THE SEC AND THE STATE UTILITY COMMISSIONS

Address of

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The timing of this meeting, coming as it does only two weeks before the Silver Anniversary of the Securities and Exchange Commission, which was established on July 2, 1934, suggests an appraisal of some of the accomplishments of this agency over the past quarter century and perhaps some consideration of the mutual problems which lay before us. In view of the particular field of your interests and the limited time which your busy program can spare to me, I will direct my attention principally to the Public Utility Holding Company Act of 1935. This legislation, incidentally, also notes July 2nd as a milestone in its legislative history, since it was on that date in 1935 that the proposed enactment, having been passed by the Senate on June 11th, was acted upon favorably by the House of Representatives. Before I discuss some of our current problems, I should like to recall briefly to you the genesis of the Holding Company Act and to outline some of the accomplishments of the Commission under that statute since its enactment.

As you will remember, one of the principal underlying objectives of the Holding Company Act was to free utility operating companies from the control of absentee and uneconomic holding companies, thus facilitating effective regulation by the states in which they operated. Contrary to a rather widespread popular misconception, the Congress in drafting the Act had no intention of abolishing all holding companies. It recognized that there would be residual groups of electric and gas utility properties whose affiliation would be economically defensible and which could provide better service to the consuming public as coordinated systems than as independently operated utility companies. By the provisions of the statute, these integrated systems are to remain to be subjected to detailed regulation by the Securities and Exchange Commission in order to prevent the recurrence of the abuses which brought about the original enactment of the law.

In 1930, fifteen holding company systems controlled 80 per cent of the privately-owned electric generating capacity of this country. A similar concentration of control existed in the gas utility field. These tremendous empires were nationwide in scope stretching from coast to coast and border to border. Some of the ablest and most imaginative minds in the field of corporate finance had been devoted to the creation of these vast and complicated structures. They had been put together

with little regard for service to consumers and equally little regard for protection of investors. On the contrary, they seem to have been created in large part with a deliberate intent to confuse and delude as well as to prevail in the competitive struggle for power. The accounts of many of the operating companies were inflated, and some of them issued tier upon tier of debt and equity securities, all based upon such improper values. In many cases, however, due to state regulatory supervision, security issues could not be effectively pyramided at the operating company level and resort was had to the holding company device, which had been invented in the 19th Century. This device sometimes resulted in grotesque organizations in which the actual control of an operating company would be vested in a group of persons as much as ten steps removed from it, four or five of which steps would be successive holding companies which had securities outstanding in the hands of the public.

Electric and gas operating companies as such were seriously, but not commensurately affected by the depression of the early 1930's. Electric and gas operating revenues country-wide never dropped more than about 15 per cent from the levels of the 1920's. Nevertheless, that decrease, however small, was enough to topple many of the holding company structures. Preferred stock and debt securities went into default and several of the largest systems were forced into bankruptcy. Almost overnight, many of what had been sold as relatively conservative investments became worthless pieces of paper. At this juncture, the Public Utility Holding Company Act came into being, under which there was delegated to the Securities and Exchange Commission the job of sifting the debris, of distributing whatever was left among the persons entitled to it and of so regulating and reorganizing the corporate structure of holding company systems that a similar collapse would not again happen.

This task of reorganization has been long, tedious and complicated. The volume and complexity of the security structures and the size and geographical diffusion of the properties involved were sufficient to perplex the most astute and experienced legal and financial talent. In the process, a host of investors were forced to realize that the purported values on the basis of which they had purchased their securities were but a mirage, or that they had been dissipated by the holding companies. The operating assets were, of course, salvaged. These assets were very valuable and their value increased substantially in the process of integration and simplification, but

it proved to be impossible to attribute any of them to a very large proportion of outstanding securities.

At one time or another, there have been 2,385 companies which have been subject to the regulatory jurisdiction of the SEC as parts of registered holding company systems. Enforcement of the integration and simplification requirements of the statutes has reduced the number of companies associated with registered holding company systems to a total of 176. At the present time, there are 22 registered holding company systems subject to our jurisdiction. Four of these systems do not own as much as ten per cent of the voting securities of any public utility company within the United States, and they are in various stages of the process of deregistration. In the remaining 18 systems, there are 19 registered holding companies which control 100 electric and gas subsidiaries, 42 non-utility subsidiaries and 15 inactive companies. These system companies had aggregate assets at December 31, 1957, of approximately $10 billion. On the basis of total book assets, they embrace nearly 21 per cent of the electric and a somewhat smaller proportion of the gas distributing and pipeline companies doing business in the United States. As you know, among them are two systems of particular interest to you, New England Electric System and Eastern Utilities Associates. It is probable that both these systems will continue to operate under the 1935 Act for an indefinite period of time. You will also remember that New England Gas and Electric Association, which was originally a component of the fantastic Associated Gas and Electric system, came out only relatively recently from SEC jurisdiction when it divorced itself of its last utility property outside of Massachusetts. Among the great horde of operating utilities that have been under our jurisdiction, but which have been deregistered in one way or another, are a number of other New England utilities which were parts of the AG&E combine, and numerous others which were affiliated with other holding companies.

The amount of financing required in order to meet plant and equipment expenditures by registered systems has been and continues to be very large. During the fiscal year ending June 30, 1958, system companies sold to the public, pursuant to authorization granted by the Commission, 36 issues of stock and long term debt securities for an aggregate of $583 million. It is generally predicted that the annual capital requirements of electric utilities such as these will more than treble by 1975.

In order to orient myself as to utility capital requirements, I have found it interesting to review what has happened in the industry in the past few years. Eleven years ago, at the NARUC Convention of 1948 in Savannah, the late Commissioner McEntire gave a very interesting analysis of this problem as it then appeared. A startling amount of water has flowed under the bridge since then, and the electric industry has grown far larger and much more rapidly than was then anticipated. At the end of 1948, the total installed capacity of all privately-owned Class A and Class B electric utilities was a little less than 45 million kilowatts. At the end of 1957, which is the latest date for which published data are available, this figure was 97.4 million KW. Over the same period, gross electric utility plant increased from $15.4 billion to $36.0 billion, while net electric utility plant increased from about $12.1 billion to about $29.2 billion. Other net utility plant, including gas plant owned by the electric utility companies, increased by $1.4 billion. To finance this increase in net plant of $18.5 billion, the electric utilities had increased their equity accounts from $8 billion to nearly $16 billion and their long term debt from $7.7 billion to $17.1 billion. Other internal sources accounted for the additional funds required in the amount of $1.1 billion. The increase in the equity component of these figures was accomplished by the issuance of about $4.3 billion in common stock and $1.6 billion in preferred stock and the addition of about $2.1 billion to earned surplus. It thus appears that, of the $18.5 billion increase in money invested in net plant during this period, over $15.3 billion was derived from the sale of securities, mostly to the public. Parenthetically and to show the changing times, Commissioner McEntire pointed out that, during the ten-year period 1932-1941, only about 18 per cent of the gross capital expenditures of the utility industry was raised by the issuance of new securities. To bring this story more nearly up to date, I should add that plant and equipment expenditures of electric and gas utilities in the years 1954 to 1958, inclusive, were (in billions of dollars) 4.1, 4.2, 4.8, 6.1 and 6.0, respectively.

Nor is there any expectation that this trend will soon level off. The total national electric generating capacity today, both publicly and privately owned, is about 142 million kilowatts. The Federal Power Commission estimates that this figure will be 394 million kilowatts by 1980. New capacity planned by private utilities for the next three years totals 38 million KW, and present plans call for 23 million more thereafter. Plant and equipment expenditures for the next four years are estimated at very nearly $6 billion per year.

Some of the merchandising figures demonstrate pretty clearly the origin of a substantial amount of the staggering increase in demand which has required this very large construction program. During 1958, there were 1,355,000 new electric ranges sold in this country. There were also sold 1,100,000 new freezers, 3,672,000 new electric washers, 12,577,000 new radios, 1,550,000 new air conditioners, and so on. At the same time, the trend to automation in industry and the increasing use of power-hungry machines and processes is multiplying the demand factor of the industrial load.

It is quite apparent, I venture to say, from the statistics I have quoted so far, that the public utility industry is going to be called on to raise very large sums in the public securities markets during the next few years, and probably for some years to come. The cost of new generating equipment has, of course, sharply increased in recent years. In 1954, the cost per kilowatt installed of a large modern steam generating plant was about $145. Today, the same plant would cost about $160, or, for a 250,000 KW unit, almost $4,000,000 more. If this trend continues, and prices continue to advance, the demands of utilities for new money will be even greater than I have indicated.

There is little doubt but that a very large part of these new securities will come out as long term debt. Although there has been some tendency for the proportion of equity securities to increase, and although this tendency may be accentuated by the constantly increasing cost of debt money together with certain other less direct influences, electric and gas utilities in 1958 were still raising about 70 per cent of their new money by bonds or notes. And it is equally clear that these debt securities will be sold in great measure to institutional purchasers. Last year, for instance, out of a total net addition to issues of bonds and notes outstanding of $7 billion, net purchases by institutions amounted to $5.5 billion. No breakdown is available as to utility issues alone, but they are unquestionably similar in this respect.

I don't suppose there is anything world-shaking in an analysis of this sort or in the conclusions I have reached. Under present income tax rates which tend to prevent significant individual savings and with the swiftly growing importance to the securities markets generally of such phenomena as pension trusts, insurance and investment companies and endowment and charitable funds, it may not be surprising to discover that

these are the investors to whom the dealers normally go to raise money for utilities. On the other hand, since these institutions are highly sophisticated and articulate investors and since the demand that delayed redemption provisions be included in indentures governing debt securities seems to stem largely from the desire of these investors for portfolio stability, their importance as the predominant source of new capital may be of substantial significance for the purposes of our present discussion.

As you will recall, I spoke to you last year on this subject of redemption restrictions. I then described the rule of thumb which we have used in determining the reasonableness of a redemption provision, that is, that the issue must be immediately redeemable at a premium equivalent to not more than the offering price plus the coupon rate. I am still convinced that it is essential for all of us, Federal and State agencies alike, to be on guard to prevent any further expansion in the use of indenture provisions which would prevent redemption through the issue of refunding bonds carrying a lower interest rate. While there has been no particular increase in the use of such provisions since I talked with you last year, the situation seems to warrant some caution on the part of the agencies in view of the fact that the latest issues of utility bonds have been sold at increasingly high interest rates. The price of triple-A securities (back in March) was 4.32 per cent; double-A bonds sold recently at 4.99 to 5.1 per cent, and single-A at 5.22 per cent. The current market for seasoned issues runs from 4.52 to 4.86 per cent, at the last available date. As you know, the Treasury is paying as much as 4-1/4 per cent for money and is currently asking for an increase in the statutory ceiling. These figures are to be compared with a price for prime money only a year or two ago as low as three per cent. Under these conditions, I think it entirely possible that there may be a renewed pressure to limit the free refundability of utility issues. It is most certainly true that the last pressure of this nature came in 1957, when interest costs were less than they are at the present time.

I attempted last year to demonstrate that there was little or no evidence to support the reasons advanced by the underwriters for insisting upon these restrictive provisions. With respect to the argument that free callability raises the cost of money to the issuer, I then mentioned that the Wharton School of Finance and Commerce of the University of Pennsylvania was conducting a study of this contention. This study is now being completed but has not as yet been issued. I was most interested, however, to note that Dean Winn and Professor Hess, who have been in

charge of it, stated at the annual meeting of the American Finance Association in Chicago in December, 1958, that their data indicated that the presence or absence of the call privilege did not appear to have any significant effect on the interest rate. This conclusion substantiates similar conclusions reached in the Commission's studies to which I have referred.

You will recall that I referred last year to a study which had been conducted by Mr. J. Arnold Pines, Chief Financial Analyst of our Division of Corporate Regulation, which indicated that underwriters appeared to be as willing to purchase an issue containing callable provisions as an issue containing restrictions on callability. The study further indicated that there is no apparent unwillingness on the part of investors to purchase freely refundable issues as against the five-year non-refundable issues, for approximately the same percentage of refundable issues was successfully marketed as in the case of the non-refundables. This study has since been extended so that it covers the period from May 14, 1957 to November 30, 1958. In this study, an issue was considered to be successfully marketed if 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-refundables were successful. In terms of principal amount, 72.3 per cent of the refundables were successful, while 73.9 per cent of the non-refundables were successful. Extending the comparison to the aggregate principal amounts of all issues which were sold at the applicable syndicate prices up to the termination of the respective syndicates, we find that 90.0 per cent of all the refundables and 89.5 per cent of all the non-refundables were so sold.

In order to bring this study close to home, I had a review made of the experience of New England utility companies. Eleven bond issues were sold at competitive bidding during the same 18-month period by New England electric or gas utility companies. I was interested to note that all eleven were freely refundable. While it is not possible, therefore, to compare marketing success of refundable issues as against non-refundables with respect to New England companies, the study indicates that these issues had approximately the same marketing success as the issues studied in other parts of the country, since eight of the eleven issues were successfully marketed according to the foregoing definition, while three were not.

When the underwriters and institutional investors are faced with

these studies, they have sometimes gone on to criticize us as being on a "one-way street" in favor of consumers, to the neglect of the interests of investors in utility bond issues. This argument takes these particular provisions of our Statement of Policy out of context and ignores the balance of the document. We are charged by the Public Utility Holding Company Act of 1935 with seeing that utilities achieve all possible economies in the raising of capital in order that consumers will not be forced to support excessive interest charges. We are, of course, also charged with protecting the rights of investors and we have attempted to balance the interests of each. Our provision for free refundability admittedly does favor the consumer. On the other hand, there are other provisions contained in the Statement of Policy designed either to protect existing rights of investors or to give substantial further rights to them. For instance, the Statement provides for restrictions against the issuance of additional bonds, for sinking and improvement funds, and for renewal and replacement funds and it also directs certain restrictions on the declaration of dividends. Those who claim that an investor should be entitled to an additional return if he is to accept a provision permitting free refundability should, perhaps, be asked to state whether they think he should accept a lesser rate because of these other protective provisions. We did not intend to favor either the consumer over the investor or the investor over the consumer. Our interest was and is to protect the interests of each, as well as the interest of the public, in accordance with the policies outlined in the Act.

In view of the statistics applicable to this area, I may possibly be open to the accusation that I am addressing the wrong group. My only answer is that I hope to arm you to some extent against any pressure which may be brought to persuade you to change your existing policies. Our jurisdiction is limited to that sizeable segment of the electric and gas utility industry which is subject to the Public Utility Holding Company Act of 1935. We cannot, therefore, do this job alone, and we must seek a unified front of both state and federal agencies. In this connection you should know that the Federal Power Commission also has a policy of free refundability on electric utility bonds issued under its jurisdiction, although they apparently do not adhere to the same rule of thumb formula which the SEC employs. I am also happy to report that on July 31, 1958, the Interstate Commerce Commission stated, in an order involving a railroad company, that it would not look with favor upon the inclusion of provisions in bonds which restrict the issuer's right to redeem them at any time upon the payment of a reasonable premium. It added that its policy in the future, in the absence of

clear justification for contrary action, would be to refuse approval of the issuance of bonds which are not freely redeemable at any time.

I am convinced that our position in this respect is sound. In an institution so many-faceted as the capital market, however, we would be unrealistic indeed if we failed to make a continuous study of callability provisions. If conditions should change, or in any special circumstance, we will do our best to adapt our thinking accordingly. Our willingness to maintain an open mind may, I think, be illustrated by our recent decision in the Yankee Atomic Electric Company case where we permitted the issue of bonds which will not be freely refundable for an initial period of years. The entire field of atomic energy seems to present many substantial and novel problems, and this is a fair example. In the case of Yankee, the indenture will contain restrictions against refundability until the plant is constructed and will provide for relatively high redemption premiums for a period of five years thereafter. We became convinced that it was necessary, in this peculiar situation, to permit a negotiated underwriting. Representatives of institutions which were approached advised Yankee that they could not undertake the necessary expensive and time-consuming analysis of the complex details surrounding the Yankee financing, unless they were reasonably certain that their investment in Yankee would not be terminated while the plant was under construction and unless a redemption price higher than usual was provided during a five-year period thereafter. We found that, under the circumstances of this case, an exception to our Statement of Policy requiring free refundability was warranted. While we are, of course, not aware of all of the financing problems which will be presented in the field of atomic energy, I would expect that, after an experimental period in which the problems of atomic energy development become more known, there will be no need to make any further variance in our policy in this respect.

Let me close these few remarks by reminding you that there are many points at which the work of the Securities and Exchange Commission touches your own field as state utility commissioners, at least as regards accounting and securities matters. In the course of twenty-five years of fairly ubiquitous experience, I think we may safely claim that we have seen almost everything, although the caliber of the ingenuity which is exercised in matters under our jurisdiction still manages on occasion to surprise us. The Commission which I am honored to represent is most anxious to come into closer liaison with state agencies such as yours, and freely offers to make our experience available to you.

I remember that, when I was associated with the Massachusetts commission, my contact with the SEC was quite occasional and my reaction to its activities was not always entirely favorable. I now see no reason why such an attitude should prevail. Dick McEntire did a great deal to bring us closer to the local commissions. I hope that more can be done along this line, and that you will feel perfectly free to consult with us as to the problems in which we have a mutual interest. My own very pleasant experiences on a state agency lasted over far too many years and are far too recent for me to permit anything but the most cordial and helpful response to any such request.