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FINANCIAL ASPECTS OF THE GAS EXPANSION PROGRAM

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<u>Financial Aspects of the Gas Expansion Program</u>

I am very glad to be here with you today to discuss certain financial aspects of the gas industry. As you are all well aware, the natural gas industry is engaged in an expansion program of epic proportions. The construction of the great transmission lines is in the most romantic tradition of American enterprise. The scale of activity involved, the engineering triumphs achieved in flinging great lines of 20- to 30-inch steel pipe thousands of miles across the face of the nation, the harnessing of vast unused natural resources for the benefit of large numbers of people, and the great rewards that come from success in such ventures are the stuff of the American dream. There is a dramatic appeal here that stirs the emotions. To my mind this dramatic appeal has been as important in the successful financing and construction of such projects as Texas Eastern, Tennessee Gas, and the other great lines as has the lure of profit. It is significant that in no other industry have so many great new enterprises been projected and financed.

The capital expenditures of the natural gas industry have increased at a phenomenal rate, a rate far exceeding that of business generally. Between 1939 and 1948, the dollar volume of all private domestic investment increased a little more than fourfold; in the electric utility industry this increase was about fivefold; but in the natural gas industry capital expenditures increased over 12 times--from a little less than $50 million in 1939 to $630 million in 1948. Furthermore, proposals now under discussion in responsible industry circles indicate that close to a billion dollars may be spent during each of the next few years.

The rate of expansion in the gas industry appears to be due to the joint action of two powerful currents, one reinforcing the other. One is the extraordinary expansion in business activity since the end of World War II and the second is the shift from other fuels to gas. In many places gas has become the cheapest as well as the most desirable fuel for many household and industrial uses. The present program, unlike that of 1928-1930, is based not on a theoretical estimate of a potential market waiting to be exploited but on the hard reality of a pressing shortage. As you know all too well, the shortage of gas became so acute in many communities last winter that supplies to industrial consumers had to be drastically curtailed, and the installation of new space heating units forbidden; moreover, appeals were made to householders to reduce home temperatures to 60 degrees or lower during the periods of peak consumption.

Because the expansion has been so heavily concentrated in natural gas, I am restricting my remarks here today to the financial developments in that portion of the industry. A good part of what I have to say is drawn from the results of a study made by the staff of the Securities and Exchange Commission as to the manner in which a group of the principal natural gas companies have financed their expansion program since 1945. The group consists of 19 companies which had assets on December 31, 1945 of over $2 billion and which hold the bulk of the assets of the natural gas industry.

Though most natural gas companies accrued substantial sums through depreciation charges and retained a considerable portion of their profits, the industry, like many others, was unable to supply from internal sources all of the funds required for expansion. The group of companies we studied had available from such sources a little over $100 million a year. While this was sufficient, after providing for debt retirement and working capital, to finance requirements during the late '30s and early '40s, it became wholly inadequate when capital expenditures rose to their present level. New pipe line companies, of course, had to finance entirely from outside sources.

In the two and one-half years from December 1945 to June 1948 this group of companies made new capital expenditures totaling about $700 million, including about $250 million by the two new transmission lines, Texas Eastern and Tennessee Gas. Of this amount $550 million was obtained from the sale of new securities and the remainder from internal sources. Excluding the money raised by the two new companies, it appears that the other companies in our group raised about one-third of their construction requirements from internal sources and about two-thirds from the sale of new securities.

How was the new money raised? Our study shows that the bulk was obtained through the sale of senior securities. Of the $245 million raised by the two new pipe line companies, over 80 percent was obtained through the sale of bonds, about 4 percent through the sale of preferred stock, and only 15 percent from the sale of common stock. Of the $305 million of new funds raised by the older companies, about 87 percent was obtained from the sale of bonds, about 3 percent through the sale of preferred stock, and 10 percent from the sale of common stock. As can be seen from these figures, the sale of preferred stock played only a minor part in the financing program of the industry. While common equity has been materially increased by retained earnings, the sale of additional common stock has also played but a small part in raising new funds. Aside from the two new transmission lines, only three of the companies in our group have issued common stock.

A striking characteristic of the senior securities issued is their relatively short life; all have heavy sinking funds or serial maturities. The principal reason for these features appears to lie in the "wasting asset" character of our natural gas resources, but they have also aided materially in providing market appeal. Because of institutional preference for securities which "pay out" rapidly, banks and insurance companies have found natural gas debt issues very much to their liking. In fact, the industry has now achieved a credit status comparable to that of electric and telephone utilities.

Of the approximately $800 million of new and refunding issues floated by the companies in our group since 1945, more than half were placed privately with institutional investors. The size of an issue has been no obstacle to direct placement, as shown by the fact that the two largest natural gas issues, each well over $100 million, were sold in this manner. Furthermore, we know that the bulk of the publicly offered issues was taken by these same investors. This is in sharp contrast to the conditions prevailing some ten years ago, when natural gas bonds aroused almost no institutional interest. In fact, institutions now dominate the market for natural gas debt to such an extent that they are virtually "locked in" their present positions: no other market at anything like going money rates appears to exist. Institutions have, therefore, great interest in the protective provisions written into these securities as well as in the general corporate health of the natural gas industry.

Let us look now at the effect of heavy debt financing upon the capital structures of the companies in our group. First, we note that the corporate structures of transmission companies vary materially from those which have both distribution and transmission facilities. Thus, the capital structure of one transmission line shows 80 percent debt; another 71 percent debt and 13 percent preferred stock; and a third 69 percent debt and 12 percent preferred. Similarly, the other transmission companies in our group show debt ratios ranging from 50 to 65 percent. The companies with large investments in distributing facilities show smaller debt ratios. Thus, five of the companies in this group, including the two largest, have about 50 percent of their capital in debt; one has 38 percent, one 28 percent, and the remaining three show about 15 percent debt.

High debt ratios for transmission companies have been defended on the ground that where such companies have firm contracts, both for the purchase of gas and for its sale to responsible distribution companies, they may safely undertake a higher initial proportion of debt. This argument has some appeal, but it has its limitations, too, and in some cases it has been carried too far. It may, in fact, be almost completely inapplicable to a transmission company whose costs of gas and costs of transmission, including depreciation on a high-cost line, are sufficiently great that other fuels may be able to compete successfully with it during periods of unfavorable business conditions. Some of the new pipe lines which are now being constructed or which are in contemplation may encounter such higher costs and, consequently, should finance their construction in a conservative manner.

Turning again to our group of companies, it is to be noted that all which participated in the expansion program have shown increases in their debt ratios. For the group the total debt outstanding has doubled since 1945, although assets rose only about one-third. In every case reasons can, I am sure, be advanced to justify the issuance of debt. However, I am not betraying any secrets when I say that we at the Securities and Exchange Commission are disturbed by the fact that many utility corporations, electric as well as gas, and, indeed, many corporations in other lines of activity, have, since 1945, relied so heavily on debt financing to meet their expanding capital requirements.

Our concern is not due to any belief that, generally speaking, the capital structures of electric utility corporations or of natural gas companies are weak. Serious problems do not, of course, arise when a natural gas company increases its debt ratio from 0 to 15 percent or from 13 to 29 percent. Indeed, it is just for the purpose of enabling management to meet expansion requirements that high common stock equities are maintained. However, when ratios begin to go from 42 to 59 percent, from 50 to 70 percent, from 40 to 65 percent, or from 30 to 60 percent, there is cause for uneasiness. It then appears that management is again looking backwards to the days of high leverage and that trading on the equity once again has allure.

Should this trend continue, the industry will face the inevitable shakedown that follows prosperity with its capital structures heavily loaded with debt and with a high burden of fixed charges. None of us wants to see the gains achieved in the last decade wiped out and utility capital structures put back to where they were in the '30s, with all the attendant dangers. Already, many companies have assumed a heavy burden of fixed charges and debt retirement. Conservatism in dividend and depreciation policies will be required of these companies during the coming years, even if the anticipated high level of revenues and profits is realized.

The reason most commonly advanced for the failure to sell common stock in recent years is that the market has been bad and the flotation of common stocks "too expensive" to be justified. This rationalization does not appear to me to be particularly strong in the case of natural gas companies. For many years natural gas equities have sold at high ratios to earnings. New offerings have been quickly absorbed and have soon sold at substantial premiums over the offering price. Shortages of materials and equipment have at times delayed construction projects, but adequate funds--both equity and debt--have been readily available.

I do not believe that the principal reason for such heavy reliance on debt financing is that management took the easiest way out and loaded up with as much cheap money as could be gotten regardless of the consequences. I am more inclined to believe that the reason why they did so lay deeper and flowed from certain assumptions as to the future of our economy. It is my belief that the reason lies in the theory widely held towards the end of World War II that war prosperity was sure to be followed by postwar depression. The unexpected need for funds, therefore, was looked upon as something limited and temporary in character, something that would be over when the projects then being undertaken were completed. The same attitude was prevalent in the electric utility industry where the size of the postwar expansion program dawned only gradually upon the industry with the result that plans had to be continuously revised upwards. Indeed, what appears to have concerned management was whether demand following the expected postwar letdown would be sufficient to keep the new facilities operating at a reasonable ratio to capacity. It therefore appeared undesirable to take in new partners. On these assumptions, it was natural to conclude that debt financing at attractive rates was the appropriate solution to the immediate problem. Cheap money for a short-term boom seems to have been the idea. The heavy sinking fund payments and the large serial retirements undertaken could, it was felt, easily be met from the depreciation charges and from the profits that were sure to accrue as a result of the expansion. Time, it was believed, would cure the capital structures and reduce debts to a point where the ratios looked better.

With the benefit of hindsight we can now see that in 1944 and 1945 we were blindly waiting for history to repeat itself. We were waiting for the problems that faced us after the first World War to reappear and this time we were determined to be prepared for them. Had we had the wisdom we would have seen that the problems facing us were not those of depression, deflation, and unemployment, but those of satisfying the huge volume of demand accumulated during the war years--a volume of demand so great that it has taxed our war-expanded capacity to the hilt for more than two years and that still appears to be far from satisfied.

We would have seen:

That the American people had accumulated huge liquid savings, were enjoying a high level of income, and were determined to translate those funds into higher standards of living.

That millions of young veterans, newly released from the armed services, were determined to set up new homes and rear families.

That the devasted areas of the world would have to be restored and that in one way or another funds to aid in such restoration would be provided.

That business had the desire and the funds with which to expand capacity, modernize plant, and put upon the market the new products developed during the war.

In short, most of us discounted too heavily the fact that consumers, farmers, business men, and state and local governments were in the best financial condition in our history, that our people had the determination and the wherewithal to live a better life.

The effect of the continued high level of business activity has been that the demand for gas, instead of leveling or falling off as was expected, has continued to increase, taxing capacity to the full. Thus new and ever larger facilities have had to be planned and constructed. Capacities of existing pipe lines have had to be increased, additional and larger compressor stations have had to be built, new reserves of natural gas have had to be developed, new storage capacity has had to be constructed, and new distribution facilities provided. The result has been that instead of being able to sit back, collect revenues, and pay off old debt, an ever greater stream of new money has had to be obtained to pay for the new facilities.

While I have pointed most of my remarks here towards underlining the importance of maintaining a strong capital structure when times are good and capital expenditures large, I must also point out that a good capital structure is vital when times are bad and revenues and profits fall. As we have all learned, depressions are not quiet periods when one can sit back and clean up the odds and ends not taken care of during the busy days of prosperity. Depression, we have learned, can be so severe that the necessity of meeting daily operating expenses becomes a troublesome burden. Indeed, during the '30s we found that a capital structure just could not be too strong.

Ours is a vitally dynamic economy, continually undergoing vast changes, severe price fluctuations, commodity substitutions, and great geographic shifts in manufacturing and distributing activities. The unexpected is always happening. It is the better part of wisdom to be prepared for it. Yet I do not wish to end my remarks on a carping note. The natural gas industry has shown the courage to undertake tremendous tasks and the ingenuity with which to overcome formidable obstacles. I am confident that its financial problems will be met in the same aggressive manner and with eminent good sense.