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ADDRESS

of

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before the

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SCATTERATION V. INTEGRATION OF PUBLIC UTILITY SYSTEMS

Observations, based on almost three years experience with the Public Utility Holding Company Act of 1935, are, I think, in order. In the first place, we are well on our way, in spite of two years or more of litigation, towards accomplishment of many of the objectives of that Act. There has been rather wide acceptance of its standards respecting the issuance of securities and the acquisition of assets and securities. Progress has been made towards regularizing and reforming (where reform is needed) the accounting practices of public utility holding companies. A start has been made towards elimination of write-ups -- the sand on which too many holding company structures were erected. Equally worthy of note, the requirements of the Act that servicing and management contracts with associate companies be based on cost seem to have been accepted by the industry. And furthermore, though we and the industry have barely started on the problems of corporate simplification and geographical integration, we are now seriously preparing to tackle them.

In the second place and based on this experience, I can say that those sections of the Act with which we have had experience have demonstrated their workability and practicability. They have proven themselves soundly conceived. They constitute a firm oasis for mobile and flexible administrative action in a field which financiers aided and abetted by lawyers apparently have delighted in making complicated and obstruse.

In the third place, I can say that since the decision in the Electric Bond & Share case (where the Supreme Court upheld the constitutionality of the registration provisions of the Act) there has been increasing evidence of the willingness of substantial parts of the industry to go along with us -- induced by their own self-interest; by recognition of the supremacy of the will of Congress; and by recognition on the part of operating heads of the enormous constructive possibilities of the Act. With this trend continuing, the next few years should produce real action towards realization of the objectives of the Congress and the President. I am confident that it will be in large measure joint action by the industry and us working together. I am also confident that it will be action by us alone where necessary, or where no progress or sincere effort is evident.

Further experience under the Act may demonstrate that amendments are necessary. If that turns out to be the case, I am sure that we will be the first to urge them. As evidence of my sincerity in this respect I need only point to the successful advocacy on our own initiative of amendments to the Revenue Act before the last Congress, in an effort to make the way of holding companies an easier one in complying with the requirements of Section 11 of our Act. But it can hardly be expected that amendments to an Act (as maturely considered and as vigorously debated line by line as was this one) constitute the sound course, in the absence of a genuine administrative effort to make the Act work. And certainly experience has not yet demonstrated the need of amendment.

As I have implied we are (because of the delay in litigation) barely on the threshold of the problems of simplification and integration under Section 11 of the Act. Hence it is as though Congress had just enacted these provisions. But the light in the eyes of an occasional conferee at our well-known round table discussions at times reflects the hope in his breast that these provisions of Section 11 will be nullified by our inaction or that we will dodge the difficult and heavy responsibility which they impose on us by urging their repeal or substantial modification. Experience gained with practical problems may demonstrate the practical wisdom of some modification. But short of that we are bent neither on nullification nor repeal. Our round tables are designed for healthy cooperative action; not for a sabotage of a law validly enacted or for oblique avoidance of our mandate under the Act.

This is not to deny that the problems of corporate simplification and geographical integration are intensely practical and difficult ones. We recognized that in the case of American Water Works where we announced that "the problem of consummating integrated public utility systems under the Act is of necessity in many cases, an evolutionary rather than a revolutionary process. As a practical matter, it will often be necessary to accomplish the ultimate objectives of the Act by a series of steps rather than by one direct and final step." Adoption of this formula makes for workability and progress, in a field where words rather than action have been too long the keynote.

This inaction has in part been the product of misunderstanding. Prophets of disaster have usually spread alarm where great advances have been made - whether those advances were in medicine, in engineering, in finance, in sociology, or in government. There was no exception here. And in this case, alleged disaster and misunderstanding have been pronounced because a catch phrase has obscured the issues. The characterization in the heat of battle of that part of section 11 which calls for corporate simplification and geographical integration as a "death sentence" has done inconceivable harm. Publicity-wise it was clever; practically it was very damaging. It cast the shadow of a hangman's noose on a purpose and program that are constructive and beneficial. It is my hope that I can today aid in dispelling this ominous shadow. Facts, I think, will do it. I have a deep faith in the power of facts. I have confidence that a problem well understood is half solved. Once having understood a problem, the public utility industry and we can, and will devote our joint resources and intelligence to a solution.

There has been substantially no opposition to the provisions of Section 11(b)(2), which call for the simplification of complex corporate structures and the equitable distribution of voting power. Attack has centered on the requirements of Section 11(b)(1). This section provides that it is the duty of the Commission, as soon as practicable after January 1, 1933, after notice and opportunity for hearing, to require each registered holding company to limit its operations to a single integrated public utility system and to such other businesses as are reasonably incidental or economically necessary or appropriate thereto. By definition an integrated public utility system means a system whose utility assets are physically interconnected, or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system, confined in its operation to a single area or region, in one or more states, not so large as to impair (considering the state of the art and the area or region affected) advantages of localized management, efficient operation, or the effectiveness of regulation. The Commission is empowered, however, to permit a holding company to continue to control one or more additional integrated systems if they are located in one state, or in adjoining states, or in a contiguous foreign country; if each such additional system cannot be operated as an independent system without the loss of substantial economies; and if the whole aggregation is compatible with the advantages of localized management, etc.

Insofar as these provisions call for geographical integration of operating companies, they are entirely in tune with what has been a trend for many years. That trend has been evidenced not only by the extent to which operating companies have expanded but also by their mergers and consolidations in various regions. That policy of the statute is not new to the industry; its leaders have seen for some time its many virtues. Improvements in business organization and technological advances within the industry have demonstrated the economies and efficiency of unified operating territories. They have shown the value of integration based upon a sound rationalization of the industry within areas not so large as to lose local character, but not so small as to prevent the realization of engineering progress. The most casual familiarity with the utility industry as a whole will reveal that these economies frequently have been sacrificed. In large part, they were neglected in the scramble by rival holding companies to acquire local operating utilities. I need not remind lawyers of the recklessness with which this was done in those halcyon days. This business of buying properties, helter-skelter, resulted in highly undesirable operating conditions. Operating units owned by rival holding companies cut across territories in the fashion of a crazy-quilt, with the result that the power requirements of many areas were not planned or served in an efficient manner.

For example, an area in a middle western state ideally suited to the operation of a single system or at the most two systems is actually served by a half dozen operating companies controlled by as many holding companies. Waste results; power costs are unnecessarily high; returns to investors are affected; and the stability and efficiency of each of the operating units is unnecessarily diminished. Let me give one simple illustration: One of these companies recently built a new generating plant to provide for a load of less than 10,000 kilowatts. It was located somewhat less than 25 miles from a large efficient plant of a neighboring company which had ample capacity to supply this load. In all probability, if these companies were integrated, duplication would not have been needed.

Such apparently uneconomic developments often flow from the strategy of immediate expediency, nurtured by individual system rivalries. I can understand the cause of these situations without condoning their indefinite continuance. Insofar as the Public Utility Holding Company Act calls for, or will result in, rational integration, it will substantially eliminate these forces of disharmony.

An executive in the electric light and power industry recently stated to me the advantages which his system had derived for both its investors and its consumers from an integration of operating companies. He summarized these as follows:

1. It makes possible the substitution of one or more large generating stations for numerous small units, and thus introduces economies in production, while at the same time increasing capacity and insuring adequacy of supply.
2. Where territories have been integrated it is often possible to dovetail steam generation with hydro-electric generation, making the most economical use of each source.
3. Integration permits planned transmission facilities in a manner which obviates frequent and costly rearrangements of lines.

4. Where operating territories are integrated, it is possible to develop greater uniformity in rates and rate structures, to introduce on a wider and more effective scale promotional activities, and to encourage wider and more diversified use of power.
5. Under integrated operation many duplicate services and overlapping departments are eliminated.
6. If the territory of a system is integrated, there is a natural tendency toward simplification of corporate structures within the system, through consolidations and mergers, with consequent economies in corporate reports, taxes, accounting supervision and the like.
7. A sound integration of operating territories promotes sound financing of the enterprise.

But it is not geographical integration *per se* with which the Act is concerned. The Act is not aimed at operating companies as such. In terms of geographical integration it has no impact on isolated operating companies. The fulcrum of Section 11 is the holding company. It is through the holding company (and only through it) that the Act attempts to exert leverage on this problem of geographical integration. To put it simply: isolated and independent operating companies remain unaffected by Section 11; 1/ a holding company must be confined (with few exceptions) to a single integrated public utility system. Theoretically then only a part of the private utility problem is touched by Section 11. Actually it has a pervasive effect on most of the industry in view of the dominance of the position of holding companies.

The policy of the Act in restricting holding companies to single integrated systems is not difficult to divine. In the first place, it reflects the desire to diminish concentration of control in the electric and gas utility industries. In the second place (and as a corollary of the first) it is designed to promote the formation of strong regional or local operating systems - rid of absentee management and remote financial control. On this matter, the National Power Policy Committee has said:

"Numerous studies have already shown, and the report of the Federal Trade Commission further demonstrates, that the concentration of control in the electric and gas industries through the device of the holding company has assumed tremendous proportions. While the distribution of gas or electricity in any given community is tolerated as a 'natural monopoly' to avoid local duplication of plants, there is no justification for an extension of that idea of local monopoly to embrace the common control by a few powerful interests, of utility plants scattered over many states and totally unconnected in operation. Such intensification of economic power beyond the point of proved economies not only is susceptible of grave abuse but is a form of private socialism inimical to the functioning of democratic institutions and the welfare of a free people." 2/

1/ Isolated companies (rid of holding company control) may be expected to respond to technological and operating considerations in development of integrated units—perhaps in some cases to state-wide integration. This is not to mention the important realm of state regulation not affected by the Act.

2/ Report of National Power Policy Committee on Public Utility Holding Companies (1935) H.R. Doc. No. 137, 74 Cong., 1st Sess. at 4.

The fact is that the electric and gas utility industries have become essentially local monopolies by virtue of their economic characteristic; yet many of the large holding company systems have succeeded in expanding their financial and economic control far beyond any reasonable limits. In Section 11, Congress has ruled that the financial and economic power of the utility holding company must conform, roughly speaking, to the economic area of the regional or local operating monopoly. Section 11 places a natural limitation upon concentration of control, for as different systems map out their single integrated service areas and in the process acquire the scattered properties of other systems, each system's boundaries impose a limit upon the future expansion of its neighbors. In contrast, when a holding company system could pick up properties any where and such properties did not have to be geographically related there was no effective limitation upon the size of a holding company system or the number of units which it might control.

The philosophy is that while our technological advances have created economic principalities in many spheres of national activity, the size and power of these principalities must correspond with the economic or social facts. No man or group of men should be permitted to expand this financial and economic control beyond limits justified by those facts. In the electric and gas industries, as in some others, a situation which logically arose because of certain inherent, operating characteristics was pushed far beyond its logic. The local units of the electric and gas industries have been referred to by some as "natural monopolies" and they have been given peculiar legal status because of the characteristics which led to this designation. This may have been wholesome and desirable; but, if so, one of the factors which made it such was the essentially local characteristic of these industries.

Now, one of the consequences of this status was some stabilization of rate of return for these industries. But this stabilized return made these industries peculiarly attractive to those who had a lust for power and profit. These persons collected more and ever more electric and gas companies and properties and combined them into huge holding company systems. The result was not merely absentee ownership, but absentee management and remote control. An essentially local industry was managed from a far distant metropolis. It was run not merely to serve the local consumers and the people who had invested their money in that company, but as part of a huge empire. It was, so to speak, a member of a scattered family with the controlling grandparent dwelling in distant parts. The local or regional unit lived not for itself, but for all of its kin. If money were needed in any part of the holding company's system, a local company was subject to raids of one sort or another to produce that money to support the ailing members. In many instances its officers and employees were used to sell securities of its remote parent or of one of its remote brothers. Its good will was dependent not upon the local life of which it was essentially a part, but upon the fortunes of dozens of remote brothers or second cousins and the vagaries and humors of several degrees of parents.

In Section 11 of the Holding Company Act, Congress has recognized not merely that reorganization of the electric and gas utility industries on a regional basis is necessary in order to promote their health, but also that the huge scattered empires must be broken up into regional systems in order to prevent the destruction of the utility industry itself. This is the philosophy of the statute. And I, like all others who believe in keeping business at home, think this philosophy is sound. And there is strong support for it in the industry itself. An executive of a holding company system soon to be revamped under the Act said this to me recently, with reference to Section 11:

"Integration of generation, of natural trade areas, and diversity factors are a very sound background upon which to reset the operating companies of the nation. The electric power industry has only one reason for existence and that is to render dependable service as cheaply as possible. To do this the capital invested must have reasonable certainty of return. The corporate form that it takes should be simple and understandable and workable. The management should be as close as possible to the territory served."

And the staff of the New England Power Association recently laid on my desk an interesting analysis and justification, from an operating and engineering point of view, of the philosophy of Section 11. Their paper said in part:

"The development of the electric power industry in the United States has brought about the existence of four broad classes of electric utility units. One is the small and constantly decreasing number of isolated local units, isolated as to electric connection with their neighbors and local in their management. Another is the group in which the units are under common management but which are not physically connected each to the other. The third class comprises those units which are physically interconnected but are under separate management. Finally there is the integrated unit, or system consisting of completely intraconnected units, located in a single area and whose development and operation are coordinated through common control but which, on account of state laws and local conditions, cannot be combined or consolidated into a single corporate entity.

The benefits which accrue from group management have for many years been widely discussed. Similarly the economies resulting from interconnection are so well appreciated that further explanation of them is unnecessary. The integrated system receives more completely the benefits arising from group management and interconnection and in addition enjoys certain advantages not available through either alone and is free from many of the weaknesses inherent in each.

The proper limitation to the area served by an integrated system, while difficult to establish, is very real. It is determined generally by the availability of suitable markets, and sites for major hydro or steam developments, all within economical transmission distances of each other. The major part of the load should be located within the outer boundaries of these sites, such remaining load as lies beyond this outer boundary must be located within economic transmission distance of it. These economical transmission distances generally depend upon the size of the load or of the sources of power. For average conditions the area served by a single integrated system would probably extend over not more than a few hundred miles, but under special circumstances it might be economical to go much further in order to obtain a proper balance of fuel and hydro generating capacity to supply the base and peak loads. Such a balance having been established, the operating advantages due to further extension become less important.

In general, however, though the technically practical extent of the interconnection may be considerable, other considerations operate to limit integration to something like the radius mentioned. Benefits accrue from integrating the power facilities on a reasonably broad scale but unlimited extension serves no useful purpose.

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We have stated that geographical limits of successful integration are usually smaller than the technical limits of practical interconnection. Our discussion of the benefits which are unique to the integrated system makes these additional limits more clear even if we cannot measure them in miles. All the benefits we have discussed stem from a single root: The close contact which gives a vital knowledge and appreciation by the central service organization of the conditions peculiar to the area within which the system operates.

So long as additional area can be included without decreasing that knowledge and appreciation, integration has not reached its most effective extent. Thus we see that in regions of large homogeneous area whose sections are quickly and easily reached, integration can be extended over a broad territory. When due to distance, natural barriers, and absence of quick and certain communication, that local intimacy with conditions diminishes, the most effective size has been passed. Then the design forces become consulting engineers for the units of the system. The operating staff becomes a central bureau supervising in only a general way the local forces by whom the decisions resulting in the day-to-day economy of the system are determined. The central maintenance organization loses the intimate character of a family physician and becomes merely a consulting specialist. The management becomes an absentee landlord in place of a resident supervisor. The whole system becomes unwieldy and the far reaching advantages of integration vanish."

The combination of these philosophical and practical considerations gives Section 11 of the Act an extremely firm foundation. Aside from the way in which extremists think the Act *might* be administered, do any sound objections to Section 11 remain?

A committee of executives of disintegrated parts of the industry has urged that "the principle of diversity of investment, represented by both geographic location of operating properties and character of business served by them, is a very important factor in the raising of additional capital and that such principle should be preserved in the public interest."

Let me re-state what I think is meant by this statement: It is important, it is contended, in order that holding companies may attract new capital, that they should have control over properties which are more scattered geographically than is permitted under the restrictions with respect to integrated systems imposed by Section 11. Freedom from these geographic restrictions, it is argued, will permit the operating companies of the system to serve different types of customers and different economic areas and thereby to lessen the tendency of the revenues of the system to rise and fall with the business cycle. Because of this, it is argued that investments in the securities of a diversified system are more stable and secure and hence more attractive to capital.

But, in my opinion, facts, history and reason, bear witness against the theory that *mere diversification* (that is to say, mere scatteration of properties and investments) has promoted stability or security of earnings. As to facts, we have collected figures showing comparatively the results obtained by various scattered, conventional holding company systems and by various integrated, regional companies and systems over a period of years. A fairly comprehensive study was made of one typically scattered or "diversified" system (American Power and Light Co.), one integrated electric utility system (American Water Works and Electric Co., Inc.) and one large integrated company (Pacific Gas & Electric Co.). A study was also made of a few types of data with respect to eight scattered, non-integrated systems 1/ and ten integrated companies and systems. 2/ In all, the book value of the assets of the companies and systems covered is about 60 per cent of the assets of the entire industry.

It should be noted that this was a mere statistical sample, subject to a more comprehensive survey. I also want to make clear that I realize that the utility industry is affected by an almost infinite number of human and economic factors which are difficult, if not impossible, to evaluate in terms of comparable statistical data. Yet these statistics do furnish some criteria for judgment. It is impossible for me in this paper to give you the detailed results of the study. But there was an amazing uniformity of results. Let me give you a few samples.

We took the gross operating revenues of eight scattered, "diversified" systems and of ten integrated, regional companies or systems for the years 1929 to 1934, inclusive. We ascertained the highest annual revenues for this period and the lowest, with respect to each company. The gross operating revenues of the eight scattered systems showed an aggregate decline of 18.4%; the ten integrated companies or systems showed an aggregate decline of only 11%. Only two of the ten integrated companies showed a decline of more than 15%; one of these showed a decline of 15.6%, the other of 26.9%. All except two of the eight "diversified" systems showed a decline of more than 15%. The six showing such decline revealed a drop of 15.9%, 16.9%, 19%, 21%, 21.3%, and 25.9% respectively. Certainly, it cannot be urged in the face of these figures, that diversification, in and of itself, has promoted stability of earnings - or has prevented hard times from cutting the heart out of the income of a diversified public utility system.

Let me cite to you some more figures leading to the same conclusion. This time I shall take my figures from our more comprehensive study of one "diversified" system, one integrated system, and one large integrated company. The "diversified" electric utility system (American Power and Light Co.) 3/

1/ These eight companies were: American Gas & Electric Company; American Power & Light Company; Commonwealth & Southern Corporation; Engineers Public Service Company; National Power & Light Company; The North American Company; United Gas Improvement Company; and United Light and Power Company.

2/ These ten companies were: Boston Edison Company; Commonwealth Edison Company; Consolidated Edison Company; Detroit Edison Company; Pacific Gas & Electric Company; Public Service Company of New Jersey; Public Service Company of Northern Illinois; Niagara Hudson Power Corporation; Southern California Edison Company; and Consolidated Gas Electric Light & Power Co. of Baltimore.

3/ American Power & Light Company; Central Arizona Light & Power Company; Florida Power and Light Company; Kansas Gas & Electric Company; Minnesota Power and Light Company; Montana Power Company; Nebraska Power Company; Northwestern Electric Company; Pacific Power and Light Company; Texas Electric Service Company; Texas Power and Light Company; Washington Water
E. J. ...

is itself a subsidiary of one of our largest holding companies (Electric Bond & Share Co.). It operates in Texas, Kansas, Florida, Iowa, Nebraska, Minnesota, Montana, Washington, Oregon and Arizona. It serves large cities, small towns and rural areas. It serves industrial and farming regions. The integrated electric utility system (American Water Works and Electric Co.) 1/ operates in West Virginia, Virginia, Maryland, Pennsylvania and Ohio -- a fairly compact territory. It serves industrial and agricultural areas, cities, towns and rural consumers. The integrated operating company (Pacific Gas and Electric Co.) operates on the Pacific Coast and likewise serves a well-diversified compact area, with a balanced urban and rural domestic, commercial and industrial load. We studied the electric operating revenues of each of these for 1930, 1933 and 1936. Both of the integrated systems were better able to stand the adversities of fortune between 1930 and 1933 than the "diversified" system; and both responded better to the upturn reflected in 1936 revenues of electric operations. Here are the figures:

We took the year 1930 as our base of 100 for each company. In 1933, the electric operating revenues of the "diversified" system declined to 82.1%; those of the integrated system dropped to 86.3%; those of the integrated company, only to 92.3%. Similarly, when 1936 brought an upturn in the electric revenues, those of the "diversified" system rose only to 103.3%, while the integrated system showed a rise to 112.1%, and the integrated company to 104.1%. 2/

These figures indicate that the integrated systems were *less* vulnerable to business depression than the scattered or diversified system, in terms of revenue from sales of electricity. The same is true with respect to breakdowns of this revenue. Revenues from residential customers, from small light and power customers and from large light and power customers -- each showed the same type of behavior. With respect to each, the record of the integrated system shows that there has been more resistance to the down-swing of the business cycle and greater response to its upswing than was true of the "diversified" system.

From the point of view of the investor, what was the result? The "diversified" system earned its fixed charges and preferred dividends 1.28 times in 1930; it did not cover them in 1933, earning only 84% of fixed charges and preferred dividend requirements, and earned them only 1.02 times in 1936. On the other hand, both integrated systems earned more than fixed charges and preferred requirements in all three years. The integrated system covered them 1.32 times in 1930; 1.13 times in 1933; and 1.21 times in 1936. The large, integrated operating company covered them 1.88, 1.45 and 1.77 times in each year, respectively.

Taking the eight "diversified" systems and the ten integrated companies, which I have already mentioned, we computed the decline in earnings available for common stocks, between the highest annual figure and the lowest, during the period 1929 to 1934, inclusive. The "diversified" systems' earnings available for common stocks dropped 72.4%; while the earnings of the integrated companies showed a decline of only 52.3%. It is doubtless true that in some of these diversified systems a high degree of recklessness characterized financial practices with the result, among other things, that they were over-capitalized and had top-heavy capital

1/ American Water Works and Electric Company, Incorporated
West Penn Power Company; Potomac Edison Company; Monongahela
West Penn Public Service Company.

2/ The figures which I have cited for Pacific Gas & Electric Company are the consolidated figures published by Moody's Manual. They have been adjusted by Moody to reflect acquisitions and mergers during the period and are therefore comparable.

structures. Such factors doubtless contributed to a degree to the volatile nature of the latter statistics. But they cannot tell the whole story. And furthermore, is it a mere coincidence that the recent parade of receiverships and reorganizations was made up essentially of these diversified systems? To mention only a few which come to mind: American Gas & Power Company; Arkansas-Missouri Power Corporation; Central Public Utility Corporation; Commonwealth Light & Power Company; Inland Power and Light Corporation; The Middle West Corporation; Midland Utilities Company; Peoples Light & Power Company; Standard Gas & Electric Company; United Telephone & Electric Company; Utilities Power & Light Corporation. Which of these companies was developed as an integrated system in accordance with the standards of Section 11? Is it merely a coincidence that disregard of such sound standards has resulted so often in financial disaster?

Now these figures speak for themselves. At the least they are a red light to those who argue that diversification of public utility systems is necessary or desirable. They cast grave doubts on the validity of the contention that diversification, as contrasted to geographical integration, has meant stability of earnings and increased safety of investment. On the contrary, they indicate that in fact and truth diversification -- that is to say mere scatteration -- has meant increased sensitivity to downward spirals and less response to upturns of the business cycle. I do not claim greater probative value for these figures than they deserve from the most cautious point of view. Some may say that too few companies were included; that the integrated and diversified companies included in the figures are not truly comparable because of differences in the areas served, the character of their business, and so on; and that the more favorable record of the integrated companies may be accounted for by factors of various sorts, too numerous to mention. I recognize the possible justification of such criticism. I do not claim that these figures *alone* show that an integrated system is more stable or more profitable than a "diversified" system. But I do assert that they demonstrate that no one can properly contend that a diversified system, *because of its diversification*, has been more stable, more productive, or more deserving of investors' money than an integrated, regional system.

To argue that the pattern of present-day holding company systems should be maintained because of a "principle of diversity of investment" is to beg a basic question. Holding company systems have not been organized upon any such scientific sounding "principle". As I have mentioned, in the roaring twenties and before, they were slapped together merely on the theory of putting together every utility property that the dominant interests could acquire. Diversity of risk was merely a slogan for the security salesman and not a standard for the promoter. Where it did exist, diversity of investment was frequently the more or less accidental result of a policy of acquiring properties, wherever located, mainly for the purpose of promoting the sale of equipment, of profiting from the sale of securities, or of realizing fees for financial, construction or management services.

No one can study some of our largest public utility systems and discover any rational diversification of investment. The dominant interests in such systems were not interested in diversification; they were interested in pyramiding control and in the power and profit incident to control. Some of the holding companies which have most loudly proclaimed the advantages of diversification to investors show the effect of such expansion. In this mad pursuit of bigness, they resorted to wild financial practices to such a degree as overwhelmingly to offset any possible advantages of diversity. When these companies argue for diversity, they argue only for bigness and for geographical and economic disunity.

The argument, therefore, that the widespread holding company which we see today must be preserved in order to secure diversification of risk does not accord with the facts. Moreover, recent experience has demonstrated the relative unimportance of the location of properties in different portions of the country in achieving stability of earning power. With the rapid extension of transportation and communication facilities, the interdependence and homogeneity of all parts of our economic structure have increased. As a result, cyclical conditions have a much more uniform effect upon the level of business in different sections of the country than formerly.

Unquestionably there is still some appeal in the theory of diversification. It is urged for example that an investor might not want to have all his funds tied up in a holding company which derives most of its income directly or indirectly from merely one segment of the industry. But on the other hand, investors know that merely because a holding company controls utilities both in California and Maine, true diversification is not obtained. True diversification depends upon a distribution of risk factors resting upon an analysis of elaborate economic facts. And more important than this, investors have come to realize that diversification of risk is an investment function, not the job of management. They have learned, from bitter experience, that so many extraneous factors enter into the decision of management to invest as to make management-diversification dangerous, in most instances. They have learned that if an investor wants diversification in his utility investments, he can best get it by direct investment in a number of companies. Diversification of risk is a matter of investment judgment to be undertaken by the individual investor or by an objective investment institution, not by those controlling or managing operating companies. As the President has said, "Investment judgment requires the disinterested appraisal of other people's management." 1/

The losses suffered by holding company investors in recent years, despite the relative stability of operating company earnings throughout the country, has strikingly demonstrated how relatively unimportant is the factor of geographical diversification; how vastly more important are the integrity of management and the soundness of the financial structure. The excellent credit of soundly capitalized local operating companies today indicates that lack of geographical diversification is no real handicap to obtaining capital on favorable terms. As a matter of fact the best securities even in the large nation-wide holding company systems have not been "diversified"; they have been the senior securities, the bonds and the preferred stocks, of the subsidiary operating units, which offer no geographical diversity of risk to the investor. As the Senate Committee on Interstate Commerce in reporting out favorably the Holding Company Act stated: "the giant holding companies, by and large, have not drawn money into capital improvement and expansion of the industry but have utilized their investors' funds for the purchase of utility properties already built. Even after the holding company became a dominant factor in the utility industry, credit and investment were obtained for the industry directly through the operating companies rather than through the holding companies. It has been in the securities of the operating companies that insurance companies and savings banks have placed the bulk of their utility investments. They have wisely chosen the tested and secured obligations of the operating companies, and not the so-called 'diversified securities' of the holding companies based on slender and speculative equities." 2/

1/ Monopoly Message (1938), p. 3.

2/ 74th Congress, 1st Session, Senate Report No. 621, p. 15.

It seems clear from these facts that the case for diversification, as it has been known in the utility industry, carries with it a burden of proof that has not been satisfied to date. But perhaps some who urge the theory of diversification mean something different from diversity as it has been practiced. It is true, as a theoretical matter, that if a holding company were restricted in its investments to *integrated systems*, a degree of stability would be obtained which is not present in the *existing diversified systems*. So the gravamen of the complaint may be, not geographical integration itself, but the limitation on the number of integrated systems to which one holding company is limited. If that is it, the answer seems clear. To limit these holding companies to geographically integrated units but to allow them to develop in such unrestricted manner would involve the grave risks which I have previously enumerated. It would run counter to the whole theory of regional growth and development. It would be a negation of the desire of communities in this country to keep their businesses at home. It would perpetuate the untenable practice of absentee management and remote financial control. It would work for pyramiding of an important segment of our economic life in the hands of a few. But the disadvantages are not purely social and economic. They go deeper than that. They embrace all of the disadvantages from the operating point of view which I have mentioned earlier in this paper. To paraphrase and adapt the observation of the staff of the New England Power Association which I have previously quoted, it would follow that under such a system the central maintenance organization would lose its intimate character of a family physician and would become merely a consulting specialist. Management would become an absentee landlord in place of a resident supervisor. The whole system would become unwieldy. The far reaching advantages of integration would vanish. Due to distance, natural barriers, absence of quick and certain communication, local intimacy with conditions would diminish. And by that test the most effective size would have been passed. In view of such considerations, the ban which the Congress has placed on any such diversification seems wholly justified in view of the heaviest presumption against it.

In belittling the importance of extreme geographical diversification, I do not wish to be misunderstood. The obvious operating advantages of having a balance between rural and urban, industrial and residential, customers also contributes an element of investment stability. This, however, is a matter which the Act not only permits but positively encourages. An integrated system, as defined in the Act, essentially depends upon engineering and economic facts. Basically, it is an aggregation of units which may be economically operated as a single coordinated system in a single area or region, whether or not that area or region is in more than one state. This is not a Procrustean, arbitrary definition. It depends upon demonstrable economic facts. Certainly, the Act does not contemplate that an integrated system shall be so restricted as to make impossible its adequate, economical operation and financing. Precisely the contrary is true.

There is no need for theoretical discussion of the workability of these prescriptions. It is sufficient to point to some of the regional systems already in existence which have had a strong appeal to the investor. I need only mention the financial experience of such regional or local systems as Pacific Gas and Electric, Public Service Corporation of New Jersey, Consolidated Gas, Electric Light and Power Company of Baltimore, among others. It is unreasonable, on its face, to concede the economic and business advantages of regional

integration and organization, and then to argue that investors will put their money only into national, disorganized and disunited systems. Investors will realize that organization upon a regional, integrated basis will contribute vastly to the stability and earning power of public utility systems; and it follows that investment capital will find such systems more attractive than ever before.

So let us not confuse the interest of investors with the self interest of a few who want to retain control over these economic empires. Congress was not so confused when it enacted Section 11; we trust we will not be, as we seek to implement its provisions.

We have entered the period of action -- constructive, not destructive action. As I announced last week, our move in the Utilities Power & Light case to enforce compliance with Section 11(b)(1) of the Act means nothing more nor less than that we mean business. We are intent on doing the job which Congress has intrusted to us. And we desire to do it in a fair and constructive way. The most appropriate formula for bringing the various systems within the pattern called for by Section 11(b)(1) seems to be the trading of properties and securities. Now we realize that this job cannot be done overnight. It will take a period of years even to break its back. And we do not propose to use haste where speed will jeopardize the quality of the product. Nor do we propose to descend with surprise on a company which has given us its token of sincerity and which is making actual progress. But to get on with our task we must insist on progress. And I hope before the year is out we will obtain from the various parts of the industry their plans and programs, so we can chart our course accordingly. I know that at least tentative blue prints are being prepared in a number of utility offices today. I further know that many leaders of the industry (even though they may disagree with the theory of Section 11) are bent not on nullification or repeal but on compliance. To all these I pledge our wholehearted cooperation. We offer them an open door to our round tables. Working together in a united front on these common problems, we can jointly see to it that the public utility industry capitalizes on the signal opportunity with which it is confronted. We can meet success in this sector, as we have in others, if the Bar uses its enormous powers in designing ways to make the law of the land work rather than to obstruct the course of government in its desire to give deserving protection to investors and consumers.

With this cooperation we have every reason to expect that the Act will prove to be a boon not only to the country as a whole, but to the industry itself, to its management, to its investors, and to its consumers.