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THE TECHNIQUE OF PUBLIC UTILITY REORGANIZATION AND
SOME REGULATORY PROBLEMS

By

GEORGE C. MATHEWS

Commissioner, Securities and Exchange Commission

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NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS

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We are now witnessing developments which, in a few years, will manifest themselves as part of a thoroughgoing reorganization of the electric and gas utilities of this country. Many things contributed to make a thorough overhauling necessary, and many factors are contributing to its accomplishment. Not the least of the factors which lead me to believe that successful reorganization is in prospect, is the attitude of leaders of the industry. There are many indications that the viewpoint of the outstanding gas and electric company executives is undergoing an adjustment which is highly important to the successful reorganization of the industry. Under the guidance and with the assistance of state and federal regulatory agencies this resetting of the industry is rapidly progressing.

The process of reorganization is not merely or principally the sort of thing lawyers think of as "reorganization". They think of reorganization as a special single proceeding in which revamping of security structures, and perhaps rearrangement of corporate forms take place as a sweeping process. Spectacular moves of this sort are playing a part, and an important part, in the rehabilitation of the gas and electric industry, but they are not the only factors at work (and perhaps not the most important). Other and profoundly significant things are happening. These are the fairly inconspicuous, day-by-day improvements which are made in the operating habits, accounting practices, and financial housekeeping of utilities.

In other words, the reorganization of the electric and gas utilities of this country is taking place in two principal ways: First, by a general and detailed toning-up process in connection with the issuance of new securities, the evolution of accounting methods, and the revamping of service arrangements; and second, by major, wholesale reorganizations of capital and corporate structures and regrouping of physical properties. The first of these is no less important than the second; and frequently the basic objective of reorganizing those companies which need it, so that they can meet today's difficulties and face tomorrow's problems with confidence, is best accomplished by gradual, detailed reforms effected in the ordinary course of their affairs.

In this paper I propose to discuss a few of the "reorganization" problems (in the broad sense of the term) which the Securities and Exchange Commission has met and dealt with under the provisions of the Public Utility Act of 1935. Many of these are problems which we have in common with state regulatory agencies; and my purpose will be served if I succeed, in this brief discussion, in indicating an approach and in highlighting a few specific problems for your consideration.

Unfortunately, not all of the public utility operating and holding companies of the country are as strong financially as we should desire; unfortunately, there are Grade B and C companies, which sometimes find it necessary to issue Grade B or C securities. When a declaration covering such securities is filed with the Securities and Exchange Commission under Section 7 of the Act, we cannot allow their issuance unless they meet the standards of the Act. In the first place, they must be the kind of securities permitted by Section 7(c) of the Act; and in the second place, they must satisfy the standards of Section 7(d). We may not permit the issue to go out if we find that the securities are not reasonably adapted to the earning power of the issuer or to its security structure and that of other companies in the same holding company system, or that the terms and conditions of the issue or sale are detrimental to the public interest or the interest of investors and consumers.

These are flexible standards, as are others in Section 7 which I have not enumerated. Consequently, in each case, the Commission must apply its judgment and intelligence to the problem of whether the particular issue satisfies the standards of the Act. Certainly the Act does not require us to prohibit the issuance and sale of all except prime securities as to which there is no element of risk. But just as clearly, the Act does not allow us to jeopardize the solvency of the company and the interests of consumers and investors by permitting the issue and sale of securities which are unnecessarily speculative.

Mechanical administration of the Act might lead to a classification of securities in two categories; those which meet the standards of the Act and those which do not. But it has seemed to us that another avenue is open. Where a Grade B company wishes to issue Grade 3 securities, it is frequently possible for that company to make provisions for safeguarding its securities and greatly improving their position over a reasonable period of time, so that the element of risk is reduced to reasonable proportions and the company is on its way to an evolutionary reorganization.

This approach is not a new thing so far as state commissions are concerned. Many of them have frequently employed it with highly beneficial results. But in these critical times, it seems to me highly important that the possibilities of this approach should be recanvassed, and that wherever practicable, it be used to bring about a gradual rehabilitation of utility companies.

Let me illustrate the practical application of this method in a case which has been before the Commission twice within the past year and a half. In the summer of 1937, this company, whose principal business is that of operating an electric utility company in a state where there is no state commission having jurisdiction over issuance of securities, filed with us a declaration covering the issue and sale to an insurance company of \$1,000,000 principal amount of 5% first mortgage bonds. The proceeds were to be used in part payment for much needed additional generating facilities. Including these bonds, the ratio of the company's funded debt to its fixed property account, adjusted to eliminate known write-ups, would be 78.4; and the company's fixed charges would be covered only 1.66 times. In addition, the company had outstanding substantial amounts of preferred and common stocks. Whether the company's properties were adequately maintained was open to question, and its depreciation reserve was obviously insufficient.

The Commission's staff felt that it was exceedingly doubtful whether the new bonds could be issued, consistently with the standards of the Act. If, however, the company were not permitted to sell the new bonds, not only would its ability to fulfill its obligations to its customers have been impaired, but it would have found itself in serious financial embarrassment, which might have produced far-reaching results among the many investors interested directly or indirectly in its securities. After study of the situation, the staff suggested to the company certain modifications of its indenture which would result in a gradual improvement of the company's position, and a gradual increase in the protection for the bonds. In brief, the company agreed through a supplemental mortgage to:

1. Limit the amount of bonds it was then entitled to issue under its existing mortgage to the \$1,000,000 in question (less than half the amount the mortgage permitted).

2. Reduce the percentage at which bonds could be issued for additions subsequently made.

3. Make substantially increased annual charges against earnings, the major portion of which was to be used, first for maintenance, and second as a credit to depreciation reserve, with construction expenditures to that extent to be non-fundable, or for the retirement of bonds.

4. Freeze its accumulated earned surplus (with a minor exception).

The effect of these covenants should be gradually to build up the company's property account and so to improve the security for its bonds. With these modifications, the Commission felt justified in permitting the issue and sale of the \$1,000,000 of bonds covered by the declaration.

Approximately a year later, the company found it necessary to extend its lines so as to provide service for prospective customers in rural areas within its territory. This necessity arose because of insistent public demand for the extended service. Consequently it filed a declaration under Section 7 of the Act covering the issue and sale to certain insurance companies of \$300,000 principal amount of its first mortgage bonds. Here again there was a close question as to whether the issue met the standards of the Act. But the company's earnings had shown steady improvement over a five-year period and there was sufficient evidence of the improvement effected by the operation of the covenants inserted in connection with the 1937 financing to enable the Commission to permit the issue of the additional securities.

Unquestionably, a conservative approach to the company's problems has gone a long way towards putting it in a position where it can fulfill its responsibilities to render adequate service to the public without jeopardizing its investors, and avoid the necessity for revamping its entire capital structure.

Another illustration of the use of what I might call the ameliorative approach is afforded by another case which was recently before us. Two subsidiaries of a holding company system, both doing business in the same state, desired to merge and thereafter call and refund the outstanding bonded indebtedness of the two companies. Two major problems presented themselves. In the first place, about 33% of the gross revenues of the combined companies came from the transportation business, and transportation assets are not looked upon as prime security by the conservative bond buyer. In the second place, it was clear that the equity in the situation should be increased, although it was not practical at the moment for the holding company to add to its investment in junior securities. By cooperation of the company, its bankers and the regulatory agencies, the problem was worked out in this way:

The transportation assets were conveyed to a new corporation, all of whose securities will be owned by the electric company surviving the merger. These transportation assets were thereupon mortgaged for an amount estimated to be the minimum salvage value of its assets and all the bonds secured by this mortgage were deposited with a Trustee as partial security for bonds to be issued by the electric company under a new mortgage. The initial issue by the electric company of new bonds was for an amount substantially less than the total of the outstanding bonds of the two companies prior to their merger. The balance of the necessary money was raised through the sale, to a few large banks, of promissory notes maturing serially over a period of ten years.

There were a number of interesting safeguards incorporated in the contracts between the various parties to this transaction. First, a limitation was placed on the payment by the electric company of common stock dividends to the end that a substantial proportion of the cash necessary to retire the bank notes would be provided out of earnings. Second, the provision with reference to the issuance of additional bonds under the new mortgage was placed at a lower percentage of property added than that contained in the previously existing mortgages. Third, the state commission incorporated a condition in its order approving the issuance of these securities, whereby, until such time as the common stock equity in the company was increased about 50%, the amount of additional bonds whose issuance it would authorize was limited to considerably less than that permitted by the mortgage itself. Furthermore, substantial sinking fund and maintenance and depreciation clauses were written into the mortgage.

As a result the company was able to sell its bonds and notes on a basis which enabled it to make a cash saving in interest payments in the first year of some \$500,000, and its security structure has been changed so that additional capital funds, as they are needed, should be obtainable on an advantageous basis.

These cases, thus roughly described, illustrate what I mean by suggesting that reorganization can often be effected by a gradual process. Careful adjustment of sinking fund provisions; adequate provision for maintenance and depreciation, and conservative dividend policies can go a long way towards accomplishing this purpose.

I am aware that sometimes state commissions find it difficult to insist upon some of the adjustments which will aid in the "reorganization" process. They must keep constantly in mind the interests of consumers - the rate-payers; and in many of these matters there appears to be a clash of interest between consumers and investors. For example, it cannot be denied that increased depreciation is advantageous to bondholders; but, increased provision for depreciation means an increase in the operating costs of the utility, and consequently may affect rates. Similarly, increased maintenance is advantageous to a company's bondholders, and so far as it results in immediate tangible improvements in service, it is advantageous to consumers. But here again, increased maintenance means a rise in operating expenses and may affect rates.

It seems to me that such conflicts are frequently more apparent than real. Of course, excessive maintenance and depreciation charges are unjust to consumers (just as they may be unfair to stockholders), but consumers as well as investors have a very real interest in *adequate* provisions for maintenance and depreciation. Unless these charges are adequate, service is likely to deteriorate, and the financial soundness of the company is threatened. These eventualities are obviously as dangerous to consumers as to investors.

All of us know how difficult it is to determine the proper charges to be made - charges which are neither so high as to be unjust to consumers nor so low as to threaten service or the company's financial integrity. We all know the conflicts of theory and the varieties of practices concerning these matters. I shall not discuss them. My purpose is solely to point out the importance of taking into account tomorrow's problems as well as today's embarrassments, and of effecting gradual improvements in the condition and practices of companies which need them, so as to establish the entire industry on a sound basis.

Of course, it is not possible to work out all of the problems of the industry on this gradual, piece-meal basis. Some things must be done which require fairly drastic steps. Conspicuous among these are things which primarily affect holding companies and holding company systems - things designed to simplify the corporate structure of the systems and to confine their operations to a scope permitted by the law. Another thing which must be done is to regulate arrangements and charges for servicing. The Public Utility Holding Company Act of 1935 gives our Commission comprehensive powers to deal with this problem. Servicing of utilities by companies within the same system must be done at cost; and we are presently engaged in working out with the various systems plans whereby this may be done in the most efficient manner possible, and so as to make it possible for state commissions and ourselves to ascertain and regulate the services actually rendered and the charges actually made.

In addition, drastic financial reorganization of some companies may be inevitable. A few holding companies and operating companies are now being reorganized under the provisions of the Bankruptcy Act. Others are burdened with such huge arrearages of preferred stock dividends as to make some sort of reorganization imperative. For such companies, the evolutionary process will not suffice; their health has already been impaired so that they need an operation, not medical treatment. They must reorganize, and they can reorganize either in advance of an imperative necessity, or when the imminence of a default makes continuous operation without reorganization an impossibility.

From time to time, officials of the Securities and Exchange Commission have called the attention of the industry to the fact that many companies are in need of this more or less drastic form of reorganization, and have suggested that the necessary steps be taken as soon as possible. This seems to me to be obviously the course of wisdom. Unless such steps are taken, rehabilitation of the industry will be retarded; service may suffer; investors will not put their money into utility equities; and reorganization under the slow and expensive machinery of the Bankruptcy Act may be inevitable.

Some companies have already embarked upon a comprehensive program of reorganizing their capital structures. For example, one of the largest holding companies has begun to work out a program for restating its capital account and that of various subsidiaries. The program is based upon studies of the companies in the system with the following objectives: (1) To obtain as accurate a figure as possible of original cost of all property; (2) to identify and to obtain facts about every transaction which resulted in a debatable bookkeeping entry; and (3) to analyze the surplus accounts. Several of the companies in the system have filed applications with us to obtain approval, on the basis of the facts so ascertained, of a restatement of capital and creation of a special capital surplus. These special capital surpluses, in addition to surpluses as at December 31, 1937, may be used to absorb all debatable items which any of the companies find necessary to remove from their accounts, or to write their properties down to original cost, should that become necessary. In this way, it is reasonable to hope, the capital structure of companies in the system will be adjusted so that they can economically finance their requirements and confidently face the future.

The broad objectives of a reorganization of a public utility company are the same, whether it be accomplished by the gradual process which I have already discussed or by the more drastic form of a voluntary reorganization or a reorganization under the Bankruptcy Act. The broad objective is to stabilize the company; to recognize its losses and to place it in a position where it does not have to seek earnings to support inordinate charges, and where it can obtain new money economically. Specifically, this may require a reduction both in the face amount of debt outstanding and in the fixed charges thereon to a point where they are well covered by the property and earnings of the company; elimination or reduction of preferred stock requirements so that accumulation of dividend arrearages may be eliminated and will not recur; adjustment of total capitalization of the corporation so that it bears a conservative relationship to the property value and earning power of the corporation; and an equitable distribution of voting rights so as to reflect the investment and real interest of the owners of the company's equity. By the same token, the standards which this Commission applies to a reorganization are the same, whether it be voluntary or under the provisions of the Bankruptcy Act. Let me explain this in more detail.

As I have indicated, any reorganization must be based upon a sound appraisal of the value of the company's assets in the light of its reasonably prospective earning power. You are well aware of the difficulties in arriving at a fair estimate of value, even though the making of that estimate may not require full application of the methods customarily employed in rate cases. Some difficulties are also encountered with respect to determining the true earnings of many companies. This difficulty frequently arises because of the absence of any state agencies exercising regulatory powers, and sometimes because of the use of unsound accounting practices. But these difficulties are not insurmountable.

I think it is generally recognized that value for reorganization purposes is principally dependent upon the determination of reasonably prospective earnings. In the case of a public utility company, however,

earning power is a factor of and is, to some extent, conditioned by the value of the property upon which it will earn a return. Corporations which are in reorganization are inclined to be highly optimistic as to their prospective earning power. Sometimes this optimism leads to the suggestion of fantastic valuation figures. On the other hand, in my opinion, valuation for reorganization purposes should not be the most conservative figure which can be obtained. It should be a reasonable figure, taking into account such reasonable prospect as there may be that the company's earnings will improve, within the limits which may be governed by a reasonable - not the most conservative - valuation of its physical properties.

Once such valuation has been obtained, the process of working out a plan of reorganization should not be excessively difficult. It is my understanding that the trend of the law with respect to reorganizations effected in judicial proceedings requires that "completely compensatory" treatment be accorded to the various classes of securities and claims, in the order of their priority. I understand this to mean, for example, that bondholders must be given securities or cash which will approximately equal in value their claims on the corporation, before preferred stockholders can be given anything; and that preferred stockholders must be made approximately whole before common stockholders can be given anything. This theory, as I understand it, rests upon the proposition that reorganization does not afford a legal opportunity for nullifying the provisions of contracts; on the contrary, it is an opportunity for revaluation of the enterprise and redistribution of interests therein in accordance with the terms of the claims against it.

But here again, the cold legal formula does not prohibit the application of practical intelligence and judgment to business situations. It merely sets the outside limits for determining the reasonableness of a reorganization adjustment. There are two important factors upon which operation of the legal formula depends; first, the valuation of the enterprise, and second, the valuation of the new securities to be issued as a result of the reorganization. Neither of these is capable of exact mathematical computation, and both of them are sufficiently matters of opinion as to permit some flexibility. Let me illustrate what I mean by referring to two reorganization plans which have been approved by the Commission within the last few months.

One of these cases concerned a holding company which controlled a large number of telephone properties and several electric companies. The other concerned an operating gas utility. In both, the reorganization plans first discussed with the staff seemed to violate the principles which I have stated above. The values placed on the assets seemed entirely too high, and the proposed distribution of securities did not seem to accord to the owners of senior securities adequate recognition of their rights. But as a result of a series of conferences between the interested parties and the Commission's staff, plans were eventually presented which were within the limits of reasonable and lawful adjustment. It could not be said with any assurance that these plans were in mathematical accordance with the strict legal principle that I have stated; but they seemed sound and equitable, and were within the legally permissible zone. The Commission's attitude towards them may best be summarized by a quotation from one of its opinions:

"In passing upon the fairness of this plan it is not necessary for us to determine the exact value of the property or the amount at which its value shall be recorded on the books of the reorganized company. The evidence which has been submitted to us points to the conclusion that the property has very little, if any, value in excess of the aggregate amount of the claims of the bondholders. In such a situation the propriety of participation in the plan by the holders of securities junior to the bonds is always open to serious question. Here, however, value is affected by contingencies to a greater degree than in most utility cases and the total participation by junior security holders, the greater part of which is allocated to creditors, is equivalent to only 3.5% of the total capitalization (including surplus) of the reorganized company and, in addition, is junior in rank to new first mortgage bonds representing slightly over half of such capitalization. Under such circumstances we do not find that this relatively small participation by the unsecured creditors and preferred stockholders results in so substantial a diversion, if in fact there is any diversion at all, to junior claimants of interests in the reorganized company which belong to the bondholders that our approval of the plan should be withheld on the ground that it is unfair and thus prevent its submission to the Company's security holders."

These cases illustrate what to my mind must be a cardinal principle in these critical days of reorganization of electric and gas utility companies. Sound administration and proper discharge of their responsibilities require that regulatory agencies must insist upon a high standard of performance; but it is nevertheless possible and sensible that tolerance be shown for honest and reasonable adjustment. If the letter of the law is applied rigidly, without regard to its spirit, the reorganization process will operate too harshly, and the impact of the necessary adjustment of inflated values to present day levels will be needlessly deflationary.

This leads me to a brief reference to the last and the most dramatic aspect of the reorganization problem. I have already mentioned the necessity of simplifying the capital structures of utility companies and the corporate structures of holding company systems, and I have referred to the necessity of confining the scope of holding company activities to a sphere permitted by the Holding Company Act. Public attention has been particularly devoted to those provisions of Section 11 of the Act which require geographical reorientation of the industry.

The section imposes upon the Commission the duty to limit operations of a holding company to a single integrated public utility system and such other businesses as are reasonably incidental or economically necessary or appropriate to the operation of such systems. By definition, an integrated public utility system is one whose utility assets are capable of physical interconnection and which ordinarily may be economically operated as a single interconnected and coordinated system, confined within an area, whether in the same or contiguous states, not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation. The Commission is empowered to permit the operation of one or more additional integrated systems in one state or adjoining states, which cannot be separately operated without the loss of substantial economies, where the aggregation is not incompatible with the advantages of localized management and efficient operation.

Most of you are probably aware that some leaders of the industry have recently indicated that they sincerely intend to cooperate with the Commission in the accomplishment of the objectives of these provisions of the Act. Tangible results of this cooperative attitude have become evident. We have already approved two fairly comprehensive voluntary plans under this section. Other companies have communicated to the Commission their tentative proposals for compliance; and negotiations for the sale and exchange of various properties in line with the statutory purpose are under way.

Only one proceeding has been instituted by the Commission to compel compliance with these provisions. This step was taken in connection with the Utilities Power & Light Corporation. This holding company is in reorganization under the Bankruptcy Act. It owns securities of public utility companies in this country and in Canada, which are widely scattered and without any operating relationship. The Commission felt that it would be uneconomical and unfair to security holders to permit the laborious process of reorganization to be concluded before definite steps were taken under the Act to restrict the holdings of the system to a compass which might be allowed to endure. Unless this were done, security holders would emerge from the reorganization with interests in a company which would soon have to undertake the further task of restricting its operations as required by the statute. It is worth noting that an official of one of the chief security holders of the company publicly announced his approval of the effort to rearrange the company's holdings, stating that it was a sound move as a matter of economic and business sense.

The task of carrying out the sort of reorganization program which I have tried to sketch is one in which both the state commissions and our own must have a part. State commissions and federal agencies are not faced with the ordinary job of regulating; we are all confronted with an unusual situation which requires an unusual degree of understanding, cooperation and forethought. We have reason to believe that the industry will work along with us in our mutual endeavor; and I am confident that the relation of the Securities and Exchange Commission and the state regulatory agencies will continue to be one of cooperation; that we will cultivate an understanding of each other's problems; and that we will render each other every possible assistance in our joint endeavor.