CHANGING CONCEPTS IN ELECTRIC UTILITY FINANCING

by

J. ARNOLD PINES
CHIEF FINANCIAL ANALYST
DIVISION OF CORPORATE REGULATION
SECURITIES AND EXCHANGE COMMISSION

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I appreciate the opportunity given me to speak before this conference of utility commission engineers. While I propose to discuss a matter which, strictly speaking, is somewhat outside the realm of engineering considerations as such, I am sure that regulatory commission engineers are vitally interested in the cost of capital to utility companies.

It is my purpose today, within the brief period of time available, to take up with you a question which I believe will receive increasing attention in the future. The question involves the appropriateness of substituting unsecured debentures for preferred stock to finance future growth of electric utility companies.

Preliminarily, I should point out that under the Public Utility Holding Company Act of 1935 the Securities and Exchange Commission has extensive jurisdiction over electric and gas utility companies which are either subsidiary companies of registered holding companies or which are themselves registered holding and operating companies.

Section 1(b) of the Holding Company Act sets forth certain policy considerations regarding the financing of public utility holding compa-

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nies and their subsidiary companies. In that section, Congress declared that "the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies * * *, and the interest of consumers of electric energy and * * * gas are, or may be, adversely affected" when, among other things, "* * * control of such companies is exerted through disproportionately small investment" (Section 1(b)(3)) and "when in any other respect there is * * * lack of economies in the raising of capital" (Section 1(b)(5)). Section 1(c) directs that "all the provisions of this title shall be interpreted to meet the problems and eliminate the evils" enumerated in Section 1(b). Sections 6(b) and 7 of the Act contain the relevant financing provisions designed to implement the Congressional policy.

In its Tenth Annual Report to Congress for the fiscal year ended June 30, 1944, the Commission stated (p. 99):

> "A balanced capital structure provides a considerable measure of insurance against bankruptcy, enables the utility to raise new money economically, and avoids the possibility of deterioration in service to consumers if there is a decline in earnings."

And in a report for the SEC Subcommittee of the House Committee on Interstate and Foreign Commerce on the Public Utility Holding Company Act of 1935, dated October 15, 1951, the Commission stated, at page 27: "An adequate equity cushion to absorb the vagaries of business conditions is an important attribute of a good security."

Basic to the Holding Company Act is the principle that excessive amounts of senior securities--i.e., debt and preferred stock--and insufficient amounts of common equity may result in injury to investors and ultimately in the quality of service rendered to the consumer. While leverage, of course, properly exists in all utility capital structures, there should not be such a play of leverage that the common stock is thereby converted into a purely marginal security, with virtually all the business risks being taken by the senior security holders.

As you probably know, by December 31, 1940, dividend arrears extending into hundreds of millions of dollars had accumulated on the preferred stocks of many holding and operating companies. A large number of holding companies had gone into receivership or bankruptcy, while many operating companies had escaped receivership or bankruptcy by deferring needed replacements, stinting on maintenance, and by stopping dividends on the publicly-held preferred as well as the controlling common stocks. In addition, the property accounts of a great number of operating companies contained write-ups and other amounts in excess of original cost which had to be written off at once or amortized by charges to income. Moreover, depreciation or retirement reserves were totally inadequate as a measure of the depreciation and obsolescence which actually existed in the utility property.

With all these considerations in mind, the Commission in 1940 issued its opinion in the landmark case of El Paso Electric Company (8 S.E.C. 366). In a special Appendix to the opinion (page 383), the Commission referred to the debt-ridden railroad industry and presented the views of various informed commentators on the subject of public utility finance. Without specifically saying so, the Commission appeared to indicate that, generally speaking, long-term debt of an electric utility company should not exceed 50 percent of total capitalization and surplus, and that long-term debt plus preferred stock should not exceed 75 percent thereof. On this basis, the common stock equity would be not less than 25 percent. This came to be known generally as the 50-25-25 policy.

Of course, the Commission has never operated in an inflexible or dogmatic manner, and in appropriate cases it permitted variations from this policy as long as there was a reasonable basis for expecting that excessive amounts of senior securities would be reduced in the foreseeable future and that the marginal nature of the common stock equity would be corrected. As a matter of fact, while this 50-25-25 policy was in effect, the Commission was generally more insistent on adherence to its bench mark of a minimum common equity ratio than to its indicated maximum debt ratio. To some extent, therefore, the debt component of the capital structure was allowed to exceed the indicated bench mark at the expense of the rather ambiguous area occupied by the preferred stock component.

In 1952, in the Eastern Utilities Associates case (34 S.E.C. 390), the Commission stated that, generally speaking, long-term debt should not exceed 60 percent of capitalization and surplus and common stock equity should not be less than 30 percent thereof. This policy, which has generally been characterized as a 60-10-30 policy, has been adhered to by the Commission in most instances save for special situations as, for example, the financing of certain natural gas pipe line companies which are subsidiaries of registered holding companies and a few natural gas distributing companies.

In a recent case, Kentucky Power Company, et al. (Holding Company Act Release No. 14353, January 13, 1961), the Commission approved a financing by a subsidiary company of a registered holding company on a basis which recognized that there existed in the balance sheet of that subsidiary company, as well as in the balance sheets of the other companies in the same holding-company system, a substantial amount of accumulated credits arising from the deduction for Federal income tax purposes of accelerated amortization and liberalized depreciation of utility plant. Under these circumstances, the Commission stated that as long as (1) mortgage debt did not exceed 60 percent of capitalization and surplus, (2) total long-term debt (i.e., both mortgage debt and unsecured debt) did not exceed 65 percent, and (3) common equity was not less than 30 percent, there would appear to be no basis for the Commission, insofar as capitalization ratios are concerned, to make adverse findings with respect to future financings by any company in that holding-company system or to impose terms and conditions in respect thereof. For purposes of meeting these ratio tests, capitalization and surplus and common stock equity were defined to exclude the accumulated balance-sheet credit. The 65 percent debt limitation provided approximately the same dollar amount of debt in the foreseeable future as a 60 percent limitation expressed in terms of a capital structure inclusive of the accumulated balance-sheet credit.

Let us now compare briefly the condition of the electric utility industry today with what it was some 20 to 25 years ago. The dividend arrears on the operating companies' and holding companies' preferred stocks have all been eliminated; some $1,107,000,000 of electric plant adjustments (i.e., write-ups and other inflationary items) have been eliminated from the plant accounts and approximately $518,700,000 of electric plant acquisition adjustments have been amortized or otherwise disposed of; depreciation reserves have nearly doubled in terms of percentage of utility plant account; the ratio of long-term debt to net utility plant, restated to eliminate the excess over original cost, has been substantially decreased; common equity ratios, also in terms of original cost, have been materially increased; and corporate structures have been substantially simplified. The coverages of income deductions and of income deductions plus preferred dividend requirements have also been substantially increased. With the tremendous increases that have taken place in utility plant investment, the average age of utility plant has constantly been lowered, to the point where a study completed in 1959 indicates that 50 percent of today's electric plant is less than six and one-half years old and 75 percent is less than eleven and one-half years old.1/

1/ See Cook and Cohn, Capital Structures of Electric Utilities under the Public Utility Holding Company Act, 45 Va. L. Rev. 981, 994 (1959).

While improved economic conditions, of course, are in part responsible for the dramatic improvements that we have witnessed in the financial well-being of the electric utility industry since 1935, including the generally high esteem enjoyed by the securities of electric utility companies, it is obvious that the combined regulatory efforts of the Securities and Exchange Commission, the Federal Power Commission, and the State regulatory commissions contributed extensively to this improved financial condition. In this connection, I should point out that an important aspect of the SEC's regulatory activities in this area has been the formulation of comprehensive protective provisions to be included in bond indentures and in corporate charters in respect of preferred stock.[2/] An additional factor of critical significance has been the advances in the state of the art. Tremendous increases in the size of generating units have been achieved. They have resulted in reductions in the unit cost of installed capacity in the face of increasing costs of materials and labor. There has also been an impressive increase in the thermal efficiency of the steam-electric generating plants. These advances have been accompanied by the ability to transmit ever-increasing blocks of energy from one area to another.

2/ Holding Company Act Release No. 13105 as to first mortgage bonds and Holding Company Act Release No. 13106 as to preferred stock (both dated February 16, 1956).

But while all these notable strides have been made in the financial and operating aspects of the electric utility industry, a further factor of importance has also made itself felt. It is the corporate income tax rate. In 1935 the rate was 13.75 percent, while today, as it has been commencing with the year 1952, it is 52 percent. For rate making-purposes as well as for financial statement purposes, Federal income taxes of electric utility companies are an operating expense and therefore are a matter of vital interest to consumers and investors.

As you know, interest on debt securities is deductible for Federal income tax purposes, whereas dividends on preferred stock issued for new money purposes are not deductible. As a result, on the basis of present corporate income tax rates, one dollar of dividends on new preferred stock capital requires $2.08 of revenues to cover the costs of capital and related income taxes, while one dollar of interest on debt capital requires only one dollar of revenues. Thus, a preferred dividend rate of, say, 5 percent imposes a revenue requirement of 10.42 percent to cover the dividend rate and income taxes, as against a revenue requirement of only 5 percent on debt capital carrying a 5 percent interest rate. This, incidentally, assumes that the preferred dividend rate and the interest rate are the same--i.e., 5 percent--but, generally speaking, a debt security will carry a somewhat lower rate than will preferred stock, so that the difference in revenue requirements would be even more pronounced than I have indicated.

During the five-year periods 1946-1950, 1951-1955, and 1956-1960, there has been a declining trend in the dollar amount of preferred stock issued by the electric utility industry as well as in the relative proportion of preferred stock to the total dollar amount of all types of electric utility securities issued. Thus, in the first of these periods, preferred stock issuances amounted to approximately $1,318,000,000, or 16.3 percent of the aggregate of all security issuances; in the second period, it amounted to about $1,248,000,000, or 13.2 percent of the aggregate; and in the third period, it amounted to approximately $932,000,000, or 9.2 percent of the aggregate. It may be noted that in 1959 there were only 16 issuances of preferred stock by electric utility companies and that these accounted for only 5 percent of the dollar amount of all securities sold in that year by electric utility companies. In 1960, the number of preferred issues increased to 21, which constituted 11.2 percent of the total dollar amount, but they were fewer in number and in total dollar amount than the preferred issues fourteen years previously in 1946. During the same five-year periods, debt securities increased both in dollar amount and in their relative percent of all security issuances.

Quite a few electric utility companies have not issued any preferred stock in recent years. Some have not sold any during the last five years, while others have not sold any for an even longer period. The SEC has recently received applications from two electric utility companies in different registered holding-company systems to issue 25-year debentures. One of these companies last sold preferred stock in 1956, while the other last sold such security in 1954. Each company has first mortgage bonds and preferred stock outstanding in the hands of the public and common stock held by its parent company. Each has indicated that neither it nor its sister companies contemplate issuing any preferred stock in the foreseeable future and that henceforth all financing so far as they can now estimate, will be effected through bonds, debentures, and common stock. One of the two companies has indicated that if it becomes financially feasible to do so it and its sister companies will take steps to retire their outstanding preferred stock which carry relatively low dividend rates. While the other company has made no similar representation, it may be assumed that it and its sister companies will do the same thing in the event retirement of their outstanding preferred stock likewise becomes financially feasible. In any event, with the passage of time, the existing preferred stock in each of these holding-company systems will either gradually become a smaller and smaller percent of the total capital structure, or else will be eliminated entirely.

In one of the applications, the company has provided in its proposed debenture indenture that, as long as the debentures remain outstanding, it will not incur additional long-term debt if total long-term debt would thereby exceed 65 percent of total capitalization and surplus or common equity would be less than 30 percent. This means that while the existing preferred stock remains outstanding, the company would be required to have a preferred and common equity aggregating not less than 35 percent; and if the preferred stock should be retired at some time in the future, the minimum common equity ratio would then be 35 percent. In the other application, these ratio limitations are not contained in the proposed indenture since the company considers itself subject to substantially the same ratio limitations contained in the recently approved financing of Kentucky Power Company, its sister company to which I referred a little while ago. Other protective provisions are contained in both indentures, including a cash sinking fund designed to retire approximately 50 percent of the issue by maturity, a limitation on common stock dividends, and, as a condition to the issuance of additional debentures, an overall interest coverage requirement of two times before Federal income taxes.

Although both applicant companies have a sizable amount of unfunded property additions against which additional first mortgage bonds can be issued, neither company wishes to limit its future security issuances to first mortgage bonds and common stock. It is their view that if the mortgage debt ratio should become too high, the ratings on all their outstanding bonds as well as future bonds will suffer and that, as maturing bonds are refunded, the cost of debt capital to the company will be higher than if only a portion of the debt capital is supplied with junior debt, i.e., debentures. Both applications are now pending before the Commission, which is expected to act thereon within the next few weeks.

I have no way of estimating to what extent other electric utility companies may be encouraged to abandon preferred stock as a vehicle of financing in favor of debentures if the present applications are approved by the Commission. If there develops a trend to debenture financing in place of preferred stock, I think the companies involved would be well advised not to switch back and forth between debentures and preferred stock, since that would entail the use of four classes of permanent securities for future financings. I would prefer to see not more than three classes of permanent securities used for such purpose.

One final word appears in order. While Federal income taxes are, as I have indicated, an important factor to be considered by management and regulatory agencies in dealing with financing programs of electric utility companies, the tax reductions resulting from the deductibility of interest on debt should not be accorded overriding weight at the expense of a sound and simple capital structure. The financial integrity of the enterprise must be safeguarded and the public interest and the interests of investors and consumers must be protected. In periods of economic adversity where earnings are in decline, the deductibility of interest on debt for Federal income tax purposes may be of little comfort to either investors or consumers.

Thank you.

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