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SECTION 11 AND A STRONG UTILITY INDUSTRY

ADDRESS

of

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before the

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Section 11 And a Strong Utility Industry

It is a great pleasure for me to be here with you today and to have the privilege of discussing with you certain aspects of the electric utility industry's development over recent years. As the title of my remarks suggests, I want to survey with you the sweeping changes in the financial and organizational structure of the industry which have been brought about under the Holding Company Act. To my knowledge, no American industry has undergone so thorough an overhauling as that experienced by the utility industry during the last ten years. This has come about none too soon, for the industry has been confronted with the necessity of financing a construction program of tremendous proportions. While the rate of future growth will depend, of course, on the ebb and flow of the business cycle, it is nevertheless an unchallenged fact that electric utilities must plan their financing in the light of long term prospects of substantial growth. The last great financing effort, in the 'twenties, had to be carried out within the framework of the holding company systems. When holding companies failed to provide equity capital, both they and their subsidiaries were forced to issue senior securities to such an extent that overstrain and collapse of whole systems followed in many instances.

Can the forms of corporate structure evolved in the last decade meet the great demands now being put upon them? Can they raise the necessary funds and can they carry the resulting burden without faltering? I believe they can. There is still work to do; some utility systems still contain corporate snarls, but by and large the industry is in a position not only to finance its needs but to finance them soundly.

It is a matter of record that during the depression years, net operating revenues of the electric industry held at levels only moderately below the best attained during the 'twenties. Yet no less than 128 companies, including 52 operating companies, were forced into bankruptcy, receivership, or

extension plans between September 1, 1929 and April 15, 1936. Arrearages on preferred stocks of holding companies reached $282,000,000 by the end of 1938, and operating company preferreds had arrearages of another $140,000,000. Most of these difficulties were not, I repeat, traceable to any substantial decline in operations but rather to capital structures with very small amounts of common equity; they were greatly aggravated by uneconomic combinations of property and the general attitude of exploitation which for a time was so prevalent.

Against this background, the Holding Company Act was enacted for the purpose of eliminating evils and abuses which had figured so prominently in the collapse of one utility empire after another in the early thirties. It sought to eliminate holding companies serving no useful purpose and to limit systems to physically integrated properties. The Act also called for elimination of undue complexities in corporate structures and for redistribution of voting power among system security holders on a fair and equitable basis. Security transactions, purchases and sales of assets, servicing arrangements and most other aspects of a holding company's relationship with its subsidiaries were likewise subjected to control under the provisions of the Act.

Many of you, I am sure, have seen at first hand the invigorating effects which have flowed from application of these provisions. The management of many an operating company can now do its own planning; it can hire legal, banking, or servicing assistance of its own choosing, from its local area or elsewhere, according to the company's own needs and the community's requirements. It can respond directly and without restraint to the fair demands of the public and of regulatory bodies. It need not await the instructions of a remote super-management, nor is it dependent upon the favor or chance recognition of such a management in order to be properly rewarded for its services. These prerogatives may now be taken for granted. It was not always so.

Before examining further the nature of the last decade's developments, I want to make one thing clear. To be sure it is the SEC which is charged with responsibility for seeing that the changes called for by the Holding Company Act are brought about. It would be most unrealistic, however, to attribute solely to the Commission the credit for the progress made in that direction. While I do not mean to imply that all has been sweetness and light, most of the industry has in fact done a great deal of constructive thinking and has seen much of it translated into action.

Ten years ago, very few of the country's electric utility companies were not enmeshed in one or another of the holding company systems. The independents included a few large metropolitan companies, certain long-established utilities in New York and New England, and the barest scattering over the rest of the nation. The overwhelming majority had been bundled up in holding company packages. Many of these packages were wondrous conglomerations indeed. It is not too surprising that water, telephone, ice, street railway, coal, oil, real estate, investment, or appliance sales companies had been mixed in with electric and gas utilities during the mad pyramiding of the 'twenties. But the list does not stop there. There were manufacturers of brick and tile, iron fence, wood products, paper. There were companies operating farms, quarries, gas stations, parking lots, theaters, amusement parks and even a laundry. There was a cold storage company operating in Alaska, and there was the New Orleans Baseball Company, Incorporated.

More than a thousand of these miscellaneous non-utility companies have been a part of holding company systems at one time or another during the last ten years; some seven hundred of them have by this time been dissolved, divested, or otherwise removed from registered systems.

Aside from non-utility properties, an electric or gas company frequently found itself packaged with many distant cousins. No less than a dozen systems held operating properties in ten or more states; one system spread over 33 states and another over 29. Various rationalizations were produced in times past for the policy which led to the accumulation of such scattered utility properties and so many diverse types of non-utility businesses. "Diversification of risk" and "efficiencies of centralized management" were among the glib justifications advanced for practices which in fact proved to have an exactly opposite effect. Congress recognized this fully; scattered properties and unrelated businesses were therefore outlawed from the new, integrated type of system contemplated by the Act.

Something over 900 utility companies were controlled by holding companies at the time of their registrations under the Act. By this time, over six hundred of these have been freed from holding company control. Where have they gone and who owns them now? The answers to these questions are both interesting and revealing, and I should like to examine them briefly.

From June 15, 1938 to April 30 of this year, 632 electric and gas companies were eliminated from holding company systems. Of these, 293 were eliminated by merger, dissolution, and certain other less frequently used means. These transactions have been primarily intra-system: that is, assets were reshuffled and were consolidated in fewer companies, but the assets were nevertheless retained within the system. Divestments, which constitute actual disposition of assets by a holding company, have accounted for the remainder of the total eliminations.

Limiting our attention to the electric companies involved in the divestment program, 210 such companies have been completely severed from holding company systems. An additional 124 electric companies have also been divested by one or more holding companies but remain subject to the Act by reason of their relationship to still another holding company. The majority of these latter companies will continue under the Act as members of integrated systems. I should like to analyze more closely the manner in which the disposition of this entire group of 334 electric companies, with assets of nearly $9,000,000,000 has taken place.

In point of size, the largest segment of assets divested is represented by distributions by holding companies to their own security holders. Forty-nine companies with assets of $2,600,000,000 are no longer subject to the Act as a result of outright distributions of this nature. The full role of distributions has in fact been much larger, for the securities of 95 additional electric companies, with assets of $2,260,000,000, have figured in exchange and distribution plans without, however, ceasing thereby to be subject to the Act.

More than a third of the divested assets have been sold directly to the public. The common stocks of 49 companies have been sold in this manner and sold, moreover, at prices which represented very little discount from going market rates for comparable seasoned securities. Over the last ten years the public has purchased a total of $3,250,000,000 of electric company securities in connection with the divestment program.

These first two types of disposition together account for 90% of electric utility assets divested. The remainder is made up of sales to public authorities, other utilities, and to individuals and non-utility companies.

Sales to other utilities have involved small companies almost exclusively. Forty-eight companies have been purchased in their entirety by other electric companies and 26 have sold a part of their properties to such companies. Aggregate assets of $360,000,000 have been sold in this way, primarily to larger companies able to integrate the smaller company's operations with their own. Integration of operations has been achieved in numerous other instances through mergers and consolidations. The emerging picture is generally something like this: companies large enough to stand on their own feet have usually found their way into the hands of investors, by sale, exchange or distribution. Smaller units have been sold to or merged with larger ones, or have been purchased by public authorities and individuals.

As indicated earlier, somewhat more than two-thirds of the electric and gas subsidiaries of registered holding companies have already been divested. Many of those remaining will also be divested. However, the Act is not, as frequent misconception has it, a completely self-liquidating instrument, but provides for continuing regulation of integrated interstate holding company systems. Among systems which will remain subject to the Act might be mentioned American Gas and Electric Company, Central and South West Corporation, The Southern Company, New England Electric System, Middle South Utilities, and West Penn Electric Company. I would like to look briefly at a few of the systems and point out some of the more striking changes which have been brought about in them during recent years.

Central and South West Corporation, for example, was evolved from the Middle West Corporation System, which in turn had succeeded Middle West Utilities Company. When Middle West Corporation registered under the Holding Company Act in December, 1935, it had just emerged from the bankruptcy

proceedings of its predecessor company. Its registration statement indicated that it had 152 subsidiaries, including 62 electric or gas utility companies and fifteen sub-holding companies. Sixteen of the 152 subsidiaries were themselves in process of reorganization under the Bankruptcy Act, and these in turn controlled an additional 74 of the system companies.

The bankruptcy proceedings cut through much of this corporate jungle, and Middle West itself did a great deal of pruning in pursuance of Section 11 requirements. Many of the smaller properties were sold or merged with other companies in the system. The common stock of large units such as Central Illinois Public Service Company, Kentucky Utilities Company, Public Service Company of Indiana and Wisconsin Power and Light Company was distributed to Middle West's stockholders.

Middle West is now well on the way toward liquidation, leaving behind it a number of well-regarded independent operating companies and the Central and South West system. This new system is limited to four electric utility companies of substantial size. Central and South West itself was formed by merging two sub-holding companies which between them had four outstanding issues of 6% and 7% preferred stock with dividend arreages totaling about $16,000,000. These shares were retired at the redemption price plus accrued dividends as a result of the merger. As compared with combined common equity of 9.5% prior to the merger, the new system had consolidated common equity equal to 29.5% of total capitalization and surplus. Central and South West has since been subjected to the test of marketing additional common stock and has successfully raised $6.5 million in this way.

New England Electric System provides one of the best examples of corporate simplification and redistribution of voting power. Its predecessor, New England Power Association, was controlled to the extent of 51% by International Hydro Electric System. New England Power in turn controlled five subholding companies. A plan filed under Section 11 (b) (2) of the Act set up New England Electric System as a new holding company and its stock was distributed to International and to security holders in all six of the old holding companies. As a result, a single issue of debt and common stock replaced eighteen securities of the old system. The interest of International was reduced to 8% of the voting power; International is subject to an order directing it, among other things, to dispose of its interest in New England Electric.

One of the most striking examples of overall improvement has occurred in the system of Electric Power & Light Corporation, itself a subsidiary of Electric Bond and Share Company. At the end of 1935 Electric Power & Light had 31 subsidiaries, of which 10 were in a "great grandchild" position and one in that of a "great great grandchild". The system had 39 publicly held bond issues and 19 publicly held issues of preferred stock. Dividend arrearages on the subsidiary preferreds amounted to nearly $18,000,000 and reached $23,000,000 by the end of 1938, not to mention the huge arrearages on Electric's own preferreds. So complex was the system financial structure and so burdensome were the publicly held securities that Electric's interest in gross income was only 10.6%. As divestments have occurred, Electric has invested the proceeds in its remaining subsidiaries. In 1948 the system's gross income was nearly 50% greater than in 1935, despite the disposition of over

half its subsidiaries. The point of real interest, however, is the fact that Electric's 10.6% equity in the gross income of 1935 had grown to an equity of 68.7% in the gross income of 1948. By reason of this improvement it was possible to set up a soundly capitalized and independent system headed by the new Middle South Utilities, Inc. to control Electric's utility properties in Arkansas, Mississippi and Louisiana.

A substantial proportion of the integration and simplification program -- certainly more than half -- is now completed. We can now say with assurance that the prophecies of sacrifice prices, forced sales, and other alarms raised before Congress in 1935 and in the early days of the Act have proved groundless. As the Senate Committee which reported on the Act predicted, holding company investors have come out of the reorganization process with far better securities than those with which they went into it. They have obtained securities which represent a down-to-the-rails investment in local operating companies or regulated regional holding companies in substitution for highly-leveraged and speculative holding company securities. These benefits to holding company investors are not merely theoretical; they are supported by the judgment of the market place. The mere announcement by management of the filing of a major Section 11 plan and particularly the actual consummation of such a plan have customarily been followed by a pronounced rise in the market price of most -- and sometimes all -- of the securities involved in the reorganization.

The last ten years have, in fact, represented a period in which operating electric companies have become almost incredibly stronger and healthier. More than $1,300,000,000 of inflationary items have been eliminated from

plant accounts; ratios of depreciation reserves to gross property are up 150%; interest coverage has increased from 2.9 times to 4.3 times and coverage of all fixed charges and preferred dividends is up from 1.9 to 2.7. Arrearages on preferred stocks have been virtually eliminated. While total debt and preferred stock has increased by less than 4%, generating capacity has been increased by 50% and generation is up 150%. I do not wish to minimize the effect of general economic climate in bringing about this improvement; at the same time I believe it is entirely fair to ascribe a great deal of this financial improvement to the salutary effects of the Holding Company Act.

As I have indicated, Section 11 has gone far to place the industry in a position to finance its expansion soundly. Electric utilities which have been divested and are now independent have demonstrated their ability to command the confidence of the investing public. A holding company with an integrated system can also -- and most certainly should -- assure its system a strong capital structure. Where the subsidiaries are wholly-owned, with no senior securities in the hands of the public, the holding company may properly issue its own notes or debentures in appropriate amounts. Some $125 million of such securities have been sold since the beginning of 1948 and have been well received by investors.

If the subsidiary companies have themselves issued senior securities to the public, as is usually the case, the task of the holding company is largely confined to providing common stock equity. This is not always an easy task. Until quite recently, a new-money offering of holding company common stock was something known only to history. The response from the investing public, however, has been quite encouraging. The real hurdle, in fact, is not the investor's willingness to purchase holding company stocks; it is, instead, the

frequent reluctance of holding companies to offer additional stock for sale. This reluctance does not appear to originate with holding company managements, although there are exceptions. Primarily, it springs from a peculiar species of stockholder group. A few years ago, in particular, the uncertainties of reorganization plus general market factors sometimes resulted in very pessimistic appraisals of holding company securities. This situation encouraged speculative purchases by persons and groups seeking capital gains. These gains were frequently forthcoming, and in many cases were quite substantial. One might suppose that stockholders interested in speculative possibilities would be prone to take their profits and move elsewhere. Some, of course, have done precisely that. There remain, however, substantial stockholder groups who wish to see holding company securities retain a speculative flavor. In order to minimize their own personal income taxes, they prefer to see earnings stay in the business rather than to be paid out as dividends. They are bitterly opposed to increasing or even maintaining the equity base through sales of additional stock. Most of them wish to see senior securities heaped upon the financial structure to increase the leverage inherent in their common stock position. Some of them go so far, in fact, as to advocate curtailment of new construction so that new capital issues may be kept to a minimum. In brief, they wish to prevent holding company stocks from achieving genuine investment status -- a status based on adequate and stable dividend income rather than upon sharply fluctuating market movements. While these groups ordinarily represent no more than a relatively small minority, they frequently exercise a disproportionate influence upon the financial policies of management.

Needless to say, the SEC will fight this tendency wherever and whenever it appears. The purposes of the Holding Company Act would indeed be poorly served if integrated holding company systems were painstakingly created, after long and difficult effort by managements and the Commission, only to be turned again into topheavy vehicles of speculation. This must not be.

The heavy demand for funds placed upon the industry by its construction program has subjected the philosophy of Section 11 to a concrete test. Fundamentally, the mark of a soundly organized industry is its ability to raise funds, which is in turn the ability to command the confidence of investors. Obviously, an adequate portion of these funds must be in the form of common stock if investor confidence is to be retained over any period of time. Thus far, the industry has met the test. In recent months we have all been encouraged by the increasing flow of equity money. I think it is quite clear that the industry of ten years ago could not have carried off this huge financial operation. Few holding companies could have raised funds, and most operating companies would have been effectively limited to senior securities, if, indeed, they were in a position to market securities of any sort. Through Section 11, scores of individual companies were placed firmly upon their own feet and many holding company systems have been soundly reorganized. Far from becoming saturated during the process of transferring operating company ownership directly to the investing public, the equity market appears to have been both educated and stimulated.

Generally speaking, the industry is to be commended for the soundness of financial structure which it has maintained. There are only a few companies in the entire industry which have shown significant deterioration in capitalization ratios. While debt ratios tended to rise during 1948, they were generally held within bounds and have shown some tendency to level off thus far this year. Retained earnings have played a large part in keeping equity

ratios on an approximately even keel; actual sales of common stock, last year and this, have equaled less than 10% of total funds raised for new money purposes. So long as the capital structure does not suffer materially, there is perhaps no reason to view the situation with alarm. Yet I for one would feel more comfortable if common equity were actually increased during periods such as the present when investors are looking very favorably upon utility common stocks. The construction program is not scheduled for completion tomorrow or the day after. Most companies will go to the public for funds once, twice, or several times before even presently scheduled construction is completed. There is certainly no assurance that markets for common stock will continue to be as favorable as has been the case in the recent past. Many companies simply cannot afford to gamble on the future in this respect; there are maxims aplenty demonstrating the folly of taking the long chance, and I leave it to you to supply your favorite characterization.

While the industry as a whole has made an honest effort to keep capitalization ratios on a solid basis, I cannot refrain from commenting briefly upon some exceptions. For example, a few companies have attempted to resort to the lease-back device. In view of the debt structures of most utility companies, the imposition of long term leases in any substantial amount is inappropriate if not positively dangerous.

One instance of this sort concerns an electric company with a capitalization comprised of 64% debt and 36% common stock. I believe most utility managements would consider such a capital structure to have reached the upper limits of soundness. This management displayed no such inhibitions. Needing new generating capacity, the company arranged to have a station built by a corporation created for the purpose and arranged further for the new plant to be financed entirely by debt. The company then proposed to enter into a leasing arrangement, thereby, in effect, creating prior lien

debt in its own structure. Pro forma capitalization ratios: 79% debt, 21% common equity.

The story does not end here, however. Because the transaction would have involved a parent-subsidiary relationship, the company was advised that it would necessitate registration under the Holding Company Act. Thereupon the company apparently gave up its leasing plans and concocted an alternative method devoid of subsidiaries. The company now plans a private issue of mortgage bonds plus a public issue of interim notes. These notes are convertible, after about a year, into common and preferred stock; they are payable at their maturity in 1951 not in cash but in common and preferred stock at the conversion ratio.

It is most encouraging that the great majority of utility companies have taken the longer view and have refused to entertain financing policies such as those just described. You may be assured that the SEC, for its part, will continue to stand for conservative capital structures and can always be counted upon to assist companies subject to its jurisdiction in achieving balanced financial programs. Strong, individual operating companies and compact new holding company systems have emerged as a result of the Section 11 program. The industry has acquired the invaluable confidence of the investing public. If that confidence is fostered by sound financial policy, I feel certain that the days ahead will be the best in the industry's history.