REDEMPTION RESTRICTIONS IN UTILITY BONDS

Address of

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before

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It is unnecessary in introducing this subject for me to do more than to remind this audience that any issue of utility debt securities which is to be sold to the general public must be registered with the Securities and Exchange Commission pursuant to the Securities Act of 1933, and that such securities of a holding or subsidiary corporation which is subject to the Public Utility Holding Company Act of 1935 must also receive affirmative approval in an order of that agency. Thus, the Securities and Exchange Commission is in a unique position to observe trends and developments in policies and fashions in utility bond and long-term note issues. One of such developments which is of interest to the Commission under the 1933 Act and which is a very important consideration under the 1935 Act is the current tendency on the part of some utilities to include among the provisions of the corporate indenture an agreement not to refund a bond issue at a lower rate of interest for a definite period of time, usually five years, or else not to redeem it at all during that time.

No specific indication has come to our attention as to the origin of this practice. As a matter of fact, it has been extended to some industrial and foreign government issues. It is probable, however, that some institutional investors have taken the position that they would like to have such a freeze included in the indenture in order that they will not be required to change their portfolio during whatever period is agreed upon. We have also received indications that certain underwriters acting sometimes as financial consultants have developed more or less of a practice of advising utilities who seek their advice and who are about to make an offering of senior securities to include such a provision in the terms of the issue.

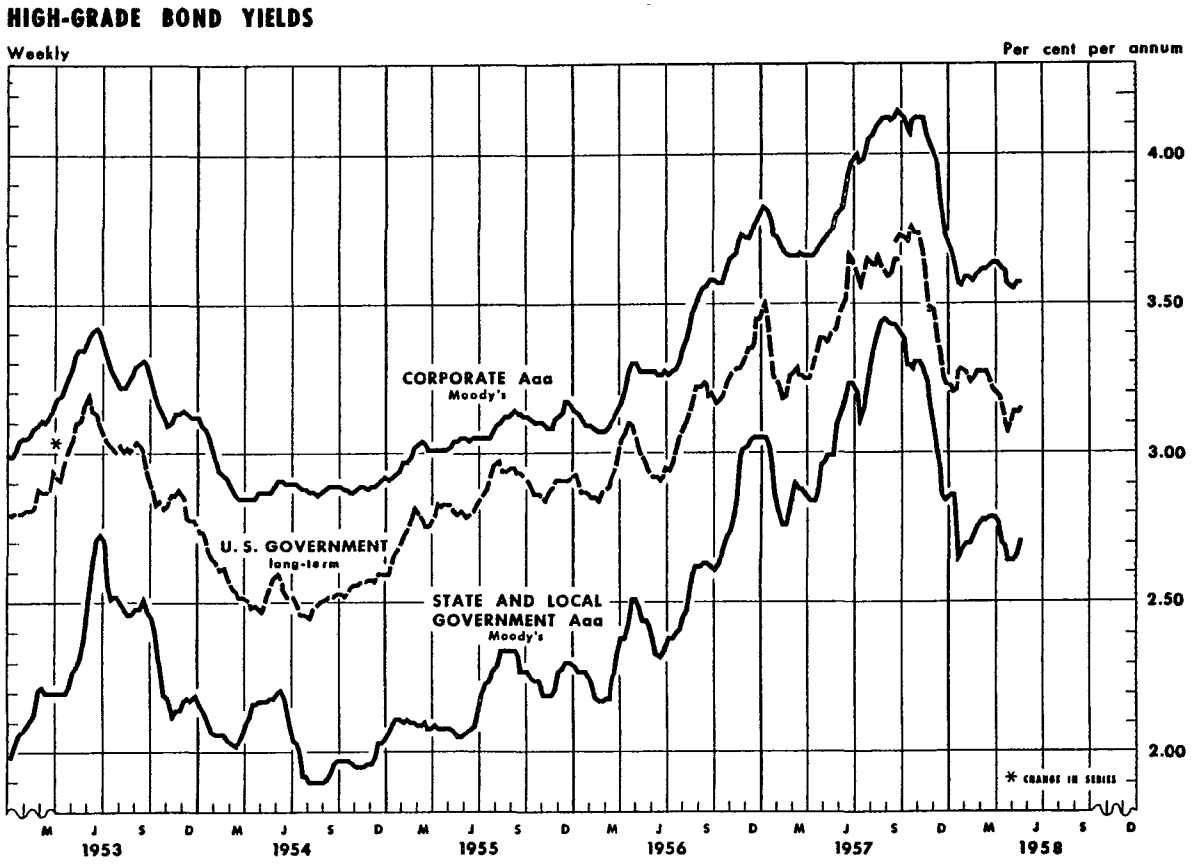
In the early history of corporate bond financing, it was common to omit any provision for calling the bonds prior to maturity to avoid payment of further interest. Dewing has noted, however, in his Financial Policy of Corporations that since 1910 most bond issues have contained some call provision. Back in 1941 we made a study of bond issues registered with the Securities and Exchange Commission for the years 1937 to 1941 and found that 97 per cent

of the 230 issues then marketed were callable. Of course, the fact that a bond issue is callable on some terms and for some purposes is only part of the story. We are here concerned only with callability for refunding and at no more than a reasonable premium, if any. Nevertheless, it seems clear that there has been a long-term historical trend away from restrictions on redemption. Despite this trend, we have seen in the recent period of rising interest rates, a resurgence of non-call provisions in utility issues submitted for competitive bidding.

This provision seems to have been first revived in May, 1957, in connection with an issue by New York State Electric and Gas Corp., at a time when bond interest rates were relatively high, and in fact were at a point where the thoughtful analyst could very easily conclude that some form of fiscal relief would be forthcoming in the not too far distant future.

It might be well at this point to recall the fluctuations in bond interest rates illustrated by the following chart:

Table I



Notes: (1) Corporate and U.S. Government bond yields are based on weekly average of daily figures; State and local government bond yields are based on figures for same day of each week.

(2) Average terms of bonds are: corporate bonds 25-26 years; U.S. Government bonds (due or callable) 10 years or more; State and local government bonds (consisting only of general obligations bonds) 20 years.

The Securities and Exchange Commission has no jurisdiction in this respect over indenture provisions of manufacturing companies or of utility companies which are not subject to the Holding Company Act. As to utilities which are subject to the 1935 Act, however, the situation is somewhat different. Section 1(b) of the Act declares that the national interest and the interest of consumers of electricity or gas are or may be adversely affected by lack of economies in the raising of capital, and machinery is thereafter set up under which the consent of the SEC is required before bonds may be issued. In accordance with this mandate, the Commission has been concerned with indenture provisions restricting the ability of utilities to call their bond issues or providing for redemption premiums which are so high as to preclude any reasonable possibility of refunding at lower interest rates. In two cases in 1953, this position was clearly set forth. For example, in the Indiana & Michigan Electric Company case (35 S.E.C. 321, 326) it was stated that:

> "It is our opinion, however, that non-redeemable features in senior securities, even though the period of non-redeemability is as short as three years, should not be resorted to as a means of reducing the cost of money, and we shall in the future insist that all reasonable efforts be made to keep this undesirable feature out of financing programs."

The other case to the same effect was Arkansas Louisiana Gas Company (35 S.E.C. 313).

This position was officially adopted in a Statement of Policy issued as Holding Company Release No. 13105 dated February 16, 1956, in which it was announced that bonds issued under that Act must be redeemable at any time on payment of a reasonable redemption premium. While no formula is stated in this publication, the Commission has followed a rule-of-thumb that the initial redemption price should not exceed the initial public offering price plus the interest rate. For example, if the bonds are offered to the public at 101 and bear a 4-1/2% coupon, the initial redemption price may not exceed 105-1/2, and the 5-1/2 point premium must thereafter be reduced pro rata to maturity. Generally, we propose to adhere to this formula -- which, I might add, actually has a certain amount of built-in flexibility in it by reason of changes in interest rates -- until we are presented with a special or unusual situation which makes its application an unreasonable hardship.

This policy was adopted after taking into consideration the expense which an institutional investor incurs when it changes its portfolio. It was felt that the most which the investor ought in good

conscience to demand as a penalty for premature redemption would be a full year's interest on his investment.

In connection with non-utility issues, if interest rates fall while the corporation is restricted in refunding its outstanding debt securities, the freeze provision does harm to no one except the stockholders of the corporation. But in connection with utility issues the interest of the consuming public presents an additional and different consideration. Even though the Holding Company Act does not give the SEC jurisdiction over utility rates, it does direct us to protect the consuming public against being required to support unreasonable interest costs. We are firmly convinced that reasonable redemption provisions are essential to that end. The Holding Company Act, however, encompasses only about one-fifth in assets of the privately-owned electric utilities and somewhat less than that proportion of the privately-owned gas utility companies, and does not cover other types of utilities at all. Consequently, for the large segment of the utility industry not subject to our jurisdiction, this protection can come only from intelligent utility management attitudes or from the efforts of State or other Federal agencies having appropriate jurisdiction.

Let us look at a few examples of just how this all works out as a practical matter. On May 5 last, New Jersey Bell Telephone Company opened bids on a $30 million issue of debentures not subject to the Holding Company Act. Four bids were received, the best bid resulting in a cost to the company of 3.87%. The debentures were rated Aaa, and are callable during the first three years at the public offering price plus 5%. This is not in strict accordance with the SEC formula, but it is far from a five year freeze provision. The purpose of the issue was to refund a previous issue in the same amount dated September 1, 1957, due in 1993 and carrying an interest rate of 4-7/8%. This previous issue had been floated on terms which resulted in a yield to the company from the refunding of 4.47%. The refunding thus resulted in a saving to the company's customers of 0.60% per year on $30 million for thirty-five years. This figure amounts to $180,000 a year or to $6,300,000 for the thirty-five year period of the bonds. The original purchaser of a $1,000 bond of the 1957 issue, who paid a premium of $21.46, received $50.00 in net premium for the trouble of changing his portfolio after a lapse of eight months - not a bad solace, it is

submitted. I recognize, of course, that the more sophisticated long-term investors, who have the continuous problem of investing and reinvesting their moneys, regard this additional compensation of $50 as being merely additive to the reduced amount of interest income they will earn on the new issue for the remaining period of years of the old issue.

Another example of what I have in mind is found right here in New England. You will recall that when the New England Electric System formed the now Merrimack-Essex Electric Company in 1957, it was found necessary to pay off some existing bonds of two of the constituent companies in principal amount aggregating $8,750,000, which had been floated in a favorable market and bore interest rates of 2-5/8% and 3-3/4 % respectively. The new company was obliged to pay 5-5/8% on the new bonds, which were subject to SEC approval and which, under our rules, had been put up for competitive bidding. However, just about six months later, on May 15, 1958, there being no bar to refunding, Merrimack-Essex was able to refund these bonds at a call price of 107.46 with an issue bearing a coupon rate

of 4-1/2% and an interest cost of 4.40%, netting the company a saving of some 73 basis points, or an aggregate of $146,000 a year.

Our staff has made a study of all electric, gas and telephone utility refunding issues offered publicly for the five years from January 1, 1953 to May 15, 1958. This tabulation covers 49 of such issues, nearly all of which refunded issues floated less than five years before, and all of which, with some immaterial exceptions, resulted in substantial savings to the utility companies involved. The total principal amount of the issues refunded was about $871 million. While there were a large number of such issues in 1954 and 1955, a period during which as we find by reference to Table I interest rates were at a fairly reasonable level, there were no refunding issues (except for Merrimack-Essex, a special situation) from August 18, 1955 when money costs began to climb to April 14, 1958, when such costs had very definitely eased off. The average interest savings per year, before expenses, resulting from these refundings amounted to one-half of one percent or an aggregate of over $4.3 million, surely not an inconsiderable item

in the total annual cost of utility services to the American public. This study, of course, covers only one period of changing interest rates. There have been other times when the same tendency to float refunding issues has been a prominent factor in the financial market, notably during the first three years following World War II.

One interesting observation is that the first company to take advantage of the recent easing of interest rates was the New England Telephone & Telegraph Company which refunded on April 14, 1958, an issue of $35 million of 4-3/4% bonds dated January 1, 1957, out of the proceeds of an issue of 4% bonds, resulting in an annual saving in interest to the utility of 0.47%, which equates to $164,500 a year. It is disconcerting to observe at this point, however, that, in spite of the economies made possible by the call provisions of the 1957 issue, the 1958 issue, for some reason, is not refundable for five years.

This last observation is doubly noteworthy in view of the experience of this particular company with non-callable bonds. During the year 1941 the New England Telephone & Telegraph Company had, as a part of its capital structure, two series of outstanding bonds, a 5% issue dated June 1, 1922 in the amount

of $35 million, due in 1952, but not callable until 1949, and another issue of 4-1/2% bonds dated May 1, 1926 in the amount of $40 million, due in 1961 but not callable until May 1, 1958. In 1941, the 5's of 1952 sold at a high of 127-5/8, and the 4-1/2's of 1961 at 131-1/4. If the company had been free to refund these bonds at that time, it could have done so at a cost of debt money of somewhere around 3 per cent. If we assume this figure for the sake of argument, and also assume that it would have been necessary to pay a few points redemption premium, such a refunding would have resulted in gross interest savings to the company of well over $1,000,000 a year from 1941 until the original maturity of the first issue and over $500,000 a year thereafter until the maturity of the second issue. I am certain that any State Commission in the area would have been very pleased to have seen the New England Company's annual expenses diminished by this amount. This would seem to be a fairly good object lesson in the disadvantages to the utility in permitting itself to be argued into inserting any provision of this nature into the indenture.

Shortly after the SEC adopted the Statement of Policy to which I have referred, we began to receive complaints from various utilities whose issues were subject to its jurisdiction, that investment bankers were putting pressure on them to apply for a modification of this policy. Not caring to trust entirely to our own judgment, we thereupon consulted a couple of other and possibly more learned governmental agencies to see if there were some factor we had overlooked. These agencies confirmed our analysis of the situation and all finally agreed that it was very desirable to have complete flexibility in the contractual arrangements for debt capital, including the redemption of debt capital, and that provisions restricting refundability were undesirable and unnecessary, provided:

(1) that the cost of the issue to the utility was not thereby unduly increased; and

(2) that there was not thereby occasioned a restrictive effect on marketing the securities.

At that time, the Commission reviewed the evidence of market reaction to securities carrying a redemption freeze, and found itself unable to

conclude that such securities were either substantially less expensive or attracted more investor interest than those not so limited.

However, we at the Securities and Exchange Commission like to feel that we are part of a dynamic economic system, and that one of our principal functions is to expedite the free flow of capital within the framework of the law. We realize that conditions change as the years go by, and that policies which are quite sound in one economic situation may in time become unduly repressive or restrictive as various factors influence the economy. Consequently, it seems important that we review our policies continually on an over-all basis, and with some particularity when the occasion seems to demand. Accordingly, our staff has made another and more current analysis of actual market operations recently to see whether our findings in 1956 and 1957, under one situation as regards the available supply and cost of capital, are still valid in 1958, under another and rather different situation.

Before I go into any detail, let me remind you of the difficulties inherent in a study of this nature. As any elementary textbook on financing will point out, there are very many factors which influence

the market price of securities, and a redemption restriction is only one among many possibilities. No two bond issues are exactly alike, even though they may enjoy identical ratings, be in the same principal amounts, bear the same maturities and be identical in every other mechanical respect. The investor may still find differences in the coverage, the character of the management or the economy of the territory served which will influence him in deciding how much interest he will demand on his money, i.e., how much he will pay for the security or, for that matter, whether he will buy it at all. It is, I repeat, extremely difficult to isolate any given factor and say with any assurance at all that that particular factor has had any weight at all, and a fortiori that it has had an influence which is measurable. Consequently, no matter what conclusion may be reached in a survey of this nature, it is extremely doubtful that the evidence will affect the attitude of anyone who is predisposed, even by some purely visceral reaction, to take a contrary view.

In the study to which I have referred, which was carried on at the Commission's suggestion by Mr. J. Arnold Pines of our

staff, the data were, naturally, quite limited. Since the more general use of the freeze provisions dates back only to May, 1957, as I have observed, it is reasonable to compare only issues floated since that time. The cut-off date used was March 31, 1958. During this period there were some 88 electric and gas utility issues placed on the market under competitive bidding, of which 68 were refundable and 20 were non-refundable. The 68 refundable issues aggregated $1.221 billion in principal amount, and the 20 non-refundable issues aggregated $676 million.

Admitting that such limited data would not justify any very strong conclusions, it is still interesting to note that an analysis by months and by ratings shows 13 instances where a comparison is feasible between the average cost of money for refundable issues and for non-refundable issues. In five of these instances, the refundable issues had a lower average cost of money and in eight of them, the advantage lay with the non-refundable issues. Considering the various other factors observable in the data, this ratio seems extremely close, and does not appear to furnish any basis for concluding that the presence of a freeze provision on refundability necessarily carries with it any advantage to the issuer in the cost

of money. Most certainly, the difference is so slight as to indicate that a relatively small decline in interest costs during the period of the freeze, once the initial redemption premium is discounted, would result in prejudice to the company floating such an issue. The only conclusion to which we can arrive from this admittedly sketchy sampling is that the inclusion of a provision against bond redemption, at least for the five-year period which is the current fashion, has no visible effect on the cost of money to the issuer.

There remains the question of the effect which the inclusion of such a provision has on the acceptance in the market place of the bonds. This question divides itself into two subsidiary questions, to-wit, does it have any effect on the number of underwriters willing to bid for the issue and, secondly, does it facilitate the retailing of the issue by the selling group?

The importance of the first of these questions lies in the necessity for having a free wholesale market for utility bonds, a necessity which was pointed up in the evidence presented in the Pecora investigation of the early 1930's, and which underlies and forms the basis, in any aspect of the matter, for evaluating even

a negotiated transaction from the utility and the public point of view. If there are no bidders, of course, the issue never gets off the ground. If there is only one bidder or if there is what might be considered an inadequate number of bidders, then the basic reason for requiring competitive bidding is inapplicable, and there is no assurance that the cost of money so arrived at is at the normal market. From this point of view as well, our studies indicate that the presence of a freeze provision is given little, if any, weight by the underwriters when the chips are down and it is necessary to decide whether or not to place a bid for an issue.

Here again, it is obvious that the number of bids received on a particular issue is affected by such relevant considerations as the quality of the issue, its size, the appeal for other reasons of the issue to investors, its timing in terms of such factors as the current market conditions, the number of issues expected to appear in the near future, the current inventory of the underwriters and many other factors. Notwithstanding these variables, it seems reasonable to assume that their presence or absence will tend to cancel out if there is a sufficient sample. It can hardly be maintained that the 88 issues which appeared during the study period constitute

a definitive or even perhaps a wholly adequate basis for drawing any very emphatic conclusions. Nevertheless, such statistics are at least some evidence and perhaps might be considered sufficient to shift the burden of proof to one who maintains the opposite.

The data for the issues included in the study are presented in Table II.

Table II

	Number of Bond Issues	
	Refundables	Non-refundables
One bid	2	-
Two bids	6	2
Three bids	12	6
Four bids	20	4
Five bids	10	6
Six bids	12	1
Seven bids	5	-
Eight bids	1	1
Totals	68	20

The weighted average number of bids in the above table on refundable issues was 4.34, and on non-refundables it was 4.10. The median number of bids for each group was the same, i.e., 4. We have been compelled by these statistics to conclude that the answer to the first of our questions is, at least prima facie, in the negative.

As we view it, we cannot stop with the bonds in the hands of the underwriters. It may be that the underwriters had their own reasons not connected with the merits for placing bids on such issues. The underwriters, let it be clearly understood, are in business to make a profit, and they cannot realize a profit unless the securities they purchase are successfully placed with the public. In this, they are no different from any wholesalers or, in a selling group, from any retailers. Securities in inventory do nothing but tie up the underwriters' working capital. If their capital could not be used to better advantage than to collect accruing interest, there would be little to be gained by going out of the investment field and into the underwriting field. Consequently, we are forced to come to the second subquestion I have posed: does the investing public buy with a satisfactory degree of eagerness utility bonds which may be refunded at any time, or are such bonds as a rule "sticky" and apt to remain for unsatisfactory periods on the dealers' shelves? With the same caveats expressed previously as to the adequacy of the data and as to the presence of other unrelated influences, our studies show no visible effect of such a provision on the marketability of utility bonds.

As a matter of definition, I think we are justified in regarding as a successful placement any offering of which, at the termination of the syndicate, at least 95 per cent has been sold at the syndicate price, or, conversely, in which not more than 5 per cent of the issue goes onto the shelves for sale without syndicate support. Of the 68 refundable issues included in our sample, 79.4 per cent were successful according to this definition. In terms of principal amount, 78.2 per cent of these issues were successful. By the same definition, 80 per cent in number and 88.3 per cent in amount of the non-refundable issues were successfully marketed. To what extent this latter percentage figure would be affected by having a larger sample of non-refundables is, naturally, entirely conjectural. However, we cannot deduce from these data that the presence or absence of a freeze has any especial significance, let alone a controlling influence, upon the success of the offering in any particular case, and we are compelled to answer the second of our subquestions also in the negative.

The subject of the effect of indenture provisions which delay or impose excessive terms on redemption is the subject of a special study which is being conducted currently under the auspices of the

Wharton School of Finance and Commerce of the University of Pennsylvania. Mr. Pines is a member of the committee which is conducting this study. I am given to understand that it covers substantially wider ground than our own, and is expected to be completed this year. Although the study is still in progress, and I have no knowledge of what it will show when completed, I would indeed be surprised if it produces results which are substantially inconsistent with what I have said here today.

Having borne with me so far, I think you are entitled to know why, aside from considerations of self-justification, I am placing these figures before you, in particular.

I began this discussion by pointing out the limited jurisdiction of the Securities and Exchange Commission over this question, and the broader jurisdiction of the State Commissions. We believe that it is to the advantage of the general public that any tendency of the financial community further to insist upon such indenture provisions be discouraged. It must be borne in mind that the data I have presented have been developed in an area in which the refundables outnumbered the non-refundables by over three to one in terms of

number of issues and by nearly two to one in terms of principal amount. The fact that the two types of issues do not, on the whole, produce particularly dissimilar statistical results may in some measure be due to the fact that institutional investors, under such circumstances, have not always had at any particular time a completely free choice -- assuming they have wished to invest in public utility bonds -- in the commitment of their funds for investment as between refundables and non-refundables.

On the other hand, if the practice of including a five-year freeze on refundability were to become much more widespread than it now is, so that the number and the dollar amount of refundable issues were to constitute only a minority of the total number and dollar amount of all bond issues which are marketed, then the institutional investors would have a freer choice than they now have in the commitment of their funds for investment as between the two types of issues. The result might very possibly be that refundable issues would then be at a disadvantage vis-a-vis the non-refundables from the standpoint of the relative chances of success or failure in the public distribution, the number of bids received and the cost of money to the issuer.

I am presenting this situation, therefore, to you in your capacity as regulatory officials of the States. I know that you are interested in protecting the utilities under your jurisdiction from being compelled to conform to financial policies which would be expensive to the utilities and to their customers. If the State Commissions will join the Securities and Exchange Commission in insisting that the institutional investors be reasonable in their demands upon the issuers of utility bonds, all of us who are charged with the duty of protecting the public can more effectively perform our respective duties. I am suggesting a substantial degree of collaboration in this field between the Securities and Exchange Commission and the State Commissions generally, and the New England Commissions in particular, leading to uniform treatment of applications of this nature. This is another case where, if we don't hang together, we may hang separately.