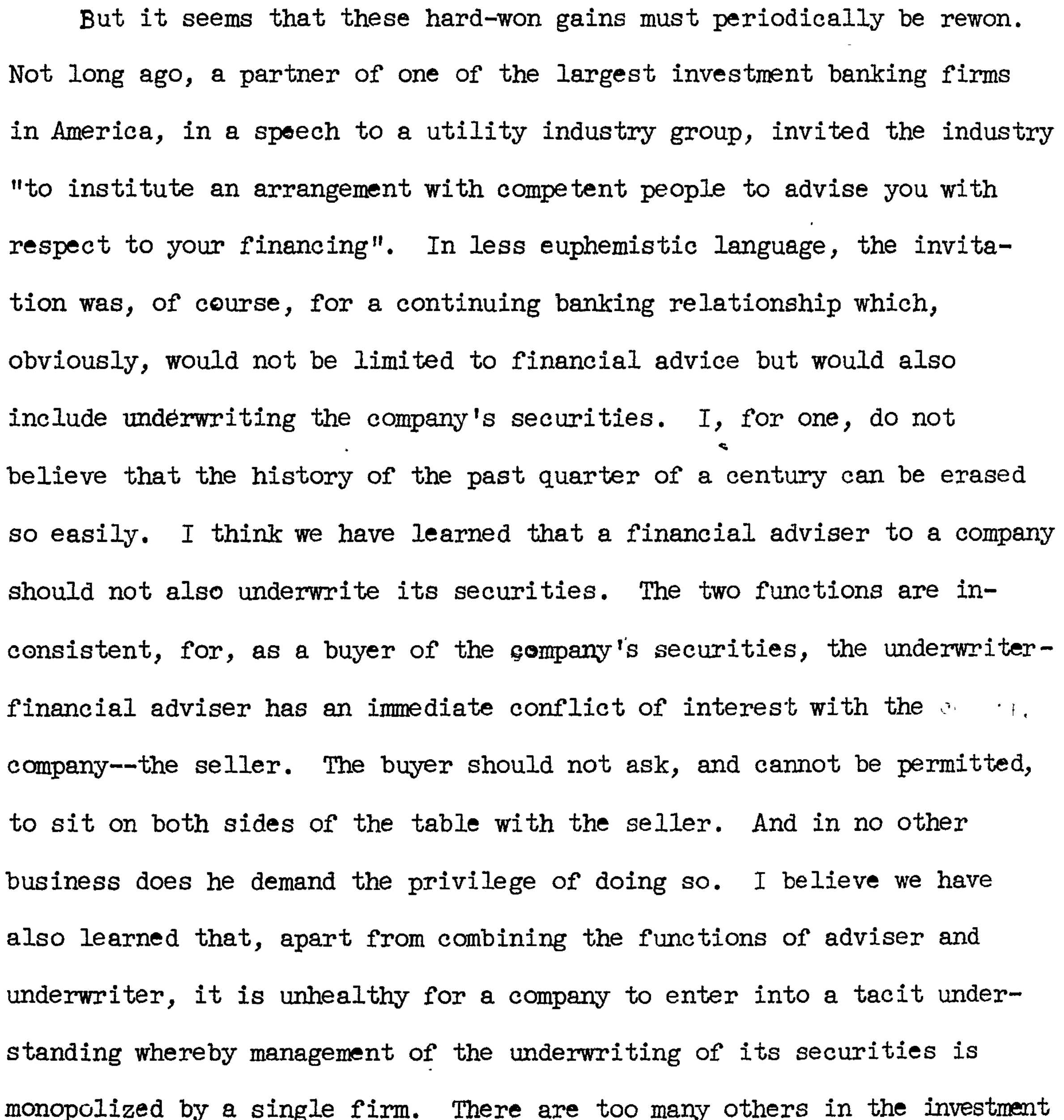
There has been another development in this industry which I want to mention. The capital structures and complicated corporate systems which flourished in the '20s reflected, in part, the type of men who then dominated this industry. Today, the utility tycoon, with his unresponsiveness to investor and consumer needs, is gone--or almost gone. In his place a new generation of utility executives has grown up. The new generation executives recognize the social responsibility of management. In varying degrees, they tend to be aware that they stand in a sort of trustee relationship to their investors, consumers, and the areas they serve. These men also tend to feel obliged to consider the interests of the public in every important decision they make. To the extent that the management of any particular company contains such men--and many managements do--it has an intangible asset of substantial importance.

Under the "old regime", by and large, financial policy for most of the nation's operating companies, whether they were located in Maine or California, was determined by a small group of holding company executives and their affiliated investment bankers in New York City or Chicago. Investment banking business of individual utility companies tended to be

monopolized by a traditional banker. Competitive bidding was then a theory--not a reality. The break-up of centralized control over utilities has given operating management the opportunity of doing its own planning and of hiring banking, servicing, and other technical assistance of its own choosing, according to its needs and the requirements of its area.

I am not here primarily to talk about competitive bidding. As you know, however, it was designed, in part, to overcome the influence of traditional relationships between banking houses and public utility companies, and its consequent deleterious effects on financing. But whatever else may be said about it, competitive bidding has diversified the management of security offerings. The Commission's Fifteenth Annual Report to Congress for the fiscal year ending June 30, 1949 contains a table covering 24 companies whose securities have been marketed at competitive bidding on at least four occasions during the last five years. The table shows the number of managing underwriters who have been succesful in purchasing the securities of these companies. In only one instance was a single manager able to win all securities offered by a particular company over this five-year period. This manager had not been that company's traditional banker, and a number of other bids were submitted for each of the issues offered. In only one other instance of the 24 companies studied was any manager successful in purchasing as many as half of the issues offered. Examination of the membership lists of underwriting syndicates also reveals that individual banking firms now participate in offerings under widely diverse leadership.

We at the S.E.C. cannot help but believe that the diversification in underwriting is healthy both for the utility company and for people in the securities business. Logically, one cannot profess to believe in the competitive free enterprise system and yet insist on restricting the scope of its operations to only the other fellow's business.



But it seems that these hard-won gains must periodically be rewon. Not long ago, a partner of one of the largest investment banking firms in America, in a speech to a utility industry group, invited the industry "to institute an arrangement with competent people to advise you with respect to your financing". In less euphemistic language, the invitation was, of course, for a continuing banking relationship which, obviously, would not be limited to financial advice but would also include underwriting the company's securities. I, for one, do not believe that the history of the past quarter of a century can be erased so easily. I think we have learned that a financial adviser to a company should not also underwrite its securities. The two functions are inconsistent, for, as a buyer of the company's securities, the underwriter-financial adviser has an immediate conflict of interest with the company--the seller. The buyer should not ask, and cannot be permitted, to sit on both sides of the table with the seller. And in no other business does he demand the privilege of doing so. I believe we have also learned that, apart from combining the functions of adviser and underwriter, it is unhealthy for a company to enter into a tacit understanding whereby management of the underwriting of its securities is monopolized by a single firm. There are too many others in the investment

banking business who, in any given case, may have fresher ideas or would otherwise be more enterprising, particularly as to price and spread. Once a utility, voluntarily or otherwise, permits the management of its investment banking business to be handled by a single firm, the custom of the investment banking business is such that other bankers will not in any way compete for the business or in other respects infringe upon the traditional banker's relationship. The utility, therefore, must inevitably incur the higher costs and other disadvantages of momopoly price.

Electric utility capital is turned over only once every four or five years; capital costs are, therefore, an important factor in the fixing of rates. The national public interest and the particular interest of consumers in low-cost power and the interest of utility common stock investors in maximizing their income require that the industry's securities be issued and sold only on the most economical terms. Management, if it perseveres in its efforts to strengthen and preserve the private utility industry, must insist on following this course.

The electric utility industry is now in the middle of a great construction program. In the five years since the War, 1946-1950, new generating capacity totaling over 17 million kw has been, or will be by the end of 1950, installed by the electric utilities. Excluding Federal projects, money expended, and to be expended, in the five-year period totals over $9 billion. While the rate of increase may now be declining, the industry is of the general opinion that installed capacity of all

electric systems, including Federal, contributing to the public supply will reach a total of about 92 million kw by 1955 as compared with about 68 million kw at the end of 1950. The electric utilities are certainly a "growth industry". Obviously, this growth will require going to the capital markets for substantial sums.

Of course, this construction program can continue to be financed successfully only if utility securities remain attractive to investors. Earnings, naturally, are basic in this respect and, while, to a considerable extent the trend of earnings is beyond managerial control, there are many other factors which are within managerial control. These latter factors are sometimes not given sufficient weight, I think, in considering how to attain investor appeal.

The main appeal of utility securities in the coming years will be, I believe, not to the speculative investor interested in large, quick capital gains but to the investor attracted by the industry's stability and prospects for growth over the years. The decline of interest rates, both governmental and corporate, and the many undesirable characteristics of preferred stocks have forced "defensive investors", including institutional ones, into common stocks. Fortunately for them, a whole new field of relatively conservative investment--as things go in these troubled times--has now been opened--utility common stocks. Primarily as a result of the Holding Company Act, highly leveraged and speculative holding company securities have now been converted to the more stable common stocks of operating utilities. This is a major development in American finance. All of you are aware, I am sure, of the trend to

change State laws to permit various types of institutional investors to buy common stocks. In some jurisdictions it is being done, in part, by extending the definition of "legals" to include stable utility equities; in other jurisdictions, including New York, there is pending legislation to substitute the "prudent man rule" for the legal list--a substitution which will permit trustees to invest in common stocks. Capital from savings banks, life insurance companies, and personal trusts is becoming available for investment in this industry in ever-increasing amounts. The great growth which is now taking place in common fund trusts, in investment companies, and in industry pension funds will increase the supply of capital for this industry.

These great sources of capital, primarily in the hands of sophisticated investors, will gravitate toward those utility companies which best maintain the essential characteristics of this industry--stability and growth--and which treat the investor fairly. The company which does not attain and maintain a balanced corporate structure without undue leverage will not appeal to these investors and will be at a disadvantage in competing for capital. As to what proper ratios are, the minimum objective today, I think, should be definitely higher than the 25 percent minimum common stock equity which the SEC spoke about in 1939. Obviously no one capital ratio formula is suitable for all the companies in this industry, but a more conservative pattern is clearly discernible.

I want to mention a number of other factors within managerial control which are important to investors. Most of the industry is fully aware that investor confidence can be retained only by a policy of full and current disclosure. The word "current" should be emphasized. By and large, the utility industry does a good job in keeping investors currently informed and is conscious of the need of doing a better job. Many electric utility companies now announce monthly earnings figures, and most companies publish quarterly earnings statements. However, there are still a few electric companies and a number of gas companies who give general release only to semi-annual or even annual reports. While some of these companies appear willing to provide quarterly statements upon request, the ordinary investor looks in vain for this information in the major financial services.

It is difficult to see why all utilities in the electric and gas industries should not, at a minimum, publish quarterly earnings data. Indeed, the time will come when utility investors, some of whom are required to make important investment decisions almost daily, will demand monthly earnings data from these industries. Publication of quarterly and monthly data not only keeps investors informed but also serves the additional function of keeping management "on its toes".

It is a truism that investors are entitled to accounting practices which do not distort income results. While accounting practices of the utility industry are undoubtedly more standardized than in almost any other, we have occasionally noticed a tendency to "play" with depreciation allowances and other non-cash charges to income or otherwise

take steps to effect artificially reported earnings. In an industry where everybody else's figures and ratios are widely known, sophisticated investors will lose faith in a management which fails to follow sound accounting practices consistently applied.

One of the most important attributes of a utility company to investors is its dividend policy. In the growing utility industry, many companies find that they must utilize retained earnings to assist in financing construction. Some utility companies, however, have attempted to finance their construction programs through a maximum of retained earnings and a minimum of new common stock financing. Our experience has been that it is difficult to maintain or attain proper capital ratios in this manner because of the large amounts of new capital needed. It is well known that electric utility common stocks sell more on a yield basis than on an earnings basis. All other elements being equal, dividends paid, rather than income earned, is the most significant price-determining factor. A utility management which relies too heavily on retained earnings is, therefore, consciously or unconsciously, cheapening the price of its stock. If it errs too much in this respect it is unfair to the utility investor interested primarily in income rather than in capital gains, and it is to the investor for income to whom it must look for new capital. If its price earnings ratios are too low, it exposes itself to relatively severe dilution of earnings when it goes to sell common stock, and this, in turn, intensifies its reluctance for common stock equity financing.

Of course, dividend policy must vary for each company and must take into consideration numerous factors such as capital ratios, the nature and volatility of the company's load, size and history of the company, trend of earnings, rate problems, margin of safety of the proposed dividend policy, to mention only a few.

I do not want to be understood by what I have said as urging general dividend increases. But there is an optimum dividend policy for each company, and I am expressing doubt that all companies have given full weight to all the factors involved. One may err, of course, on the high side as well as on the low side, considering the necessity of having balanced ratios and financing construction needs.

We are now in the fourth year of the electric utility expansion program. During the first two years--1947 and 1948--many companies financed their expansion through heavy reliance upon senior securities, particularly debt money. It is estimated that common stock and retained earnings were only 24 percent of new money financing, exclusive of intrasystem transactions, in the two-year period 1947-1948, the balance being raised by 64 percent of debt and 12 percent of preferred stock. For the year 1948 alone, common stock and retained earnings were only 19.8 percent of the new money raised. The common stock market had been very good in the first half of 1946, and, apparently, companies could not reconcile themselves to selling common stock at the materially lower levels prevailing in 1947 and 1948. As you know, of course, the market has been steadily rising since June 1949 and we have seen a substantial amount of common stock financing for this industry in 1949. It is

estimated that, in 1949, common stock and retained earnings constituted 33.3 percent of new money, exclusive of intrasystem transactions, the balance consisting of 53.6 percent debt and 13.1 percent preferred. The gamble that many companies took that markets would be better in 1949 "paid off". But it **was** a gamble, and, considering the senior securities of the industry, it was gambling on a "margin" of only 31 percent for the median publicly held company in the industry. Utility managements should not be in the business of speculating on the stock market and they do not, any more than you or I, have a crystal ball which can assure them that the market will be better "next fall" or "the following spring".

In many cases, appropriate common stock financing is postponed because of the expectation that the next six months or the next year will see better earnings. Such a decision involves the assumption that the market will value those higher earnings on at least as favorable a basis as today's earnings. Of course, that is merely another way of betting on the market--which is not the business of an electric utility company.

It is time to abandon the view that new issues of electric utiltiy common stock should be confined to "boom" markets. By and large, the capital needs of the utility industry should be financed on an "as-you-go" basis. Under this policy, and in the light of the company's objective as to an optimum capital structure, permanent financing would always include common stock among the securities offered to finance expansion. In this way its capital ratios will be constantly maintained

and it will assure itself of attaining its ultimate objective as to capital structure. As W. F. Stanley, of Southwestern Public Service Company, recently pointed out, a "financing-as-you-go" policy is similar to the policy followed by insurance companies in investing their funds "as they go". The "averaging" of prices involved in "financing-as-you-go" programs should result over the years in relatively low money costs. A "financing-as-you-go" program reflects the growing status of electric utility common stocks as a relatively stable investment security and assigns to them a constant and major role in the financing of utility construction.

As security analysts, your work has been greatly facilitated by the developments in the utility industry in the last ten years. The elimination of "wind and water" from utility accounts and the simplification and integration of holding company systems have now placed security analysis in the utility industry on a rational basis. In the past, with few operating company equities available and with all the complexities and uncertainties, including the effect of excessive leverage, surrounding holding company securities, you could put only the speculative investor into securities of this industry--others had to be warned: "Danger, stay away." Today it is possible for you to speak with relatively greater confidence--I emphasize relatively--about this industry than perhaps about any other.

You, as security analysts, can play a dynamic role in keeping utility securities a relatively stable investment. Your views tend to be reflected in the investment advice people receive in all parts of

the country. Investment decisions made by a small local trust fund in Kalamazoo or a large insurance company in New York reflect your recommendations. Utility companies should realize that, to the extent that their financial policies and other practices affecting investors minimize investor appeal, you, as a group, will divert funds to co companies which treat investors more considerately and more fairly. I would urge you to speak out, both individually and through the Society, against "unfair-to-investor" practices. To the extent that you will reflect the long-run needs of the investor as distinguished from the in-and-out speculator in utility common stocks, you can become the articulate voice of the owners of this industry--its common stockholders. And don't forget the consumer. His interest in a public service industry should be, and is, parallel, and not antagonistic, to the interest of your clients'--and, therefore, your--interests.