

"Caution - Release Not Before Noon of Wednesday, November 17, 1948"

APPRAISAL OF THE CURRENT STATUS OF THE  
FINANCIAL NEEDS OF THE ELECTRIC INDUSTRY

ADDRESS

of

RICHARD B. McENTIRE

Commissioner, Securities and Exchange Commission

before the

NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS

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You have been kind enough to ask me to appraise with you again the financial and regulatory aspects of the construction program of the electric utility industry. I am glad to have the opportunity to discuss these matters with you a second time. As you all know, the utility expansion program has been growing like Jack's beanstalk and is now twice what it was 18 months ago. The enormous physical size of the program and the tremendous volume of new money that will have to be raised to finance it create problems of new and far greater dimensions than any ever faced before. Let us try to sketch some of these problems and outline their implications.

When we last met in July 1947, we had already enjoyed a year of full employment and record output. We have had 18 months more of this. Industrial production is double prewar, employment is over the 60 million mark, agricultural output is 50 percent greater than in 1939, the gross national product is running at \$250 billion per year, private capital expenditures are at a \$40 billion annual rate, telephones are being installed at a rate of over 3.5 million per year. Steel is being produced at the record rate of over 90 million tons per year, housing construction is approaching a million dwelling units per year. How long will this pace continue? Not being the seventh son of a seventh son, I don't know when it will end.

It is, of course, much too early to appraise with any degree of accuracy the effect upon the economy of the recent action of the stock market, and I shall not make any attempt to do so this morning. We certainly cannot now say that there is indicated any satisfaction of the demand for the products of industry or that industrial activity will be greatly affected -- even if a definite market trend is established. In any event, it seems clear that the electric utility industry must still increase its capacity very considerably. Indeed, it appears that scheduled construction for the next two or three years may well be considered as firm.

Now, let us see what has been accomplished in the electric utility industry during the past three years, 1946 - 1948. Although 1948 is not yet over, a reasonably good guess can be made as to what the figures will show. (1) Generating capacity has increased 6 million kilowatts, or about 12 percent, from 50 million to 56 million; (2) kilowatt-hour output has increased from 222 billion to 280 billion, or about 30 percent; (3) residential consumption of electric power has increased almost 50 percent, from 34 billion to 50 billion; (4) the number of customers has increased from approximately 34 million to 41 million, an increase of 7 million.

This sharply increased demand has placed great strains upon our power production capacity. Indications now are that power shortages may be widespread this winter. The most skillful management will be required to steer industrial and domestic consumers over the hump without undue suffering. The latest Edison Electric Institute estimates show that reserves for the country as a whole will be down to 4 percent by the close of the year. Such a narrow reserve, even if realized, would mean critical shortages in many areas.

This inability of the increases in capacity to keep pace with the increases in demand reminds one of the words of the Red Queen when she said to Alice: "Here, you see, it takes all the running you can do to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that."

What are the reasons for this tremendous increase in demand for electric power?

In the domestic field the most important factor is the construction of two million new dwelling units in these three years and the sale of huge quantities of electrical appliances. The year 1947 alone saw the sale of 1,200,000 electric ranges, 1,100,000 water heaters, almost 4 million

electric washing machines, 3-1/2 million electric refrigerators, 17 million radios, and 450 thousand home freezers, as well as vast quantities of electric clocks, waffle irons, toasters, and all the myriad electrical appliances that go to make life more pleasant and the home easier to manage. Statistics on the output and sales of consumers' durables in 1948 show even higher figures and indications are that output and sales in 1949 may well be still greater.

In addition to these already developed appliances, a potential load builder of great consequence is the heat pump. This is now being tested in experimental installations in various parts of the country. It is estimated that one heat pump for the average home will consume between 12 and 15 thousand kilowatt-hours per year, or close to 10 times the present rate of domestic consumption. If the electric industry should serve 5 percent of the present homes, it would increase its residential load by almost 50 percent. The gas industry, too, is eyeing this possible source of business. Competition should speed up the development and exploitation of this revolutionary appliance.

The American farm is another great source of potential load. In a year or two over 90 percent of the farms will have electricity available. Even now the demands for power on the farm are very great. The impending development of new appliances will make them greater.

In industry, too, the long-range prospects are for greater electrification. In addition to the many new ventures which have appeared and the increased operations of established enterprises, new processes are being developed which will require vast quantities of electric power. Among these are the synthetic fuel program, the treatment of low-grade ores, high frequency heating, and a further expansion of electro-chemical industries as a result of the increased use of synthetic ammonia, aluminum, and

magnesium. In appraising the industrial use of electric energy we must always bear in mind the natural urge to substitute relatively low-cost electric power for relatively high-cost man power. Increases in the wage level accentuate this motive.

Many of you may have seen the Westinghouse study -- "The Electric Utility Industry by 1957". This study estimates that the electric utility industry may be expected to increase sales to residential consumers during the next ten years by 100 percent, to farm consumers by 140 percent, to small industry and commercial business by 50 percent, to large industry and commercial business by 71 percent, and that the over-all increase will be 72 percent. The study concluded that, in order to meet this anticipated load, the industry as a whole, government power projects included, will have to increase generating capacity during this ten-year period by 80 percent. This means an increase of more than 40 million kilowatts of capacity in ten years, or an average of over 4 million per year. Since considerable obsolete capacity will have to be retired, total installations on these assumptions would average at least  $4\frac{1}{2}$  million kilowatts per year. This is more than twice the 20 million kilowatts of capacity increase of the decade 1921 - 1931, the previous peak. Whether time will bear out these particular estimates is, of course, conjectural. The industry is convinced, however, that the long-term trend is one of substantial expansion.

In each of the years since 1945 the utility industry has been unable to install the capacity planned for the year, chiefly because of material and equipment shortages. It now appears quite likely that the industry will again fall short by perhaps as much as 700,000 kilowatts of the  $4\frac{3}{4}$  million program for the year 1948. Although the official estimates for 1949 and subsequent years have not yet been published, a recent statement issued by the Edison Electric Institute indicates that the sights have again been

raised. Plans for 1949, including public projects, call for the installation of approximately 6.7 million kilowatts of new capacity and plans for the four years 1948 - 1951 will total some 23 million kilowatts. While the capacity of equipment manufacturers is being increased rapidly, in the light of experience I personally have considerable doubt whether the 1949 program can be fully achieved.

Eighteen months ago when I spoke to you in Boston the industry was talking in terms of a four-year expansion of 11 million kilowatts. Today it is talking about a 23 million program for the next four years. This startling increase in projected installations speaks for itself.

What these various figures and projections add up to is that the industry is not confronted with a short-term construction program. On the contrary, the industry is planning for large-scale expansion at a rapid pace and for a long period of time. This fact has important implications as to the character of the financing which is appropriate during the current and succeeding years. First, let us take a quick look at the financing of the past three years and the effect which it has had on the capital structure of the industry.

The available data 1/ indicate that the industry will have spent approximately \$3.4 billion for new plant in the three years 1946-1948, inclusive. To finance this volume of capital expenditures the industry had available from internal sources approximately \$1.7 billion. Of this amount \$1.3 billion came from depreciation, amortization, and working capital; \$400 million came from undistributed profits. Cash generated from internal sources was, of course, inadequate to finance this construction program and, accordingly, the industry raised the remaining \$1.7 billion from the sale of securities. Of this total, \$1.3 billion came from the sale of bonds, about 1/ Federal Power Commission, Class A and Class B Utilities projected through December 31, 1948.

\$200 million came from the sale of preferred stock and a like amount from common stock. Thus, about three-quarters of the new money obtained by the industry from the market during these three years was derived from the sale of debt securities and about one-eighth each from the sale of preferred and common stocks.

If we add to the proceeds from the sale of common stock the retained earnings (which are, of course, an addition to the common stock equity), new capital has been obtained to the extent of 62 percent from debt securities, 9 percent from preferred stock, and 29 percent from common stock. These industry-wide figures are not too bad. But buried in them are some companies whose individual capital structures have deteriorated seriously. Some of these are now at the danger point and may be in trouble if the financial climate is unfavorable when next they are forced to go to the market.

Now with regard to the future: How large will the program be? What will it cost? How will it be financed? What effect will the 1946-1948 pattern of financing have on capital structures?

The best guess appears to be that the expansion program will involve the expenditure of at least \$2 billion per year during the next three years and -- barring major reversals -- perhaps as much if not more per year for the next decade. Past experience indicates that of this amount approximately \$700 million per year will probably be available from internal sources such as depreciation, amortization, and retained earnings. Approximately \$1.3 billion per year will, therefore, have to be raised through the sale of securities.

As we all know, debt securities of electric utility companies have enjoyed ready markets -- a fact which has much to do with the very substantial extent to which debt has been employed. This market has been largely among

life insurance companies. Generally speaking, no difficulty should be experienced in obtaining ample funds through this medium. The problem is rather to secure sufficient funds in the form of junior securities to maintain balanced capital structures.

At the time of my remarks last year it was already apparent that the market for preferred stocks was deteriorating. Preferreds of medium grade were almost invariably difficult to sell, and institutions were withdrawing more and more from that area of investment. In an effort to regain institutional favor, issues of medium grade preferreds resorted to sinking funds, an innovation in utility stocks. Initially these sinking funds called for the annual retirement of 2 percent of the issue; as more issues came to market the rate sometimes rose to 2-1/2 percent, or even higher. These efforts proved fruitless, however, so far as medium grade preferreds were concerned and these stocks have been forced to rely upon the long-neglected individual market.

High-grade preferred stocks a year ago continued to enjoy substantial demand from life insurance companies and other institutions. Gradually, however, these too lost their appeal in many quarters. Dividend yields rose sharply and sinking funds or purchase funds came into rather general usage. It appears likely that some institutional demand for better grade preferreds will continue, but this market is limited for the time being, at least, and any sizeable issue of preferred stock will probably have to be priced to attract individual as well as institutional investors.

The extent to which individual investors can again be interested in preferred stocks is not known. The extensive refunding of preferreds a few years ago at yields as low as 3.3 percent not only served to retire large amounts of stock held by smaller investors; yields at such levels militated against repurchases by this type of investor and the new stock moved instead



into the institutional market. Thus it has been many years since dealers were faced with the problem of selling preferred stock to individual investors and a great deal of more or less painful probing has been necessary in seeking out new yield levels at which such stock can be sold. Please do not misunderstand this. I do not mean that we must "write off" preferred stock as a means of raising utility capital. During the first nine months of this year, there were marketed \$133.5 million of new-money utility preferreds. The bulk of these new issues, however, was sold by higher grade companies, with only small amounts being marketed by companies of medium to lower grade.

Last year I discussed a number of protective provisions which have been developed by the SEC for the benefit of preferred stockholders. With the smaller individual investor assuming greater importance as a market for preferreds, I urge upon you again that these protective features be incorporated whenever possible. Sound and attractive issues should be the objective of the industry and of regulatory bodies alike.

Turning to common stocks, we find that the market has displayed considerable appetite for this class of securities during the past year. Since July 1, 1947 common stock has been offered to the stockholders of electric and gas utility companies in 27 instances. In 17 of these rights offerings, over 90 percent of the stock offered was taken up through the exercise of rights; parent companies figured prominently in six of these. In eight additional cases more than 70 percent of the offering was subscribed. Offerings of this type totaled \$132,000,000 and ranged in size from \$500,000 to more than \$20 million.

In addition to the 27 issues offered to stockholders during this period, ten other new money issues of common stock aggregating approximately \$25,000,000 have been marketed directly by underwriters. These, I understand, have been generally well received.

Let us refer again to the sources of additional funds obtained by utility companies -- these were in the ratio of 62 percent debt, 9 percent preferred stock, and 29 percent common stock, including retained earnings. In view of the unfavorable market for preferred stocks, it is not surprising that they have played so relatively minor a role in financing the construction program. It is unfortunate, however, that the resulting gap has been closed entirely with debt securities. Common stock has, in fact, failed to hold its own percentage-wise.

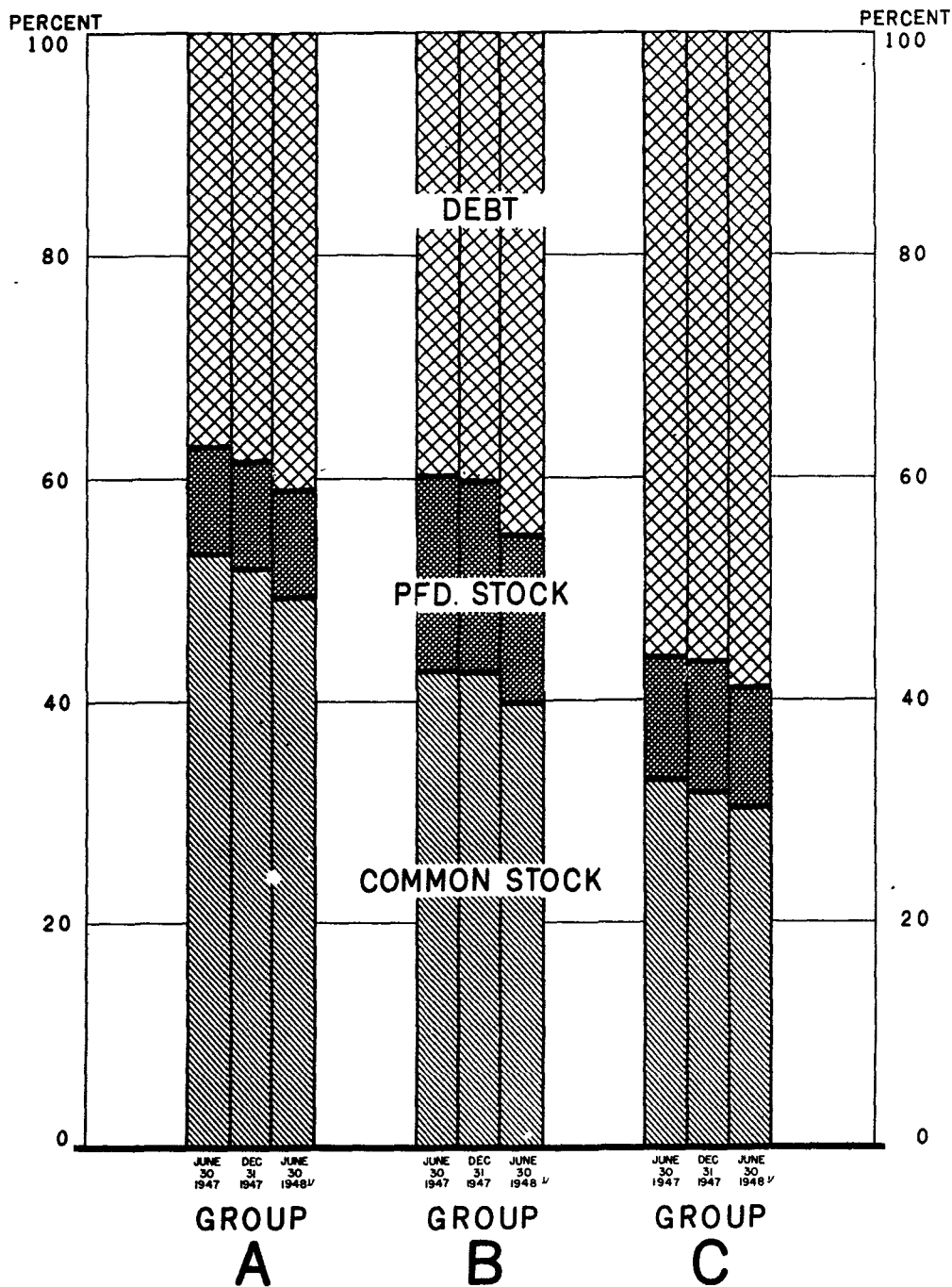
Some of you may remember a study to which I referred last year based upon the price-earnings ratios of substantially all electric companies whose common stock had been traded during at least four years in sufficient quantity to provide a reliable market. Several additional companies have now met these specifications, so that currently the group is made up of forty-one companies. These companies were ranked in the order of their average price-earnings ratios over a four-year period and the sample was then divided into upper, middle, and lowest thirds. These three groups, which we will again call Groups A, B, and C, provide a means of observing three distinct levels of market appraisal. As we noted last year, there was a marked correlation between the capital structures of these companies and the market's valuation of their earnings. Group A, whose common stocks enjoy the most favorable market appraisal, shows a low debt ratio and a large common equity. Group B companies have somewhat more debt and less common. Companies in Group C, to which the market looks least favorably, typically had heavy debt structures with only moderate amounts of common stock. Let us see how the capital structures of these companies have changed under the stress of the construction program.

As is evident from Chart I, debt ratios have increased in all three groups and common stock ratios have decreased. While the capital structures

in Groups A and B remain in satisfactory areas, the pattern which has been set is not the sort which can safely be followed throughout an expansion program so extensive as the present one promises to be. However, it is to be expected that companies which have accumulated a comfortable proportion of common stock will turn first to debt securities for additional funds. Thus the movement of ratios in Groups A and B is not yet seriously disturbing. If common stock financing is employed in somewhat more generous amounts by these companies during the remainder of the program, they should emerge with sound structures.

The problems of companies in Group "C", however, may not be so lightly dismissed. Although there are exceptions, we find that these companies are typically among the smaller in the industry, usually operating in less thickly settled territory and frequently having a background of financial difficulties during the '30s. Expansion needs found them with capital structures already heavily loaded with debt. Preferred stock has been very difficult for these companies to market and their common stocks, while showing good to excellent longer-term growth in earnings, are not well known. These companies have, in most cases, attempted to build up common equity by retaining earnings, and until quite recently they were able to maintain or improve existing ratios in this manner. It seems clear, however, that retained earnings will be inadequate for this purpose. If these companies are to come through their construction programs without becoming financial cripples or worse, they must secure adequate common equity. In marketing common stocks of these lower grade companies, substantial discounts from going market prices may frequently be necessary. This will be even more painfully true if markets continue to be unsteady. Neither management nor stockholders like to see new partners come in on a cut-rate basis, but much of this difficulty can be met through the use of rights

# CAPITAL STRUCTURES OF A, B & C COMPANY GROUPS



<sup>1/</sup> ADJUSTED FOR CAPITAL CHANGES TO NOV 1, 1948

offerings. In any event, regulatory bodies will be called upon to play much stronger roles in determining the shape of utility financing policies.

In fact, any serious economic reversal might make it difficult for all utilities to market their equities. But at the same time such an event would create the very conditions which make a sound financial structure imperative. It is therefore of the utmost importance that we begin now to build and maintain this strong equity foundation under the capital structures of our utility companies as we go through this period of rapid growth. The time may come for some of them when it is too late to act.

The industry's construction program can be financed successfully, of course, only if utility common stocks retain their "investor appeal". To do this, earnings and dividends must be attractive. Market declines serve to underscore this point. Many commissions have already been faced with instances where earnings have become inadequate and relief has been granted to quite a few companies. Naturally, earnings are basic. But, as we all know, earnings may lose much of their effect marketwise unless they are also reflected in dividend policy. Earnings retained in the business are all well and good, but when a company goes to the market to sell common stock, dividends assume a new importance. A company must, quite literally, compete for capital, and if it seeks to do so while continuing to retain in the business an unduly large part of its earnings, it can expect to be at a disadvantage. The old maxim applies here as elsewhere: You can't have your cake and eat it too.

But in addition to sound earnings and an attractive dividend policy, there is still a third ingredient which must be present if the construction program is to be successfully financed. Electric utility common stocks as a class are generally regarded as among the most attractive of equity investments. This ingredient, and it is an indispensable one, is action to

match this belief. Let management and regulatory bodies work together in keeping common stocks strong and inherently attractive. Let management and the investment banker take the case before the investing public. The result, I believe, will be a great and strong industry which will ably serve the community, the investor, and the nation -- and this result is certainly what we all desire.