# THE GROWING THREAT OF A DOMESTIC FINANCIAL CRISIS

---

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MARKETS

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

---

AUGUST 7 AND 8, 1974

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1974

[illegible]-544 O

16

XF

S361-7361

## COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
WALTER F. MONDALE, Minnesota
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas

WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware

MICHAEL STERN, *Staff Director*

---

### SUBCOMMITTEE ON FINANCIAL MARKETS

LLOYD BENTSEN, Texas, *Chairman*

HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
RUSSELL B. LONG, Louisiana, ex officio

WALLACE F. BENNETT, Utah
WILLIAM V. ROTH, Jr., Delaware

ROBERT A. BEST, *Chief Economist*

## CONTENTS

WITNESSES


| | Page |
|---|---|
| Alioto, Hon. Joseph, mayor, city of San Francisco, and president, U.S. Conference of Mayors | 1 |
| Beame, Hon. Abraham D., mayor, New York City | 5 |
| Childs, John F., senior vice president, Irving Trust Co | 67 |
| Cohn, Herbert D., vice chairman, American Electric Power Co | 44 |
| Corey, Gordon, vice chairman, Commonwealth Edison Co | 55 |
| Cornell, John P., senior vice president and chief financial officer, Columbia Gas System, Inc | 79 |
| Goldfinger, Nat, director, Department of Research, AFL-CIO | 29 |
| Thornton, John V., vice president and treasurer, Consolidated Edison Co. of New York | 71 |


COMMUNICATIONS


| | |
|---|---|
| AFL-CIO, Nat Goldfinger, director of research | 43 |
| American Telephone & Telegraph Co., William G. Burns, assistant treasurer | 113 |
| Armco Steel Corp | 147 |
| Brophy, Theodore F., president, General Telephone and Electronics Corp | 93 |
| Burns, William G., assistant treasurer, American Telephone & Telegraph Co | 113 |
| Continental Telephone Corp., Charles Wohlstetter | 131 |
| Freeman, Mark H., executive director, League of New Community Developers | 132 |
| General Telephone & Electronics Corp., Theodore F. Brophy, president | 93 |
| Goldfinger, Nat, director of research, AFL-CIO | 43 |
| Howarth, Thomas, director of government relations, U.S. Independent Telephone Association | 123 |
| League of New Community Developers, Mark H. Freeman, executive director | 132 |
| Municipal Finance Officers Association, John Petersen, Washington director | 149 |
| Petersen, John, Washington, director, Municipal Finance Officers Association | 149 |
| Racz, Andrew G | 137 |
| U.S. Independent Telephone Association, Thomas Howarth, director of government relations | 123 |
| Wohlstetter, Charles, Continental Telephone Corp | 131 |
| Wright, John Winthrop | 151 |

# THE GROWING THREAT OF A DOMESTIC FINANCIAL CRISIS

---

**WEDNESDAY, AUGUST 7, 1974**

U.S. SENATE, SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
*Washington, D.C.*

The subcommittee met, pursuant to recess, at 10:05 a.m., in room 2221, Dirksen Senate Office Building, Senator Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senators Hartke, Bentsen, and Bennett.

Senator BENTSEN. The committee will come to order.

The Senate Financial Markets Subcommittee is resuming its hearings on the financial impact of high interest rates and the disproportionate effect it has had on the economy. One of the areas, of course, that has been hit the hardest includes our local governments that raise funds for municipal services through the role of municipal bonds. Apart from that, I suppose, the housing market has been the one that has had the most severe impact.

We see today some 460,000 construction workers who are out of jobs, construction workers who would be contributing to the productivity of the country, and in addition to that, would be paying some half a billion dollars in taxes into the Treasury to help reduce the deficit.

Many people hear about bond markets and hear about municipal bonds and do not really understand their full impact on our economy. They do not understand that when high interest rates come along, municipal bonds generally react even faster in increasing their rates than do conventional bonds.

We have before us this morning two of the most distinguished mayors in America who have very serious responsibilities and are facing the problem of trying to finance services in their cities, and we are very pleased to have them here to share their views with us.

This morning we have Mayor Joe Alioto, who is president of the U.S. Conference of Mayors; and Mayor Abe Beame of the city of New York.

Mayor Alioto, we are appreciative of the fact that you have flown across the continent to share your views with us this morning. If you would proceed, sir.

## STATEMENT OF HON. JOSEPH ALIOTO, MAYOR OF THE CITY OF SAN FRANCISCO, AND PRESIDENT, U.S. CONFERENCE OF MAYORS

Mayor ALIOTO. Thank you very much, Senator. It is good of you to hold a hearing on a problem that is so important to us. We would

come across the country, indeed, across the world if it were necessary in order to try to put this picture before the Senate because we think it is important.

Very frankly, as I sit here with Mayor Beame, I am involved with two emotions. One is an emotion of apology, and the other is an emotion of gratitude. The emotion of apology is that we are intruding on the almost total absorption that Watergate has on everybody these days. It is an unfortunate thing, coming to a climax with almost the aspects of a Greek tragedy. Everybody has his attention riveted on it, and so I apologize for intruding upon that monopoly of absorption with a problem that may seem to some rather prosaic or mundane, and to us happens to be very, very important.

Senator BENTSEN. Mr. Mayor, you know, I cannot help but be impressed with the power of this system of ours and the point that you have just brought up, the possibility of a transfer of power taking place in this country of ours, and we do not see any tanks rumbling in the streets. We do not see a great group of armed soldiers, and about the only soldiers I have seen in the last couple of days are a couple of them with cameras taking pictures of buildings and that type of thing. You see a city with tourists going peacefully on their way sightseeing. It shows you again the strength of this system of ours.

Mayor ALIOTO. There is no question about it.

This kind of touches on the second feeling I have this morning. It is a feeling of gratitude to you particularly for your interest in the problems of the cities, and generally to the system which can take up a relatively dry subject matter so far as the public is concerned at a time when we are going through the trauma that we are witnessing today. We are grateful to you, too, for your interest in the economic status of the cities. Your interest was demonstrated in your recent appearance on national radio and television. We are grateful, too, for the very creative ideas you are advancing at a time when everybody is saying there is nothing we can do but simply let nature take its course. We do not think that is the attitude.

Now, to get down to the subject matter we are talking about. The cities of America are still here and we still have our problems. And we hope that the transition of power, which seems inevitable, will come quickly within the claims of due process so we can get about the business of solving those problems.

We had a meeting up at Gracie Mansion yesterday, hosted by Mayor Beame. We tried to make the point there that because of this total absorption of the country in Watergate, we get the impression that we are kind of crying in the wilderness about the problems of the cities and the claims of the cities. Because we are not having riots in our streets anymore, it is a little more difficult to get attention. Indeed, you will recall President Nixon's statement about a year and a half ago announcing that the crisis of the cities was over. Those of us who work in the cities know that is not true. The crisis of the cities is not over. There are emotions building in the cities that can be as disruptive as those of 1967, 1968, and 1969. Thanks to the Federal programs that we have been talking about, programs like Revenue Sharing and Community Development we have been able to stabilize some of our problems. But it would be a serious mistake to believe that the economic problems of the cities cannot erupt, not necessarily into a riot, but almost into something that is akin to despair.

So we are grateful for the chance to make this presentation to you.

The cities do not have the great luxury of the Federal Government and others where we can run multimillion, multibillion dollar deficits. We have to have balanced budgets. We have to be finished up at the end of the year with money to apply to these needs. If money is not there, the needs simply have to go down the drain.

One major item, because we do not have the ability to get into great operating deficits, is our ability to get bonded, that is, the ability to sell our bonds at reasonable interest rates.

You know, earlier this year we thought we were in great shape in the bond market. In March of this year, the average interest rate on municipal bonds was roughly about 5.32 percent, and that compared very favorably with the average interest rates for municipals following the very severe credit crunch we had in 1969 and in 1970. Four months ago you could say the market looked in pretty good shape. As a matter of fact, if there was any bright spot at all in this whole picture of the problems that we are experiencing at the urban level, it was what was happening in municipal bonds.

Now suddenly something has happened in the last 30 days. The month of July saw the volume of long-term tax-exempt financing drop by 30.6 percent.

Senator BENTSEN. Would you say that again so I understand it.

Mayor ALIOTO. In the month of July the volume of bond financing dropped by 30 percent over June. This is the lowest monthly volume since August of 1970 after we had that credit crunch, as you recall. That is the lowest monthly volume we have experienced, and I think that it is somewhat dramatized by what has happened in four instances, one of which we are going to hear in detail from the distinguished mayor of New York.

On July 9 New York City rejected a record high bid of 7.923 percent on a $438 million issue of city bonds. On July 10 the city comptroller of the city of Chicago agonized for 5 hours and finally decided to turn down a bid of 6.96 percent for $40 million in general obligation bonds, the city rate limit being 7 percent. He turned it down after agonizing for 5 hours about it as to whether he really had any viable alternative.

On July 11, the city of San Antonio offered $85 million in triple A electric and gas revenue bonds carrying a 7-percent rate limitation. Not a single bid was offered.

On July 7 the Santa Clara Redevelopment Agency offered two issues of $12 million and $7 million with a 7-percent rate limitation. Not a single bid was offered.

This was all in the period of the last month, and you will see, we are talking about very big cities with very big bond issues as in the case of New York, medium issues in the case of the city of Chicago, it was a $40 million issue; in the case of San Antonio, an $85 million issue: in the case of Santa Clara, $12 million to $7 million, a $7 million to $12 million issue, and no bids received.

Now, there are factors at work that make it necessary for us to bring this problem to your attention. We are not contending here, Senator, that this problem can be divorced from this general problem of inflation. It is part of the problem of inflation. It is also part of the problem of what is happening in alternative areas.

You saw that just yesterday, for example, people lined up for blocks to get a 9-percent Federal bond that they could buy in denominations

as low as $1,000, which meant a substantial drain on the bank savings accounts, savings and loans savings accounts, money traditionally used for mortgages, compounding the problem you so eloquently pointed out in your television address concerning how we are going to get sufficient money to do the housing that is absolutely indispensable in this country.

So we recognize it is part of that general inflation problem, and I wish I could come down here and tell you that we have some ready answers to that bond situation. I think all we can do at the present time is tell you a story of horror, and it is a real story of horror when you cannot borrow the money to build your hospitals, the money to build your police stations, your fire stations, your schools, rehabilitate your sewer systems as we must do, build the parks that you have to build for recreation in our cities, and to do the things that all of us have to do in connection with the very expensive demands of ecology today. I wish I could tell you we knew an answer to that, but we don't. We really do not know an answer. What we are saying is there are a few things in the hopper that we do not mind commenting on.

One of them is the proposal that you are going to be acting on very shortly, Senator. I understand the Senate is now marking up a bill that relates to the rise of the commercial banks to underwrite revenue bonds as well as general obligation bonds. The Conference of Mayors does not have an official position on that, but those of us who have been dealing in the municipal bond market over a long period of time do not get the impression that there is a kind of cutthroat competition taking place between the underwriting houses in connection with municipal bonds, and so our view would be that anything at all that opens up the area of competition and that introduces a new element of competition would be a very desirable thing. And so we have no brief with the commercial banks as against savings and loans, as against investment houses. We have no brief at all. We are simply saying in an area where competition is not particularly evident, or at least vigorous competition is not particularly evident, and it has not been over the years, without being able to assign the precise source, why there is not the kind of competition that we think ought to exist. We think that the addition of any new element like a commercial bank, in the bidding on revenue bonds of the cities would be a desirable thing.

Now, we have certainly in San Francisco run into the problem, very frankly, of getting bond issues out and not receiving a single bid. This happened about a year and a half ago. We are not without resources to do something about it. On that particular occasion I called the large banks in the area and reminded them of how much we had on deposit from our city retirement funds—in one case $56 million—and suggested very kindly, and I trust urbanely, that there had better the hell be a bid next Tuesday when these things were coming out. We got a bid on that Tuesday.

But these are isolated examples and we no longer can use even that type of economic clout, legitimate economic clout, so far as I am concerned.

Senator BENTSEN. What do you do on the next issue?

Mayor ALIOTO. This is a legitimate reciprocity, I think. We got the bid. We got a pretty good bid. But we are now in the situation

where you cannot even use that type of clout. So that is a problem, and I think that problem can best be highlighted by the mayor of the biggest city in this country.

And you know, when the mayor of the biggest city in this country, a city that has more economic clout than perhaps any major city in the world, is experiencing real problems on bonds, you can imagine what the rest of the country is experiencing for that reason.

And I would like, with your permission, to turn this matter over to Mayor Beame at this point.

Senator BENTSEN. Thank you, Mayor Alioto. It was a very interesting presentation and I want to ask you some questions concerning it.

But if we may hear from Mayor Abe Beame now, please.

## STATEMENT OF HON. ABRAHAM D. BEAME, MAYOR OF NEW YORK CITY, N.Y.

Mayor BEAME. Thank you very much, Senator.

I, too, want to express my appreciation to you for the interest and concern you have shown, not only in this problem, which is so basic to the operation of any city, but also particularly in the area of transportation, which is another very vital area that all the cities of our country are concerned about. Your visits to our city, I think, best express your concern and your interest, and I know that we can look forward to the help and support that you have expressed to us when you were there.

Senator BENTSEN. Thank you, Mr. Mayor.

Mayor BEAME. I also want to echo the observations made by Mayor Alioto in relation to the problems of the cities and the fact that they are sort of being sidetracked now in the light of all that is going on in connection with the national picture, and to hope that Congress will get down to getting at these problems as quickly as possible.

I am glad to be able to make some observations and suggestions about the rapidly escalating interest costs of municipal borrowings. I recognize that our problem is part of a larger collection of problems affecting the economy of the entire Nation. I also recognize that the costs of municipal borrowings are causing new hardships and a rethinking of public priorities, not only in large metropolitan areas. but also in towns and villages throughout the country.

I, of course, am most familiar with the effects of this economic phenomenon in New York City, and I certainly hope that Congress will take steps as soon as possible to help State and local governments throughout the country.

I would like to give you some inkling of the agonies which New York City is experiencing right now in the money market. Since the first of this year, the city sold more than $1,100 million in serial bonds in three bond sales at average interest costs of 5.17, 6.18 and 7.69 respectively.

Now, these are rates, mind you, for tax-exempt bonds, and the 7.69 percent which the city had to pay last week was an all-time record high.

Senator BENTSEN. If you had someone in the 50 percent tax bracket, that would be equivalent to over a 15-percent rate they would be paying, is it not?

Mayor BEAME. That is true.

I might say that also since the first of the year, the city had to sell a total of more than $4.7 billion of short-term notes in 11 note sales at rates which range from 4.48 to a staggering 8.59 percent, and this 8.59 also being the highest rate in the history of the city for short-term borrowing.

On the long-term borrowings, $1,100 million, our taxpayers are going to have to pay nearly $600 million in interest over the lifetime of the bonds, and they will also be paying an additional $170 million in interest costs next year on the short-term borrowings we have had to make in the 7 months of this year.

Now, compounding our difficulties is the fact that the money market has been experiencing an inverted curve, which means we are paying more for short-term than for long-term bonds. Normally we could look for cheaper rates on short-term paper because usually no one likes to tie up his money for 10, 20, or 30 years unless the rate is relatively attractive. But the crunch for short-term paper last fall and just recently were so severe and the demand so great that we had to pay this 8½ percent I mentioned a moment ago.

And this phenomenon penalizes New York City's long-term bond sales, too, because all of our issues are front loaded, that is, in an issue with maturities as long as 30 or 40 years, most of the bonds will mature early, which gives us an average life of 7 to 9 years, and in the normal market, this is good for us, since we pay lower interest rates on the average and, at the same time, we are in a position to be able to pay off our debt in 5 to 10 years.

But when we experience an inverted yield curve in the money market, or even a flattened yield curve, our taxpayers are penalized by what in normal times is good policy.

To show the incredible upsurge in such costs, I would like to point out that in the first 7 months of last year we incurred short-term debt which cost our taxpayers $55 million in interest, and in dramatic contrast, as I mentioned earlier, the first 7 months of this year our short-term debt will cost our taxpayers $170 million, an increase of more than 210 percent, and though it is true that some part of that is due to the fact that we have a higher budget and had to borrow more against the revenues, the bulk of it, however, can be attributed to the spiraling costs of borrowing.

As I indicated earlier, short-term rates in the last 7 months went to 8.59 percent, and caught in this squeeze, we had to go into the market for shorter periods of time and borrow more frequently in the hope that the rates would drop, but unfortunately they did not.

And similarly, if we compared the interest costs on the bonds we sold last year to this year, we would find that last year it cost us $400 million and this year, as I indicated earlier, almost $600 million, an increase of almost 50 percent.

Now, what are the real effects of these increases? They could mean delays in construction, postponement of needed projects, and new strains on an already overburdened property taxpayer and make it nearly impossible to meet the great needs for capital for pollution

control, mass transit, and for the continuing task of renewing our cities.

And they also mean reduced opportunities for work on public as well as private construction projects, and they also absorb funds which would have been spent for services rendered by the cities in their day-to-day operations.

And finally, they impair the ability of local governments to cushion the harsher blows of economic change, and they make it more difficult to correct the inequities of economic policies whose impacts fall unevenly across the country.

And because of these consequences, delaying or avoiding expenditures is extremely difficult to State and local governments. Many of these costs are mandated by both State and Federal requirements.

For the older, inner cities, the process of renewal and renovation is a constant imperative. In every case, these expenditures are a response to the expressed demands of the public for public improvements which cannot be ignored or deferred.

Now, the causes of higher interest costs are simple to state and difficult to resolve. There are three fundamental explanations, which I am confident you are familiar with, one being the extraordinary inflation; a second, the extremely restrictive monetary policies of the Federal Government; and third, the structure of the tax-exempt market for State and local securities which I will discuss in a moment.

Senator BENTSEN. Let me ask you at this point, Mr. Mayor, when you talk about the extreme monetary policy of the country at this time, do you think they are leaning too much on monetary controls themselves rather than doing some of the other things that are necessary on inflation?

Mayor BEAME. I agree with that, yes.

Senator BENTSEN. So it has had a disproportionate effect on the economy.

Mayor BEAME. That is right. I think it is important that we look beyond only the money market to try to see what can be done to fight inflation which really eats into everybody's pocket.

Tight money, which is part of our problem, is supposed to help control prices, which are another part of our problem. But I want to emphasize that the interests of full employment and economic vitality caution against the heavyhanded use of monetary policy.

I believe the burden of meeting unprecedented costs of money falls too heavily on State and local governments. The public suffers more than the private borrowers when money is tight, and even when credit is more plentiful, I believe the cost of public credit is higher than it could and should be, because in general, the market for State and local debt is thinner than the market for private debt. And in the long term, individual investors and private, taxable trusts have declined in importance as direct suppliers of credit.

Savings banks, pension funds, life insurance companies, tax-exempt institutions have correspondingly greater importance. But these investors have less or no use for the tax exemption offered by public debt, and they are attracted only if our interest rates are made higher.

And for large users of credit, such as our city, New York and other large cities generally, the lenders' desire to diversify investment makes the market even thinner.

Therefore, we are very grateful that this committee, your committee, Senator, is going to take a look at it in order to explore ways of increasing the supply of credit available to State and local governments.

Now, there have been a number of devices which have been proposed to accomplish this objective. Some of them have their own difficulties, but if nothing is done at all, State and local governments and their taxpayers will continue to bear too much of the burden of tight money.

And I would like to offer three approaches to trying to help in this situation. One is to set up a Federal municipal financing agency which would issue taxable bonds and then lend the proceeds to State and local governments at a lower rate. And these loans could be secured with a lien on Federal aid which we would be getting from the Federal Government.

There is, of course, a Federal Financing Bank Act of 1973 which does this on behalf of Federal agencies, and that legislation might be amended to include municipal governments.

A second proposal which has been under consideration at times by Congress and deserves further study is the creation of an option for State and local governments to issue taxable securities, replacing Federal tax exemption with a direct Federal subsidy for the difference. Such an option would permit the State and local governments to issue bonds for either taxable or tax-exempt market, whichever was more favorable at that particular time.

And by providing access to a larger money market, the taxable option could provide a real saving to State and local governments and their taxpayers.

Senator BENTSEN. You would favor, you think, the ability of a city or a State to have an option to issue a taxable bond, but you are talking about, in that instance, that there be a Federal subsidy to make up the difference?

Mayor BEAME. Exactly, exactly, and the Federal subsidy should be tied in with a fixed formula so that——

Senator BENTSEN. Now, you would not favor the one to the exclusion of the other. You are talking about leaving the option there, is that it?

Mayor BEAME. Exactly. That is very important because there might be times when it would be in the localities' better interest to issue a tax-exempt bond, and so, an option of this kind at least has to be fixed and not be changed.

Senator BENTSEN. Mayor Alioto, do you agree with that?

Mayor ALIOTO. Perhaps with a little less enthusiasm than others. The position of the mayors is coming around generally to the view that there is so much public pressure about the very wealthy who pay no taxes by reason of tax-exempt bonds, and yet you cannot afford not to have tax-exempt bonds; that perhaps if there were an option involved, it would not be the worst thing in the world.

On the other hand, I have to qualify that, very frankly, with a lot of caveats. I am just afraid that maybe they can set that option up, and at some juncture some Congress decides in an Appropriations Committee that in effect, they are not going to, subsidize the difference between the tax-exempt bond and the taxable bond. Some of us are a

little more skittish than others about admitting that a city bond ought to be taxable under any circumstances.

Senator BENTSEN. But in years past the mayors have opposed that idea.

Mayor ALIOTO. They have opposed the idea. In years past they have said we do not want our bonds taxed. We simply need that credit and cannot afford to have it jeopardized. But we are aware, Senator, of this growing feeling that is developing about the rich men who escape taxation entirely by the use of buying nothing but municipal bonds. Perhaps it is in recognition of that pressure that we are hoping that if the bridge comes, it will be in the form of an option.

But as I say, this is not a position that some of us go to with a great deal of enthusiasm because we think that once you admit that a city bond may in fact be taxable, going the rest of the way at a later period in our time, in the next 10-year period, may not be that difficult. That is the way we feel.

Senator BENTSEN. But the point you make, Mayor Beame, is there are times when a taxable bond has a better market than a nontaxable bond, and that gives the city greater flexibility from that standpoint.

Mayor BEAME. Exactly. And of course, I share the concern that Mayor Alioto expressed. But then, we have the same problem every year, a threat by Congress to take away the tax-exempt feature. And so it is a question of phrasing legislation in a manner where the subsidy will not be tampered with any more easily than the taking away of the tax-exempt feature. It is always a threat, and obviously there are times when there is a greater opportunity to get a better interest rate because of the greater number of investors which would be available in terms of the taxable bonds.

For example, pension funds have no interest in tax-exempt bonds because of the fact they are not subject to tax.

Senator BENTSEN. It would seem to me that we could phrase that obligation where it was a continuing obligation on the Federal Government to make up the differential if we went that way to try to avoid the problems Mayor Alioto brings up of possibly not providing an appropriation some year.

Mayor BEAME. That is right.

A third approach would be, or a third suggestion, to accelerate the payment of Federal receivables to State and local governments, which would, of course, reduce the need for short-term borrowing in anticipation of such receivables. For example, New York City in the current fiscal year is anticipating $2.6 billion in Federal funds, $1.8 billion for our operating budget and $800 million capital funds in general fund revenue. Now, because of the delay in the transmission of this aid and because of the fact that it is handled on a claim and reimbursement basis on some instances, we are forced to go into the short money market.

At the present rates, it would cost—we face an interest cost of at least $50 million on the borrowings for the Federal aid in anticipation of receiving. Now, for years I proposed in the State of New York a similar monthly installment plan for the transmission of State aid to the city, and maybe Congress could consider such a monthly installment plan for the timely transmission and transmission of Federal aid to States and municipalities. What I had proposed was to pool all anticipated State aid to the city in the upcoming fiscal year and take 90 percent of this total, divide it by 12. That would be the monthly installment paid. The other 10 percent could be used for

adjustments made as a result of actual claims submitted, and such a system would reduce the city's needs for dipping into the short-term money market, and that, of course, is something which would help all cities.

I would like to close with the understanding, at least the accepted notion, that the Federal Government has the ultimate responsibility for getting our country back to full or nearly full employment and for reestablishing price stability, and we look to the Federal Government to use its tools of economic policies in such a way that our citizens do not suffer from economic dislocation.

I sincerely hope and look forward, knowing of your concern in this matter, to seeing this committee draft legislation which could help us meet this problem.

Senator BENTSEN. Thank you very much, Mayor Beame.

Let me ask you about the problems of the utilities as compared to the cities, and I am speaking of companies like Consolidated Edison.

Do you find their problems any better or any worse in financing today than in cities?

Mayor BEAME. Your question is addressed to whether——

Senator BENTSEN. I am trying to see whether they are having more or less of a problem than you are in selling bonds to provide services to the cities?

Mayor BEAME. I am sure they are having their share of their problems. Of course, in New York what we did, as you know, was to try to help them by having the State power authority buy some of their plants and giving them a cash flow of about a half a billion dollars. But notwithstanding, they obviously are having problems because they are continually just getting higher rates in order to meet their increased operating costs.

Senator BENTSEN. You mentioned revenue sharing. When it gets to revenue sharing, and then I look at the budgets of the cities as compared to the States—I understand that a number of State budgets are ending up with surpluses.

Do you feel that the cities are having a more difficult time presently than the States or not?

Mayor BEAME. Well, without a doubt the cities are, and what I think everybody understands is that the cities actually deliver the service. They are close to the people. Most usually the State acts in a great number of instances as purely a transmission agency of collecting money and handing it back to the city, and therefore does not have the responsibility or the problem of actually rendering services like police and fire and sanitation. The cities really have their problems, and especially in relation to the tremendous inflation which has occurred and the demands of the municipal employees to meet those increased costs.

Mayor ALIOTO. I would like to comment on that feature.

Senator BENTSEN. Yes.

Mayor ALIOTO. There are many instances in which the Congress of the United States has seen fit to give the States money not based on need. For example, the States, as the Senator knows, the States were not particularly conspicuous in the fight for general revenue sharing. Yet, when we got to the point where both the Congress and the administration backed general revenue sharing, it was deemed politically expedient to give a substantial portion of it to the State. The State of California, among others, received $288 million in general revenue sharing.

Senator BENTSEN. Did they not report a $683 million surplus last year in the State of California?

Mayor ALIOTO. That is what I was about to say. Of the surplus reported in the State of California, $288 million of it was general revenue sharing funds, and that was never the intent of general revenue sharing funds. We thought the States should have used those funds to ameliorate some of the problems of the cities by having a kind of subagency on general revenue sharing. So to that extent, of the surplus you are talking about in California, approximately one-third of it or more was supplied by the Congress on the basis not of need, but on the basis of the fact that we thought it was necessary politically to do that in order to get general revenue sharing at all. So among other reasons, that is why the problem of the States is not quite as intense as ours. When you speak of the utilities, for example, we have had to suffer in connection with the bond market something dramatically more than the general inflation rate. Between March and July of this year, there has been a significant change. In March we thought we were in pretty fair shape as far as bonding was concerned. Since then, there has been an increase of 30 percent in the cost to the cities on interest. That is 30 percent. That bond index, the 20 bond index, has soared to 6.95 percent from 5.3 percent.

Now, 30 percent has not been the range of inflation in this period of time. So that you see in this area we are suffering much more acutely than the general public by reason of the general inflation. You talk about a double digit inflation at 11 percent being outrageously high. What we are talking about as far as city finance is concerned is, in the period of March to July, a 30-percent increase in the cost of money, and this is what highlights the problem.

Senator BENTSEN. Would you develop that a little bit more?

I notice in your statement you point out that many experts claim that the rate of inflation is often 50 percent higher in the public sector.

Mayor ALIOTO. Fifty percent higher. Well, this is one dramatic evidence of it. We speak of an inflation rate of 11 or 12 percent. Here on just the cost of money alone, we have an inflation rate that is at 30 percent, in the last 4-month period.

Senator BENNETT. May I ask a question?

Senator BENTSEN. Yes.

Senator BENNETT. Have you compared that with the increase in the cost of private interest?

Mayor ALIOTO. I have not made a direct comparison, but just on the basis——

Senator BENNETT. I wonder if that is not comparable with the percentage of increase in the interest rates that private individuals have to pay.

Mayor ALIOTO. I do not think that would be correct to say. I do not have a statistical comparison right now, but on the basis of personal experience and experience that you are familiar with, there certainly has been no 30-percent increase in the prime rate from March to July of this year, and that is a pretty good index, Senator, that there has been a more dramatic increase in the public area than in the private area.

Senator BENTSEN. Well, the numbers you have given me seem to show that in this last 30 days or 45 days that you have seen a very marked acceleration in interest rates for cities.

Mayor ALIOTO. In the month of July.

Senator BENTSEN. Do you see any end to it?

Mayor ALIOTO. It is beginning to taper off slightly in the past week or so, but very, very slightly—you know, coming from 5.3 percent in March to almost 7 percent in July. Now it is tapering off slightly. I do not see it getting back to a 5.3-percent rate unless some of these actions are taken. And I would like, too, to say a word on the very fine point made by Mayor Beame about the acceleration of Federal receivables to the cities. You know, so many of our receivables are based upon claim and audit and payment. The Congress has been able to work out in many areas a system of subsidy where 90 percent of the payment is made almost immediately and 10 percent is left for audit and whatever adjustments that audit may disclose. The shipping subsidy is one example of that. For example, the Federal Government pays 90 percent of that immediately upon completion of a voyage, and then 10 percent is set aside for audit and adjustment.

In connection with the export subsidy of agricultural products, the actual subsidy or the difference between the domestic price and world price, until approximately the Russian wheat transaction, was payable immediately upon the transaction of the regular formal documents.

So, if you can, as Mayor Beame suggests, work out a system to accelerate those receivables, that will reduce the necessity of our going into the short-term market and put a certain downward pressure on that interest rate.

Senator BENTSEN. Mr. Mayor, when we have a situation of inflation we know that restraints have to be exercised to a degree to try to bring it under control. But what we are all striving for, it seems to me, is evenhanded restraint that does not result in serious economic distortions.

We have seen construction very materially affected, more so than the rest of the economy and substantially more so, and we see unemployment reaching 10 percent for construction workers, where the overall rate for the economy in unemployment is about 5.3 percent.

What would you think if we, without increasing appropriations or authorizations, if we could pay particular attention to clearing some of the redtape on some of the applications for some of the programs for the cities, such as sewer plants and that type of thing, get that pipeline cleared and some of those things out where the designs have already been completed?

Isn't this something that we should be trying to do?

Mayor ALIOTO. If the question is directed to me, I think that that is a great thought and one that we ought to work on very, very intensively. We have a very interesting study that I would like to make available for the committee, besides filing this statement of mine today, Mr. Chairman, and that is to demonstrate that when you throw in the Federal taxes of the construction workers that the urban renewal program of this country on which we appropriated last year something like $1 billion, the urban renewal program in this country did not cost the Federal Government a dime. It did not cost it a dime.

So anything that can be done to accelerate public construction and urban renewal urgently needed in the cities, obviously would be very helpful in supplying money that we must otherwise try to seek some-

where else or scramble for somewhere else, and in scrambling for it artificially raise the interest rate. The notion of accelerating that time between application and grant is something that I was going to do anyway, and I think it is a great thought.

Senator BENTSEN. Senator Bennett?

Senator BENNETT. I am sorry, I had another meeting, as we all do these days, and I did not hear your full statements.

I would be interested in your comments about the situation that might exist if we authorized the issuance of taxable bonds on a voluntary basis so that you had both taxable and nontaxable bonds outstanding at the same time. I asked the chairman if that was mentioned in somebody's statement, and he said it had been touched on, but apparently not developed.

Do either of you have any greater or any more comments about that situation that might arise?

Mayor BEAME. Well, I had made that observation and obviously it enables any community depending upon the market conditions at the time to exercise the option, which would give it better opportunity to get the lowest interest rates. The important factor, of course, is as to how a formula can be developed, No. 1, to get the Federal subsidy in the adequate proportion, and No. 2, that there be less opportunity for Congress to abandon it at sort of a whim or a wish. As I indicated, Congress today has the power to, and every year we get the threat of having the tax exempt feature of municipal bonds taken away, that Congress continually renews that or at least abandons that threat.

Senator BENNETT. There will always be somebody in Congress who thinks it is a good idea to juggle this relationship, so that threat will always exist.

I would like to ask each of you the simple question:

Would you like to see us try to pass a law which would allow you to go into both the taxable and the nontaxable market?

Would you like to have that option, or would you prefer to keep the nontaxable option or nontaxable privilege without the other option?

Mayor BEAME. Well, I have indicated that I think that it would be an option that would be beneficial.

Senator BENNETT. But you recognize the difficulty that exists, because there would have to be great care exercised in changing the rate of subsidy as the difference between the two rates or return changes.

Mayor BEAME. That is why I dwelt upon the fact that the safeguards in the legislation will protect that possible complication.

Senator BENNETT. Mayor Alioto, do you have the same point of view?

Mayor ALIOTO. The same point of view with a little caveat, Senator. If you could write into that legislation the fact that this is not a bridge to the destruction of the tax exempt city bond, if we can get some kind of assurances that that can be done, I would share the view, because there are markets that are not interested in a nontaxable bond, and to the extent that we cut ourselves off from those markets we are putting an upward pressure on our own interest rates.

But there has been so much agitation about the rich people who do not have to pay taxes because they have city bonds and so much a recognition on our part that if we are going to continue to build

hospitals and schools and police stations and fire stations that we have to have a tax exempt bond, that we would have to be pretty sure that legislation will recognize, or at least be debated, that this is not simply a halfway house to getting rid of that tax exemption. With that caveat, and it is a pretty strong caveat, I would agree with Mayor Beame.

Senator BENNETT. Thank you.

Senator BENTSEN. Mr. Mayor, I may just draft such a piece of legislation and see if we can work out that problem and send it to your Mayors Conference and let you fellows debate it, because unless we can get your support we are not going to pass it.

Mayor ALIOTO. Yes.

Senator BENTSEN. Senator Hartke?

Senator HARTKE. I am delighted to see my colleagues. I am a former mayor, and I think I share somewhat of the anxiety and the anguish that you people feel, not quite as deeply, because it was in an earlier year.

Quite honestly, I disagree with the chairman, and frankly, with most of the Members of Congress, upon how you approach the question of inflation, and I think history demonstrates that they are completely wrong. I am not saying that my view is right, but their view is wrong. Tight money has never cured inflation. Tight money is an inflationary factor. It is quite obvious that if you talk to any businessman he will tell you that. He will tell you that high interest rates contribute to his cost of doing business without any return.

Senator BENTSEN. Do not get the chairman endorsing high interest rates.

Senator HARTKE. You seemed to. You said restraints are necessary and the key to restraint is the Federal Reserve Board. The Federal Reserve Board has the biggest restraint upon the money supply of this country which is forcing interest rates up. The negligence of the SEC is another matter. Why aren't they going after Citicorp?

Senator BENTSEN. Let me interject here. I am not endorsing high interest rates. I made a couple of speeches on that.

Senator HARTKE. I would agree with you that that is an interpretation. I think you are. I think that this Congress is putting the stamp of approval on high interest rates, which is going to plague not only the cities but our children for generations. I think it is disgraceful and I think it is outrageous, and I approve of what the chairman of this committee said, that anybody who gets over 10 percent interest ought to have a 100 percent tax. Senator Long proposed that and I think that is fair.

Over 10 percent is usury; I think anyone who gets 10 percent interest ought to examine his conscience as well as his soul. There is no way that you people who are asked to provide the everyday services of living can cope with the job and pay these interest rates.

Mayor BEAME. I think he should run for the border.

Senator HARTKE. Being mayor is the roughest political job in the world. You do not have any money and you are expected to perform all of the services. I am sympathetic with you, but you cannot cure this problem with a piecemeal approach.

Citicorp came on in with $850 million. They are going to force the people, and savings and loan institutions into bankruptcy. They are going to force the highest cost of money for the Federal Government. And our cities will come in dead last, and they will have to pay the

premium. Unless you can turn the tight money situation around I do not think there is a prayer for you. You will get more problems. I think we ought to take back the authority we gave to the Federal Reserve Board. We gave them the authority to regulate the currency, not to regulate the economy, and there is a lot of difference.

The Federal Reserve Board has taken upon itself legislative and administrative authority to put the restraints on this country and put us into a recession. It is a tragedy—a recession in which unemployment problems are going to continue and the problems of the cities are going to mount.

I looked at your proposal here and the anticipation of revenues. It is a stopgap proposition. It is a drop in the bucket of what you need, Mayor Beame, and you know it, and if people want to talk about the problems of the cities, if they are not willing to face up to the fact that we are going to continue to strangulate the cities financially, then there is not any question that ultimately the problems you have today are going to be magnified many times over tomorrow. I am very sympathetic to your cause.

A piecemeal approach won't work. We fail to recognize that the Federal Reserve and the SEC have a responsibility to the public first, not to the financially rich of this country and not to the big bankers. To find out who is prosperous in the city, you find out who owns the biggest building in town. You will find that it is a banker in every community.

Mayor ALIOTO. Well, Senator, in the beginning of our presentation both Mayor Beame and I recognized that the problem we are dealing with is a part of the general problem of inflation. We do not think it is a special problem. The cure of inflation will ultimately cure the thing that is bothering us. What you say about tight money has in our opinion a great deal of validity.

Now, if some genius would came along who could work out a two-price interest system, that could cure it. That is, that interest obviously feeds the inflation, when you increase that cost of money, as in the case, say, of an agricultural cooperative, from 4.25 percent to 12 percent, when you increase the cost of that money to organizations doing $100 million a year of business, manifestly you are adding to the inflation.

On the other hand, if you lend a lot of money for new ventures you are also feeding the inflation at a time when supply cannot meet demand. So if some genius can work out a system of loose money on daily business transactions and tight money on new ventures we might have the answer we are talking about, Senator.

Senator HARTKE. Mayor, I am not even going to make that second assumption. If you are going to take those two assumptions, you either make the assumption that increase of the productive capacity of America is an inflationary factor, then the whole theory of America is destroyed. Henry Ford in the middle of the depression said, we are going to have a $5 day and a 5-day week. If I can get money in those people's pockets I can sell more cars and I can bring the price of that Ford down and I will make money. Now, that has been the whole genius of the American success, and every single time that we have made the assumption that you create prosperity and defeat inflation by creating unemployment and putting in restrains and tight money,

it has been a failure. All the economists of the District agree with me. You have more people going on welfare, you have a $38 billion welfare cost today. You have 80 million people who at one time or another qualified for welfare in the last year in this country—80 million out of 210 million people, and the people in this country are going in debt and you wonder why they are up tight. They are not up tight about Watergate; they are up tight about meeting the bills on Friday night. That is what they are up tight about. I am not saying that they are not upset about Watergate. But I am telling you that every day they live with the fear of paying the bills on Friday night. A young couple gets married—I came out of school, I bought a home, $200 down and $50 a month. You have to have a fortune today even to make the downpayment, and then you have to pay points.

In my judgment, if you put on a ceiling on interest, as Senator Long suggested, with a 100-percent tax, or if you make it usury to collect over 10-percent tax, you will lower interest rates. People say you cannot do that. They put it on the cities. They tell you how much you can charge. Almost every city has a limit on how much they can pay by legislative fiat, and the city has no choice if they have a limit on how much they can pay in interest. The city has a limit. And they say you cannot put any more on the taxpayers' back in some of these cases. Seven percent is a maximum in some cases.

I do not want you to go home and think that you are going to solve this problem with any of these little piecemeal approaches unless you get the country back into the hands of the people and away from those who are the bigshot bankers—not the little ones. The SEC is afraid to investigate Citicorp when Citicorp did something which violated every principle of financing and monetary affairs of this country. But they let them issue $850 million worth of them, and every bank holding company in the United States is going to do it now and I do not blame them. It is the sweetest little deal I have ever seen. One percent floating over the interest rate of the Treasury bill rate.

Mayor BEAME. I guess sometimes it is a little difficult to find out which comes first—the chicken or the egg, in terms of the fact that tight money causes inflation and inflation causes tight money.

So——

Senator BENTSEN. Let me say——

Senator HARTKE. Just a minute. I will be glad to yield in a minute. I guarantee you that I am out of step. I am out of step with the Congress and I am in step with the people and that is the difference.

Mayor BEAME. I think fundamentally we agree that the basic problem, of course, is inflation, and if that is curable or minimized, it is going to help all around.

Senator BENTSEN. I will tell you, if I may now, Senator, for a fellow that has owed as much money as I have owed, you will never find me in favor of high interest rates and I am still not. But what we need to find is a way to have selective credit restraints so that we can encourage money and loans to be channeled to productive purposes at a time like this. That would take some of the heat off the monetary system and hopefully bring down some of those interest rates. We should try to discourage loans for nonproductive purposes, to take an extreme example, for a gambling casino, or a corporate

takeover. We should encourage loans for municipal services and for increasing the capacity of industries that are in short supply, where the prices are being driven up.

Senator HARTKE. Would the Senator yield?

Senator BENTSEN. I will be through in a minute.

And if you do that, then I think competitive forces take over and the free enterprise system takes over and you hold prices down.

And so we are talking about increasing production and having a growing economy and not trying to curb inflation by stagnation. And I think too often that is what they are trying to do now, and I think that you have a very disproportionate effect on the economy, as we were citing for construction.

Yes, Senator Hartke.

Senator HARTKE. You talk about selective restraint, but you are always talking about selecting somebody else. You are never talking about yourself. And when they are talking about tightening the belt, they are always talking about you tightening your belt. I will not tighten mine.

That is the whole theory of this present economic thinking. I do not believe in that. I am just going to tell you that that is not the way this country became the great country it was. It became a great country by expansion, by going on out and building. When you have a productive business venture to finance, the banks tell you: "Yes. As far as our loan board is concerned, you have an excellent proposition. You have a capacity to be paid. We do not have any money."

Restraint is in the wrong place. You have got to put a restraint on interest rates. You cannot get this Congress to put the same type of restraint on the interest income on the man on social security that you do on a man that works with his hands.

A poor old man who works all of his life and retires at the age of 65, and if he wants to continue to work with is hands, he has an earnings limitation on how much he can earn. When he gets to $2,700, he has to pay back dollar for dollar anything above this figure.

You take a good old rich banker in New York City right down on Wall Street there, and he can collect $100,000 in interest and collect his social security and never give back a penny of it because it is unearned income; it is not, therefore, subject to the restriction. That shows you that all you have to do is be rich and do not work in this country, and the Government will take care of you.

Mayor ALIOTO. I would like to say, first of all, that Mayor Beame and I are absolutely delighted to act as sounding boards for this little informal debate between you and Senator Bentsen. We are just absolutely delighted to be in that position.

Second, there is a good deal about the fact that you can go to a bank today, and let me give you an experience of a medium-size bank. This occurred just within the last month or so.

You go to a bank today and you give them a proposition on a productive thing. Very fine. Something that is needed. It fills a need. It is not whimsical. It is not a gambling casino. Do you know what the banks tell you today? They say, "We do not have any money to lend you."

Senator HARTKE. That is right.

Mayor ALIOTO. And do you know why? Because we are lending it on a week or overnight basis to larger banks at 14 percent.

Senator HARTKE. That is right.

Mayor ALIOTO. This is with the medium-size bank, telling people within the last month or so in a situation with which I had personal contact. Every small and medium-size bank is doing that: the overnight rates or the weekly rates of 14 percent as against something that is productive.

I agree with you, Senator Bentsen. If there were only some way—I do not think that jawboning is going to lead banks to direct their priorities to housing, for example. I wish it could. And I do not know the instrument by which you force an economic incentive to a bank to divert money, say, to housing, so that a young fireman or a young policeman, building his family these days, can buy a home. First of all, there is not a $35,000 home to be bought in the major cities of this country. There is no way of buying a home. But I do not know how in the free enterprise system you direct the allocation of credit. That is the thing that bothers me. And if there were a way of accomplishing that, it would be just great. But I do not know how you do that.

Senator BENTSEN. Let me tell you one of the problems we are running into.

You have the situation where the Export-Import Bank today is financing the exporting of some products that are in short supply in this country. They are financing the establishment of manufacturing plants in other countries, and they are doing it at 6-percent and 7-percent interest rates, when a local businessman has to pay almost double that, and I do not think that is right.

I do not think it is fair. I think it is unwise. That means a drain of capital out of this country.

The other thing that you are seeing is the outflow of capital from this country. We took the limitation off of the outflow of capital in this country, and we did that—Senator, was that last year when we passed that before this committee?

Senator HARTKE. Yes.

Senator BENTSEN. Anyway, it has been in the last 12 months, and we have seen the foreign holdings of our domestic banks go up $2½ billion since that time.

So I think we are going to have to reevaluate this. This outflow of capital is a pressure on the domestic banking system, and it helps force these interest rates up, which have to be brought down.

Well, gentlemen, we are——

Senator HARTKE. Excuse me. Could I ask a question?

Senator BENTSEN. Yes.

Senator HARTKE. I am intrigued by the couple of suggestions which have been made here. One of them is the Federal municipal financing agency concept.

As I understand what you want to do, Mayor Beame, is to go ahead and have the Federal Government create—you say here that it is in the Federal Financing Bank Act of 1973.

The Federal Government should obtain a fund which would be based on the concept of reconstruction finance corporation fund, as we did for private business with Jesse Jones in the 1930's. Then come on back and provide at a decent rate of interest the opportunity for cities

to move on in and obtain funds out of that fund. That would mean, of course, the difference in the interest rate would have to be subsidized by the Federal Government.

I find that has a great deal of merit. We should at least start treating our mayors decently.

The other suggestion, I see no reason why we should not move into this field of giving you the option on taxables and nontaxables. If there is going to be Federal revenue sharing, then let us proceed and permit it on a monthly basis.

It is very easy to determine approximately how much you can anticipate is going to be allocated.

Is that not right? And what you are saying is, you want to get that on a monthly basis instead of getting it in a lump sum or in reimbursable——

Mayor BEAME. Yes. Sometimes, of course, you get it quarterly or later; and of course, there are times when you have to wait until a claim for reimbursement is processed, and the bureaucratic redtape, of course, delays it for months. Meanwhile, cities have to go out and borrow the money, and the Federal Government, of course, has a better opportunity to do that than the cities.

Senator HARTKE. What rate of interest under the first option under the so-called Federal financing agency, what rate of interest would you anticipate would be a fair rate?

Mayor BEAME. I think everything would be in relation to the money market at the time. For example——

Senator HARTKE. Forget the money market. Let's get back to what you can pay.

Mayor ALIOTO. Five percent.

Senator HARTKE. Five percent interest? I mean, after all, is that not a decent rate, 5-percent interest, in order to keep the cities of this country going?

Mayor ALIOTO. Yes, tax free.

Senator HARTKE. When we wanted to electrify the country in rural areas where they could not afford it, we gave you 2-percent interest. Of course, at that time, the interest rates on Federal securities were around one-half percent, if you remember.

Mayor BEAME. That is why I say it has got to be taken in relation to the interest picture of the time.

Senator HARTKE. Let me ask you if you did that——

Mayor BEAME. Well, New York City was paying 2½ percent some years ago.

Senator HARTKE. Let me ask you, though, would you have a limit under this agency on how much a city could borrow?

Mayor BEAME. Well, something, of course, would have to be considered.

Senator HARTKE. In other words, not unlimited.

Mayor BEAME. It would seem logical it could not be too free because New York City could take a big chunk of that, you know.

Senator HARTKE. I think all of those are positive suggestions. I have known you both for a long time, and I will congratulate you both on the fine job you are doing in your respective cities. I do not know of any mayors who are better qualified in the Nation to do the job both of you are doing.

Congratulations.

Senator BENTSEN. Thank you, Senator Hartke.

Mayor Alioto, I know you have a plane to catch; and Mayor Beame, we are very appreciative of your taking the time from your heavy responsibilities to come down here and discuss these issues with us.

I think you have made a substantial contribution, and I hope we can show you some results. Thank you very much.

Mayor ALIOTO. We are very thankful for your extending us the opportunity to talk about the—bonding is a prosaic subject, you know, particularly when we have all of this great emotional absorption in Watergate and impeachment. But the problems of the cities are not going away, impeachment or Watergate or anything else, and we are grateful to you for listening to us.

Senator BENTSEN. Thank you.

Mayor BEAME. The interest is high in the cities in bonds, and interest is very high here on Watergate.

Senator BENTSEN. The hearings are recessed.

[The prepared statements of Mayor Alioto and Mayor Beame follow:]

PREPARED STATEMENT OF MAYOR ABRAHAM D. BEAME ON ESCALATING INTEREST COSTS OF MUNICIPAL BORROWINGS

Chairman Bentsen, distinguished Senators, thank you for this opportunity to make some observations and suggestions about the rapidly escalating interest costs of municipal borrowings.

I recognize that our problem is part of a larger collection of problems affecting the economy of the entire nation. I also recognize that the costs of municipal borrowings are causing new hardships and a rethinking of public priorities, not only in large metropolitan areas, but also in towns and villages throughout the country.

While I am most familiar with the effects of this economic phenomenon in New York City, I would urge the Congress to take steps as soon as possible to help state and local governments throughout the country.

Let me give the Committee some inkling of the agonies which New York City is experiencing right now in the money market.

Since the first of this year, the City sold more than $1.1 billion of serial bonds in three bond sales at average interest rates of 5.17, 6.18 and 7.69 percent, respectively.

These are rates, mind you, for tax-exempt bonds and the 7.69 percent which the City had to pay last week was an all-time record high.

Also, since the first of the year, the City had to sell a total of more than $4.7 billion of short-term notes in 11 note sales at rates ranging from 4.48 to a staggering 8.59 percent, the latter also being a record all-time high for The City of New York.

On the long-term borrowings, our taxpayers will be paying a total of nearly $600 million in interest over the lifetime of the bonds. They will also be paying an additional $170 million in interest costs within the next year on short-term borrowings made just in the last seven months.

Compounding our difficulties is the fact that the money market has been experiencing inverted yield curves, which means that we are paying more for short-term paper than for long-term bonds.

Normally we could look for cheaper rates on short-term paper, because usually no one likes to tie up his money for 10, 20 or 30 years unless the rate is relatively attractive. But the crunch for short-term paper last fall and just recently was so severe and the demand for such paper was so great that the rates for our tax-exempt notes skyrocketed to 8½ percent last week.

This market phenomenon penalizes New York City's long-term bond sales, too, because all of our issues are "front-loaded," that is, in an issue with maturities as long as 30 or 40 years, most of the bonds will mature early, placing the average life of the issue at seven to nine years. In the normal market, this is good for us, since we will be paying lower interest rates on the average and, at the same time, we can be in a position of seeing that we pay off about

half of our outstanding debt in five years and about two-thirds of that outstanding debt in ten years.

But when we experience an inverted yield curve in the money market, or even a flattened yield curve, our taxpayers are penalized by what is, in normal times, a good policy.

To show the incredible upsurge in such costs, let me point out that in the first seven months of last year we incurred short-term debt which has cost our taxpayers $55 million. In dramatic contrast, as I mentioned before, in the first seven months of this year, our short-term debt will cost our taxpayers $170 million.

This represents an increase of 210 percent in our short-term interest costs so far this year over those costs during a similar period last year.

It is true that part of this increase is due to the fact that our budget is higher and we must go into the short-term market in anticipation of higher receivables such as state and Federal aid and real estate taxes.

But the bulk of the increase can be attributed to the spiralling interest costs of borrowing. As I noted before, short-term rates zoomed in the last seven months to 8.59 percent. Caught in this squeeze, the Comptroller's Office has been borrowing for shorter periods of time in hopes of a break in the market and thereby being forced to go into the market more frequently, rolling over some of the short-term notes into new time periods. Unfortunately, the rates have not dropped.

Doing the same computations for our bonds, in the same time span, we find that interest costs on bonds sold last year totalled $400 million, while this year those costs totalled $590 million, an increase of 48 percent.

What are the real effects of these interest rates? They could mean delays in construction, postponement of needed projects, and new strains on an already overburdened property taxpayer. These costs will make it nearly impossible to meet the great needs for capital for pollution control, mass transit, and for the continuing task of renewing the cities.

They mean reduced opportunities for work on public as well as private construction projects. These increased interest costs also absorb funds which would have been spent for vital services rendered by the cities in their day-to-day operations.

Finally, they impair the ability of local governments to cushion the harsher blows of economic change. And they make it more difficult to correct the inequities of economic policies whose impacts fall unevenly across the country.

Precisely because of these consequences, delaying or avoiding expenditures is extremely difficult for state and local governments. Many of these costs are mandated by state and Federal requirements.

For the older, inner cities, the process of renewal and renovation is a constant imperative. In every case, these expenditures are a response to the expressed demands of the public for public improvements. These demands cannot lightly be ignored or even deferred.

The causes of high interest costs are simple to state and difficult to resolve. There are three fundamental explanations, each of which contributes to the problem:

1. Extraordinary inflation. This boosts the overall costs of projects financed by borrowing, and also leads investors to demand higher interest rates to offset inflation.
2. Extremely restrictive monetary policies by the Federal government.
3. The structure of the tax-exempt market for state and local securities, which I will discuss in a moment.

There is no question that the Federal government's task of maintaining full employment with price stability is one of its foremost responsibilities. Just now, the emphasis is on controlling inflation.

I recognize that tight money, which is part of our problem, is supposed to help control prices, which are another part of our problem.

But I would emphasize that the interests of full employment and economic vitality caution against the heavy-handed use of monetary policy.

I do believe the burden of meeting unprecedented costs of money falls too heavily on state and local governments.

Because of the structure of the public money market, the public suffers more than private borrowers when money is tight. Indeed, even when credit is more plentiful, I believe the cost of public credit is higher than it could and should be.

In general, the market for state and local debt is "thinner" than the market for private debt. In the long term, individual investors and private, taxable trusts have declined in importance as direct suppliers of credit.

Savings banks, pension funds, life insurance companies, tax-exempt institutions and even foreign investors have correspondingly greater importance. But these investors have less or no use for the tax exemption offered by public debt. They can be attracted to our market only by higher interest rates.

Moreover, for large users of credit, such as New York City and other large cities generally, the lenders' desire to diversify investment makes the market even "thinner".

Therefore, we are most grateful to this Committee and its staff for exploring ways of increasing the supply of credit available to state and local governments.

A number of devices have already been proposed to accomplish this objective. Each of them has its own difficulties, but if nothing at all is done, state and local governments and their taxpayers will continue to bear too much of the burden of tight money.

Permit me to make the following suggestions to the Commitee for its consideration and possible use:

(1) Set up a Federal municipal financing agency. This agency could issue taxable bonds and lend the proceeds to public bodies at lower rates. Those loans could be secured with a lien on Federal aid receivables.

I might add that I believe a mechanism already exists which could be used to implement this idea. The Federal Financing Bank Act of 1973 issues obligations on behalf of Federal agencies, and I believe this legislation might be amended to include municipal governments.

(2) One proposal which has been under consideration by Congress and which deserves further study is the creation of an option for state and local governments to issue taxable securities, replacing Federal tax exemption with a direct Federal subsidy. Such an option would permit state and local governments to issue bonds for either the taxable or tax-exempt market, whichever was more favorable at a particular time.

By providing access to a larger money market, the taxable option could provide a real saving to state and local governments and their taxpayers.

(3) Accelerate the payments of Federal receivables to state and local governments. This would, of course, reduce the need for short-term borrowings in anticipation of such receivables.

In New York City, in the current fiscal year, we are anticipating $1.8 billion in Federal aid for our expense budget, plus another $800 million in capital funds, general revenue sharing and other grants. Because of delays in the transmission of this aid and because some of it must be handled on a claim and reimbursement basis, we will be forced to go into the short-term money market.

The way rates are going now, we could face an interest cost of at least $50 million for borrowing just in anticipation of receiving Federal aid we're entitled to.

For years, I have proposed to the State of New York a monthly installment plan for the transmission of state aid to the City and perhaps Congress could consider such a monthly installment plan for the timely transmission of Federal aid to states and municipalities.

This is what I proposed to the state: pool all anticipated state aid to the City in the upcoming fiscal year. Take 90 percent of this total and divide it by 12, in order to arrive at a monthly installment. The remaining 10 percent would be used to make the proper adjustments after the fiscal year is over.

Such a system would reduce the City's need for dipping into the short-term money market.

I would like to close with the accepted notion that the Federal government has the ultimate responsibility for getting our country back to full or nearly full employment and for re-establishing price stability.

There are economic forces at work in the world and in the nation today which are not really understood, but their effects on the daily lives of our citizens are quite profound and somewhat frightening.

We look to the Federal government to use its tools of economic policy in such a way that our citizens do not suffer from economic dislocation.

I urge this Committee to draft legislation to help us meet this problem, and I hope the Committee will find my suggestions useful.

Thank you.

PREPARED STATEMENT OF HON. JOSEPH L. ALIOTO, ON THE MUNICIPAL BOND MARKET

Mr. Chairman, my name is Joseph Alioto, and I am Mayor of San Francisco and President of the United States Conference of Mayors. With me this morning is Mayor Abraham Beame of New York City. We appreciate the opportunity to testify before this committee to discuss the critical situation that cities are facing in selling their municipal bonds.

Mr. Chairman, we have heard a great deal about the renewed fiscal health and vitality of our nation's cities. Even the President of the United States has gone so far as to proclaim an end to "the fiscal crisis of our cities." I have noted with great interest recent publication that project billion dollar surpluses for state and local government. I often wonder when I hear these claims of urban affluence if the authors are speaking of the same American cities that I so intimately know. Perhaps they have confused their data with the surplus reports that are arriving daily from the oil-rich lands in the Middle East. Unfortunately, Mr. Chairman, I perceive a yearning for normalcy in our land—a yearning to turn away from our complex social and economic problems and to carve out individual domains of peaceful security. It is a yearning that I can understand, but the illusions that it creates I cannot accept.

Ten years ago, no one disputed that there was a crisis in our cities. With riots erupting in city after city, and basic services such as police protection and garbage collection drastically deteriorating, the enormity of the crisis was vividly real to every American.

Now, a mere decade late, people are proclaiming that the crisis is over. Let us not be deceived—the fact that our cities are no longer burning does not mean that the problems of urban America have been solved.

The subject we are discussing this morning—the crisis in the bond market—is only one manifestation of a continuing crisis. A crisis that cannot be solved by wishful thinking and optimistic rhetoric. I do not believe that anyone can comprehend the significance of the current capital financing crunch facing our cities without first understanding that it is only one component of the larger urban fiscal crisis.

Mr. Chairman, the cities of America are not sitting with billions of dollars in their coffers. They are not rolling in unspent revenues. The economic crisis that is gripping this entire country is impacting hardest on our cities. I need not remind this committee that the current rate of inflation stands at over 11%. But I should point out that many experts claim that the national rate of inflation is often 50% higher in the public sector. If true, this translates into a whopping 16.5% inflation rate for the governments that I am representing. I am not an economist so I cannot verify these figures. But I am a mayor in charge of a city budget around $700 million, and I do know that the current levels of inflation are having a devastating impact on my city. The skyrocketing costs of fuel and building materials—the escalating wage and fringe benefit demands of public employees—all these inflationary pressures translate into one single phenomenon. City expenditure demands are vastly outstripping the revenue available to city governments. Mr. Chairman, we are not little federal governments. We cannot carry over billion dollar operating deficits. Our operating budgets must be balanced at the end of the fiscal year. So when expenditures demands outstrip available revenues, we are faced with two choices: either we can cut essential city services or we raise local taxes, primarily the local property tax.

I need not belabor this point. Let us all understand that the fiscal crisis of our cities has not ended and that current conditions in the municipal bond market are only one indicator of a deepening crisis.

Mr. Chairman, we are faced with a rapidly deteriorating situation in the municipal bond market. It is almost incomprehensible what has occurred in the last few months.

To illustrate my point, let us begin with some base figures from earlier this year. In March the average interest rate on municipal bonds was roughly 5.82%. This compared favorably with the average interest rates for municipals following the severe credit crunch of 1969-1970. Four months ago, the market looked in good shape. In fact, in the first five months of 1974 financing by state and local governments through the issuance of long term tax-exempt bonds totaled nearly 11 billion dollars. This was a rise of 17.7% from the volume during the same period in 1973 and was reflective of the increasing capital financing demands on state and local governments. If I had appeared before this

committee two months ago, I would have indicated that the only bright spot on the urban fiscal landscape was the strength and stability of the municipal bond market.

Now let me turn my attention to what has happened in the last 30 days. The month of July saw the volume of long term tax-exempt financing drop by 30.6% from the June figures. This is the lowest monthly volume since August 1970, when the country was experiencing a severe credit crunch. This dramatic downturn in the overall volume of tax-exempt bonds is directly related to the skyrocketing costs of borrowing money. From the early March figures of 5.32% the 20 Bonds Index soared to 6.95% on July 11. This is only a few basis points below the record interest rates of the 1969–1970 credit crisis. In four months, the cost of borrowing for city governments has increased by an incredible 30%.

*The Bond Buyer* in its July 22 issue stated: "The unprecedented escalation in interest rates in the period July 1 to July 12 has pushed borrowing costs on municipal bonds close to their record highs of May 1970. The market climate deteriorated so quickly and so drastically in the week of July 8 that out of a stated competitive volume of 861.7 million, a total of 660.3 million—a record high displacement issue figure—failed to reach dealer's hands."

In other words, state and local governments were going to the market but near record interest rates prevented them from obtaining nearly 95% of the capital they sought. Let us look at some of the individual issues.

July 9—New York City rejected a record high bid of 7.923% on a 438 million dollar issue.

July 10—The city comptroller for the City of Chicago agonized for five hours and finally decided to turn down a bid of 6.96% for $40 million in general obligation bonds. The city rate limit being 7%.

July 11—The City of San Antonio offered 85 million dollars in triple "A" electric and gas revenue bonds carrying a 7% rate limitation. Not a single bona fide bid was offered.

July 7—The Santa Clara Redevelopment Agency offered two issues of 12 and 7 million dollars with a 7% rate limitation. No bids were offered.

July 11—St. Claire County, Michigan, postponed a 36 million dollar offering in new revenue bonds designed to finance pollution control facilities. The reason—a projected 8% interest rate for the month of July. The list of displaced issues goes on, totalling over 600 million dollars.

As demonstrated by these examples, three factors prevent municipalities from borrowing when interest rates drastically climb.

First, in many states and municipalities, there are statutory limits on the amount on interest that can be paid on an issue. Although these limits have been eased since the 1969–1970 credit crunch, they are still a factor for many cities.

Second, many local officials refuse to accept bids with exorbitant interest rates, knowing that the taxpayers in their communities cannot be burdened with the additioinal costs from skyrocketing interest costs.

Third, under tight money conditions, the buyer of municipal bonds go elsewhere. This is especially true of the large commercial banks which presently hold over 50% of our bonds. As witnessed in the 1969–1970 period of tight money, commercial banks will shift away from the municipal bond market in order to provide the capital needed by their business customers. For state and local governments, the result is substantially increased borrowing costs.

Let us now look at what it means to municipal governments when they are unable to obtain necessary capital at reasonable interest rates. Debt financing is used to construct needed public facilities—schools, hospitals, roads, mass transit facilities, libraries, pools, water pollution control facilities—all of these depend upon an adequate supply of capital at reasonable interest costs. If the capital is not obtainable through the issuance of municipal bonds, then vitally needed public facilities do not get built. They are postponed, and for every week that construction is delayed, double-digit inflation is forcing up the eventual cost of each project. For example, a school costing a million dollars in 1974 is likely to cost a million and a half by the end of this decade. Postponement means skyrocketing costs and such costs must eventually be borne by the taxpayer in each community.

A city which is not restrained by an interest rate ceiling may choose to, or may be forced to, go to the market regardless of the cost of borrowing. If a water pollution control facility must be built in order to meet state and federally-mandated standards, then a city must obtain the funds to finance the project. Again, it is the local taxpayer who must suffer the additional financial costs. He is the one who will have to foot the bill—he is the one who will eventually pay the extra 1-2% interest costs over the life of the bonds.

The only other option available to local officials is to dip into their operating budgets to meet the increased interest payments. But no public official welcomes the opportunity to divert scarce city funds from essential operating needs to nonproductive interest payments.

Mr. Chairman, added to these harsh realities, today's credit crisis appears to be unique in its dimensions. Two factors stand out. From the cities' perspective, the demands for improved public facilities has never been higher. It is estimated that in 1975 state and local governments will require over $30 billion in long term borrowing to finance needed capital improvements. This will represent a 163% increase in bonds sold over the 1970 period. We do not need these statistics to tell us that the cities need billions and billions of dollars in the immediate years ahead to rebuild their deteriorating public facilities. And we do not have to be reminded of what will happen if we allow our cities to further decay.

The second unique factor regarding current credit crisis was articulated by a prominent bond dealer several weeks ago in the *New York Times*. Allow me to quote:

"We've had tight money markets before, most recently in 1966 and the 1969-70 period. But those were minor inconveniences compared with what we see today. In the past we did not have inflation to worry about. Today, every important lender to the bond market is terrified by inflation. We've never had so critical a situation before and what's worse—no solutions are in sight."

Mr. Chairman, I have attempted to give you an overview of the present crisis. Soaring interest costs, a dramatic decline in the volume of long term tax-exempt financing, unprecedented demand for improved public facilities, and the devasting impact of double digit inflation. Before turning to my colleague who will detail his experience under the current crisis conditions, I would like to return for a moment to my opening remarks. Congress and the Executive must not view this most recent credit crunch in isolation. It is only one element in the larger urban fiscal crisis. I do not have a remedy for inflation—nor do I have the complex answers that are needed to reverse the deteriorating situation in the bond market. What I do know, and what I cannot strongly enough emphasize, is that the federal government must renew its commitment to American cities.

We need immediate action on the omnibus Housing and Community Development legislation which is pending in Conference.

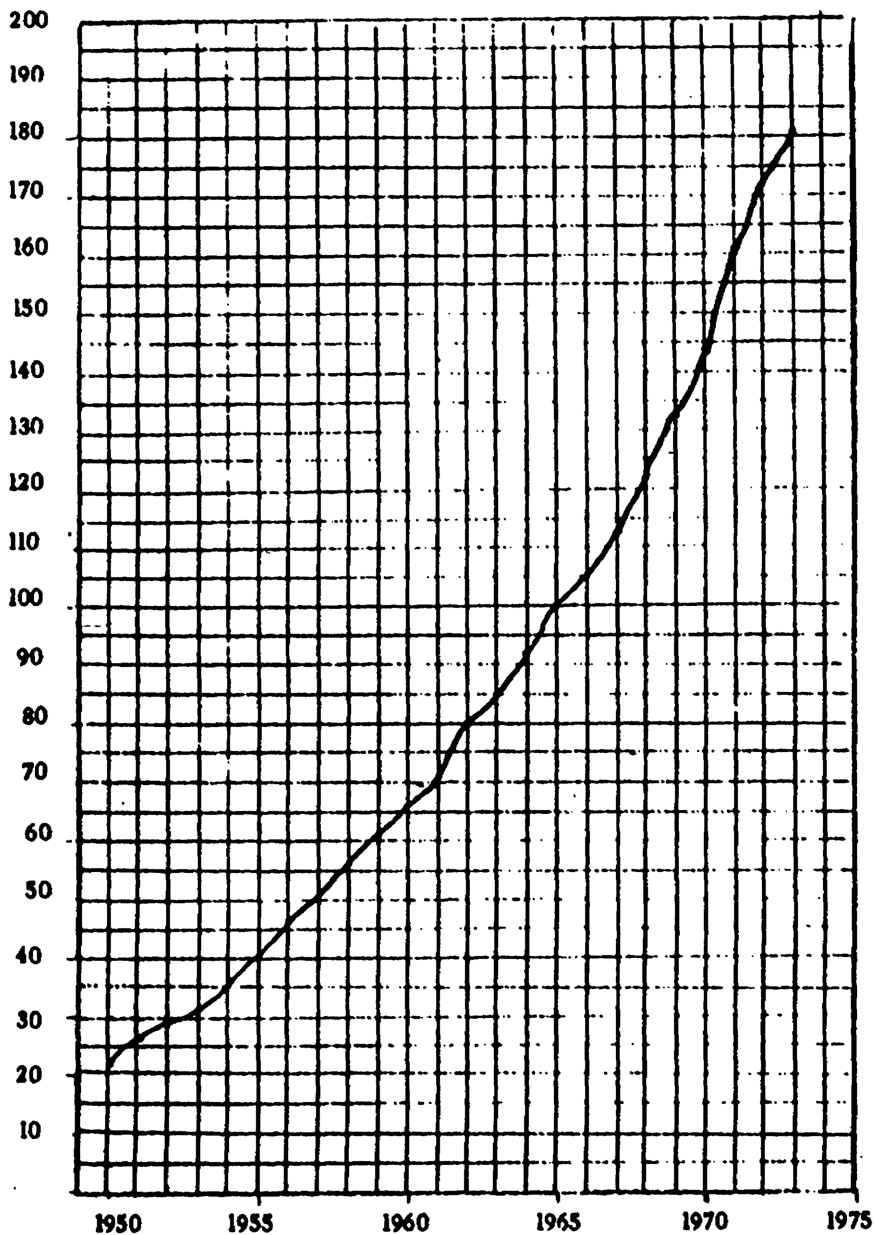
We need action on urban transportation and, in particular, operating subsidies for mass transportation.

We need action on welfare reform and national health insurance.

And we need action to insure the continuation of the general revenue sharing program beyond 1976.

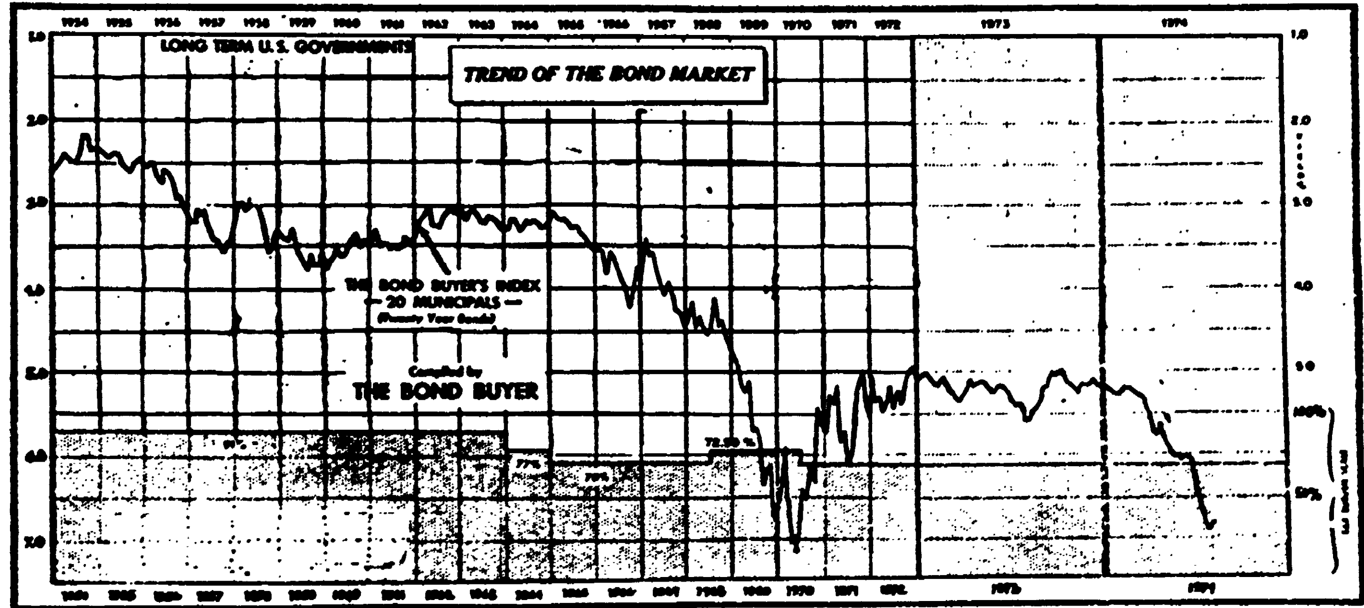
These are concrete measures that can be taken to help solve our complex urban problems. These are actions which will help hold the fiscal crisis of the cities. I urge you to act.

OUTSTANDING DEBT--STATES AND MUNICIPALITIES--1950 TO 1973



BEST COPY AVAILABLE

THE COST OF BORROWING 1953-1974




NOTE: Long-term U.S. Governments—The line for Government bonds in this graph from March 28, 1974 to date is based on yield of 7s of 5/15/98, after 48% corporate income tax, as shown in our weekly compilation "The Bond Buyer's Index of Municipal Bond Average Yields." From Feb. 15, 1973 through March 21, 1974 yield of 6¾s of 2/15/93 was used. From Feb. 1958 through Feb. 8, 1973 yield of 3½s of 2/15/90 was used. From 1954 through Jan., 1958 yield of 2½s of 1972/67 (Banks) was used. Corporate Bonds—Beginning in 1963, the yield shown for corporate bonds is after corporate income tax rates shown above. From 1954 through 1962 yields shown are before corporate income tax.

Source: The Bond Buyer

[Whereupon, at 11:15 a.m., the subcommittee recessed, to reconvene on Thursday, August 8, 1974, at 10 a.m.]

# THE GROWING THREAT OF A DOMESTIC FINANCIAL CRISIS

---

THURSDAY, AUGUST 8, 1974

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
*Washington, D.C.*

The subcommittee met, pursuant to recess, at 10:07 a.m., in room 2221, Dirksen Senate Office Building, Senator Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senators Bentsen and Hansen.

Senator BENTSEN. Ladies and gentlemen, we will now get underway. The committee will come to order.

I apologize for the fact that there are not more of the members here. We are having caucuses on the Democratic side and the Republican side these days, as you can well imagine, in these rather difficult times for the country, on other matters than the specific ones before us this morning.

We are very pleased to have as our first witness this morning Mr. Nat Goldfinger, who is director of the Department of Research for the AFL-CIO.

Mr. Goldfinger, if you would come to the witness stand and give us your views on the economic problems facing our Nation.

## STATEMENT OF NAT GOLDFINGER, DIRECTOR OF THE DEPARTMENT OF RESEARCH, AFL-CIO

Mr. GOLDFINGER. Thank you, Mr. Chairman.

I am pleased to have this opportunity, and I want to thank you, Mr. Chairman, for this chance to present the views of the AFL-CIO on this very serious problem. As we look at it we are now in a money crunch. This is not a threat of a money crunch, but we are already in it, and the combination of the policies of the administration and the Federal Reserve have put us where we are.

These have been the most utterly misguided policies in terms of attempting to handle the inflationary problem which exists. This inflationary problem was touched off by the huge Russian grain deal back in July of 1972, aggravated by the devaluations of the dollar, and further aggravated by the utter lack of effective regulation of the commodity exchanges. The response of the administration and the Fed has been tight money and a phaseout of essential Government programs such as housing assistance programs.

We are in an inflationary recession. The inflation is continuing to climb, and, Mr. Chairman, the Bureau of Labor Statistics, about three-



40-544 O - 74 - 3

quarters of an hour ago, released the Wholesale Price Index for the month of July 1974, and in that one month, wholesale prices jumped 3.7 percent; in the month of July they were up 20.4 percent over July of 1973, and in the past 3 months they rose at an annual rate of 24.1 percent.

The inflation problem continues, and it continues to get worse. We have had this accelerating and raging inflation now for almost 2 full years. On top of that, we have a recession which started in the final months of 1973. And the sharp runup of interest rates to the highest level since the Civil War, have created a serious money crunch with the withdrawal of funds from the savings and loans and the mutual savings banks. Housing is in a depression. The real volume of retail sales is running 4, 5, 6 percent below the same levels of a year ago. And now, on top of all of these other problems, in the past several weeks we have had serious problems emerge, with the sharp runup of interest rates for local governments. Many cities and counties are unable to float bond issues and are thereby cutting back their capital improvements.

In addition to that, similar kinds of problems now face the public utilities, causing them to postpone and stretch out plant expansion programs, despite the urgent need that this country has for increased gas and electricity facilities.

This is not merely creating an immediate problem. It is creating a long-term problem in terms of the potential shortages of capacity of gas- and electricity-producing capacity, with its impact on productivity and so forth. But more than that, in the immediate sense, this situation, which is producing postponements, cutbacks and stretchouts of capital improvement and plant capacity expansion by the public utilities and cities and counties is eroding the whole base of whatever strength there has been in the economy in the past 6 months, because the only part of the economy which has evidenced any degree of strength at all in these past 6 months has been the investment area. This is now eroding and has been eroding in the past number of months.

In our view, Mr. Chairman, this economy is on the brink of disaster. We are on the brink of disaster in terms of a sharply deepening recession combined with raging inflation, the threat of business failures, of bank failures, and the imminent threat of very sharply rising unemployment and layoffs in the face of a rise of unemployment of about 750,000 between October 1973 and July 1974. In our view, a number of decisive changes in economic policy are essential, and I will spell them out very briefly.

First, we believe that it is necessary to change the monetary policy. We believe that a somewhat easier monetary policy with lower levels of interest rates generally is necessary, but that should be combined, and we believe that the latter part of what I am going to say now is utterly essential, and that is, we need a selective monetary policy in which money and credit should be allocated on the basis of social and economic priorities. There should be an eased flow, a greater flow of credit for housing, for community facilities, and for such essential activities as public utility expansion, while at the same time the flow of money and credit should be tightened considerably for such lower and unessential activities as the building of gambling casinos, land speculation, loans to foreign borrowers and credit for the foreign subsidiaries of American corporations.

Second, we believe that in order to bolster the housing market which is collapsing at present, that a direct Government lending program is essential, at reasonable interest rates, to provide mortgage money for middle income housing, in addition to the expansion of Government assistance programs for low income and moderate income housing.

Third, we believe it essential for the Government to establish export controls on the exports of agricultural products and other goods which are in short supply at home and which are creating inflationary shortages. And such export controls, in our opinion, should be maintained so long as such inflationary shortages with their price pressures continue. And we believe that effective Government regulation of the commodity markets should be established instead of the ineffective regulation that now exists.

Moreover, we believe that the Government should rebuild America's stockpile reserves of agriculture products and raw materials which have been depleted as a result of administration policy in the past 2 years. And in our opinion, the re-establishment of such reserves to adequate levels as rapidly as feasible is necessary to serve as a price stabilizing factor as well as for national security and to help meet domestic or foreign emergencies such as droughts, disasters and shortages.

That is a very brief summary of my statement which I hope you will accept in full for the record, Mr. Chairman.

Senator BENTSEN. Yes. The whole thing will be taken in its entirety.

Let us get into some of the points that you raised.

Not long ago we repealed the interest equalization tax. We did it in this committee, we did it in the Congress. We did it at the recommendation of the administration, and I for one voted for it. But since that time we have seen the loans of banks in this country, to foreigners expand by some $2½ billion. That is money going out of the country when we are having a credit crunch inside this country.

Don't you think it is time we took another look at the interest equalization to see if we should reinstate it?

Mr. GOLDFINGER. Mr. Chairman, I think that should be done as quickly as possible. In line with your comment, the current monetary policy, in addition to being inflationary by raising costs and prices directly, and in addition to depressing the rise of productivity by creating slump conditions, this monetary policy is also utterly discriminatory. It permts the easy flow of credit for unessential and low priority kind of purposes such as foreign loans——

Senator BENTSEN. Let me give you another——

Mr. GOLDFINGER. Now Governor Brimmer of the Federal Reserve in an address on July 17, stated that "in the first 5 months of the year," which as he says,

> which is about the same as saying in 4 months following the end of capital outflow restraints, total foreign assets held by U.S. banks and U.S. agencies and branches for their own account increased by about one-third. In dollar terms, the increase was about $8½ billion, and brought the level to $84 billion. Almost all of that increase represented credit extended to foreigners.

Senator BENTSEN. Let me get another subject. The Export-Import Bank participated in a loan for a $180 million fertilizer plant in Russia. They participated in a loan for 20 drilling rigs for Algeria. They participated in a 6- or 7-percent loan for an offshore drilling rig for the OPEC countries. Every one of these things is in short supply

in this country. And yet the Export-Import Bank is doing it at interest rates approximately half of what American businessmen would have to pay in this country. They are doing it at rates of 6 and 7 percent, in effect, subsidized interest rates.

Do you not think that is wrong?

Mr. GOLDFINGER. We think it is outrageous, Mr. Chairman, and we have been urging the Congress to take a very hard look at the whole operation of the Export-Import Bank and the subsidized loans to the Russians and to other countries. These subsidized loans, as we see it, are in effect a form of economic aid.

Senator BENTSEN. Of course it is, and you are doing it to countries that cut off the valves, for example, in Algeria, the OPEC countries, and you are subsidizing loans to them at the expense of the American taxpayer, and I think that is unwise, and I think that is wrong, and I am introducing legislation to see if we cannot correct this and turn it around.

Mr. GOLDFINGER. Well, we are glad to hear that, Mr. Chairman. Furthermore, as you pointed out, these subsidized loans are for goods which are in short supply domestically.

Senator BENTSEN. Let me ask you about proposals for selective credit restraints to try to ease the pressure on the monetary system, and to try to help those areas of the economy where we have short capacity. One of the ways to stop inflation is to increase production, it seems to me. We should not be following a philosophy of stagnation but one of growth, and if we get production up, competition will take over, and we will have plenty of products. In the current inflation, a good part of it comes from the fact that we have short capacity in some of our basic materials. Last year, about 60 percent of inflation came from commodities—oil and other commodities.

How would you go about accomplishing credit allocation in a way that would be feasible and where we would not get too much Government control? The objective is good. Now, I am trying to figure out the mechanics.

Mr. GOLDFINGER. Well, Mr. Chairman, our recommendation is for the establishment of priorities and the establishment of these social and economic priorities, as we look at it, probably should be done by a committee, not by the Federal Reserve, and that the Federal Reserve should direct the commercial banks to maintain certain proportions of their portfolios in different forms of assets, in different forms of loans so that the flow of credit would be enlarged for housing, community facilities, and as I said, such essential business operations as the expansion of public utility plants, and the flow of credit should be tightened considerably for such things as gambling casinos, loans to foreign borrowers and so on.

We think that is essential. Governor Brimmer of the Federal Reserve has made another proposal which we have some doubts about in terms of effectiveness, but we would be willing to support it and give it a year or so. That is a system of variable reserve requirements, based on a selective priority basis. So in other words, Governor Brimmer's idea is similar to ours, but the mechanism would be different.

Senator BENTSEN. That would be an incentive to encourage the banks? Some loans would be more profitable, in effect, than others?

Mr. GOLDFINGER. Right.

Senator BENTSEN. So that it would push the banks to a degree, in a direction. Of course, that does not get to the situation of life insurance companies which are great long-term capital providers, and it does not get into the situation of savings and loans, which provide most of your home loans. There is a real crisis there. You have a serious disintermediation of funds, where you have got them involved in long-term securities, mortgages, in effect, and yet they have got short-term savings. They are being whipsawed in this kind of a high interest rate deal.

Mr. GOLDFINGER. I think one of the most fantastic things, in my mind, is what the Federal Government has done in the past few days on top of what Citicorp and the holding company of Chase Manhattan have done in the form of these floating notes where the Federal Government has now issued very high interest bonds in small amounts which are flowing, resulting in an outflow, very substantial outflow from savings and loans and mutual savings banks in addition to the massive disintermediation that you refer to, Mr. Chairman.

I think the S. & L.'s and the mutual savings banks are in very serious trouble right now.

Senator BENTSEN. Any time you see some S. & L.'s selling at two times earnings, as I see out on the west coast, you know they are in trouble. You know what the investors are thinking of today, and the problems that they have. I have never seen that in my lifetime.

Mr. GOLDFINGER. Yes, sir.

Senator BENTSEN. One of the other serious problems we have is that about 460,000 construction workers are out of jobs. If all of them were employed, you would have about another half a billion dollars in Federal taxes that they would be paying, plus the social security payments, plus they would be off the unemployment rolls and we would not be paying that kind of compensation. So obviously they can contribute very much to the economy. We must try to find ways to avoid some of the serious dislocations in the economy brought about by very high interest rates. We see a situation where the sacrifice is not equally shared in this country.

I am convinced we are in a recession. The classic definition of a recess, of course, is when you have two quarters of falling GNP, and I get terribly concerned anytime an administration starts redefining what a recession is. Then I know we are in one.

But some parts of the economy have a depression today such as homebuilding and construction.

Now, what would you do to try to alleviate this? Arthur Burns testified before our Joint Economic Committee the other day, and he proposed a $4 billion program of public service employment to create 800,000 jobs at State and local government, if the Nation's unemployment rate got up to 6 percent.

What do you think of that proposal?

Mr. GOLDFINGER. Well, Mr. Chairman, we have been the leading advocates of the program of public service employment which we believe, unlike Dr. Burns, should be a permanent program. We have advocated this since 1968, and we have testified at great length on this subject—we believe that a public service employment program is essential. However, Mr. Chairman, a public service employment pro-

gram of this type, which is an utter essentiality at this point, particularly since we are in a recession with rising unemployment and the threat of sharply rising unemployment, but this kind of program in itself will not do very much for the 10.6-percent unemployment rate among construction workers now.

We also have to get at this depression in homebuilding. In the first 6 months of this year it has declined 31 percent below the same period of last year, and in 1973 there was a 13-percent decline in residential construction. In recent months, building permits have moved down sharply, pointing to a further sharp decline of residential construction.

Moreover, this is probably the first time in the postwar period where high-interest rates have not only hit residential construction, but are now hitting heavy construction, utility expansion, and plant expansion generally. I think that we are in a most dangerous situation with a deepening recession, and unfortunately a very widespread lack of public confidence in the ability of this Government to handle economic problems.

Senator BENTSEN. Mr. Goldfinger, I know that one of the arguments against public works projects for unemployment is that there is such a lag time involved, and by the time you get some of these things underway, the problem has passed. I am wondering if it would not be practical for those projects that are already approved and for which funds have been appropriated—we are not talking about raising the budget any—to cut through the redtape of the applications.

Now, I am talking about sewer plants, and I am talking about pollution control plants that cities are trying to build around the country that are very much needed.

Do you not think if we had a concentrated effort to try to clean up some of the redtape and expedite some of those applications where the design is already done, that you would not get a reasonably quick result and a lasting investment in the country's welfare?

Mr. GOLDFINGER. Oh, I could not agree with you more, Mr. Chairman. I think the Congress should make an effort to accelerate those kinds of short-term public works programs of construction and repair as well.

Senator BENTSEN. Let me ask you about DISC. I think the objective of DISC is a good objective. But it looks to me like in many, many instances it has failed its objective. It looks to me from what we have been able to find that a lot of major corporations that were already exporting have formed, in effect, paper corporations that became DISC corporations and this resulted in a very substantial tax saving without an increase of exported goods. And yet, in trying to encourage new companies to get into the export business, selling our products overseas and creating jobs here. I am wondering if it could not be done by monitoring the DISC corporation and saying that the DISC provisions would apply to, say the first million or the first $2 million worth of exports. Now, if you did that you would still be encouraging the company that had not been in the export business to try to do it and to get into the business up to the point that it might be profitable, and then they could carry it on, and you take away a great deal of the tax advantage for some of the large companies that already export anyway.

What would you think of that?

Mr. GOLDFINGER. Mr. Chairman, we opposed the DISC proposal from its very beginnings when the Treasury people came up with the idea. We view the DISC proposal as a loophole in the tax structure which is of special benefit to the large corporations which are engaged in export trade, and we think that the facts bear us out.

However, we pointed out at the time when this issue was being discussed in the Congress, that we would be willing, despite our opposition to the whole idea, we would be willing to reconsider if the DISC proposal were applied to the incremental increase in exports rather than to the volume of exports in general.

Senator BENTSEN. Be applied to the what?

Mr. GOLDFINGER. To the increase in exports.

Senator BENTSEN. Increase?

Mr. GOLDFINGER. Yes.

We discussed this idea at great length with Chairman Mills of the Ways and Means Committee, and we discussed it with our staff people on this side of the Congress as well.

Senator BENTSEN. What was the objection to that? Were there mechanical problems?

Mr. GOLDFINGER. We were told that there were mechanical problems. But I am convinced, Mr. Chairman, that those mechanical problems could be offset.

Senator BENTSEN. Well, I will take a look at that one and see if we cannot find a way to make it meet its objective.

Mr. GOLDFINGER. You know, there is a huge amount of money that has been going out through DISC that the Treasury is losing, and these are for export sales which would be going on in any case. There is no evidence on the basis of the reports from Treasury, on the basis of the first year of DISC, that DISC has had more than a minimal, insignificant impact on export sales at all, if any at all.

Senator BENTSEN. Mr. Goldfinger, during the period of wage and price controls the real income of American workers went down and they suffered a decline in comparison to prices. Now, they are trying to catch up and that is understandable. But you have got a situation where we are trying to beat inflation. We are concerned about how high prices might go or how high wages might go.

What would be your attitude toward a Cost of Living Commission or Council that was not selected entirely by the White House. For example, Congress could nominate say four out of seven of the Members and the White House the other three, and we could try to get representatives of business and labor?

Now, I understand that jawboning is not too effective sometimes. But I believe that if you had an agency like that or a commission like that which was objective it could make a contribution.

Mr. GOLDFINGER. The Executive Council of the AFL-CIO met in Chicago at the beginning of this week on August 5 and 6, and we looked at these issues and at the issue of housing and of the monetary policy. With your permission, Mr. Chairman, I would like to put these three statements of the Executive Council on these issues in the record of these hearings.

Senator BENTSEN. They will be included.

Mr. GOLDFINGER. However, to give you an answer to the specific proposal or the idea that you just posed, we would be willing to look at that. We would be willing to look at any idea in terms of a program that is fair, equitable and balanced.

However, that idea that you posed, in itself would do little as far as we can see except to put the pressure back on holding down wage increases?

Senator BENTSEN. Why could it not also put pressure on excessive price increases?

Mr. GOLDFINGER. Well, we would like to see that as part of such a program. But profits have also gone through the roof. Interest rates have skyrocketed, and way back in February 1966 the AFL–CIO Executive Council stated that the organized labor movement would be willing to cooperate in an emergency overall stabilization program that attempted to restrain and stabilize all costs, prices and incomes, including profits, interest rates, executive compensation, rents and so on, as well as the wages and salaries of working people.

But getting back to this issue, Mr. Chairman, the working people of this country have been the victims of inflation and not the generators of inflation. In the month of June, which is the most recent month for available information——

Senator BENTSEN. Well, that has certainly been true from what we have seen over the last——

Mr. GOLDFINGER. The Labor Department reports that the average worker's weekly take-home pay was 4.5 percent below the level of a year before and nearly 7 percent below October 1972. This is the sharpest drop in workers' buying power in 28 years.

Senator BENTSEN. Mr. Goldfinger, it is not just the workers. It is the retired people, the people on fixed incomes. They are really taking a beating. And the mail I get today, it really is extremely disturbing. I had a letter from a woman in Texas who said she and her husband were looking forward to retirement and he was a fireman, and she said they retired 4 years ago on $450 a month. She said in Texas they could get by on that. She said they cannot get by on it any more. He is out on part-time work, and at his age today that is not easy. And you get that story repeated over and over.

Mr. GOLDFINGER. We have been getting the same stories from all over the country. Retired people who are living on fixed incomes and low- and middle-income families with children, those two groups have been the particular victims of this raging inflation because of its very marked impact on the prices of food and fuel and other necessities.

Senator BENTSEN. Mr. Goldfinger, we are appreciative of your testimony. It will be a contribution to the considerations of the subcommittee. Thank you very much.

Mr. GOLDFINGER. Thank you, Mr. Chairman.

We earnestly hope that the Congress will be able to move rapidly in the direction of a selective monetary policy, which we think is absolutely essential to replace this very blunt instrument of a general aggregate monetary policy which is having a devastating effect on the economy.

Senator BENTSEN. Do you have some examples of other countries that have used it and with what success, and if you do, could you give them to us for the record?

Mr. GOLDFINGER. Yes.

Senator BENTSEN. All right.

Mr. GOLDFINGER. Thank you.

[Mr. Goldfinger's prepared statement, the executive council statements referred to previously, and information requested by Senator Bentsen, follows:]

STATEMENT OF NAT GOLDFINGER, DIRECTOR, DEPARTMENT OF RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The Federal Reserve's policy of severe monetary restraint and the highest interest rates since the Civil War have pushed the American economy to the edge of disaster. It is a threat to the welfare of all Americans.

This monetary policy, reflecting the views of the Nixon Administration, has contributed to the inflationary recession, which started in the final months of 1973 and is still continuing. It has added a depressed home-building industry, a continuing decline in the real value of national economic activity and increasing unemployment, to the accelerating inflation that got under way in the second-half of 1972.

Now, this Federal Reserve-Nixon Administration policy poses the dangers of business failures, widespread cutbacks of business plans to expand plant and equipment and a prolonged recession, with additional increases in unemployment as well as continued raging inflation.

The present money crunch and utter disarray of the nation's capital markets place the American economy in jeopardy.

The aim of the Federal Reserve-Nixon Administration policy is a further slowdown of economic activity. It can "succeed" in its reported objective of reducing the pace of inflation only by placing the American economy into a depression or long, drawn-out recession.

The prime interest rate has jumped from 6 percent in the early months of 1973 and 8¾ percent in the first-half of March 1974 to 12 percent—a 100 percent boost since early 1973 and a 37 percent hike in five months. The entire structure of interest rates has soared to record peaks or close to them.

As a result of these policies, the Federal Reserve is an engine of inflation, in the guise of combatting inflation. The extraordinary rise in interest rates is directly increasing costs and prices throughout the economy. It is adding to raging inflation indirectly, as well—by adding substantially to recessionary conditions, the Federal Reserve-Nixon Administration policy is suppressing the advance of productivity and thereby adding considerably to upward pressures on unit costs and prices.

These interest rates are adding to the heavy burden of American taxpayers. Interest payments on the federal government's debt rose from $22.8 billion in fiscal year 1973 to $28.1 billion in fiscal 1974—a rise of $5.3 billion or 23 percent, mostly due to higher interest rates. Interest payments of states and local governments are also moving up.

These record interest rates are building in an increased cost structure—for consumers, taxpayers, home-buyers, communities and businesses. The higher rates will have to be paid on loans until they are paid off—every month for 25 to 30 years on the usual home mortgage—unless they can be renegotiated at lower rates in the future.

The total amount of money paid on interest charges by business, governments and consumers rose from $148.7 billion in 1971 to $165.1 billion in 1972, according to the Department of Commerce. In 1973, it was probably over $180 billion and may be in the neighborhood of $200 billion this year.

The monetary squeeze, combined with the Administration's curbs on the government's programs of assistance for low- and moderate-income housing, have already clubbed residential construction into a deep recession. Housing starts fell 31 percent in the first-half of 1974 from the same period of last year, following a 18 percent decline from 1972 to 1973. Building permits, in recent months, have dropped even more sharply—indicating a further decline in housing starts from its present depressed level.

Residential construction has been hit first and hardest by the Federal Reserve's policy and resulting money crunch. Interest rates on loans to building contractors, as well as land costs, have soared—with the resultant jump in the median price of new single-family homes from $25,600 in 1969 to $35,800 in

May 1974. In that period, financing costs jumped from 7 percent of the price of the home to 10 percent—and share of the price for both land and financing costs rose from 29 percent to 35 percent—while the on-site construction labor cost of the home fell from 17 percent to 15 percent, according to the National Association of Home Builders.

The additional troubles imposed on home-building by the Federal Reserve-Nixon Administration policies involved disintermediation. The upward ratchet of interest rates, with the big city commercial banks in the lead, has resulted in the withdrawal of huge amounts of funds from the savings and loan associations and mutual savings banks, which provide the major source of money for mortgages. Mortgage money is drying up and mortgage interest rates have skyrocketed.

So these policies are driving home-building down, while the housing shortage grows. Unemployment among construction workers rises—it was up to 10.6 percent in July. And many building contractors go out of business.

The Federal Reserve's brinksmanship with the American economy is also spreading most serious troubles for other parts of the economy. Most serious economic weakness and money-market chaos are spreading.

Many cities and counties are now being squeezed out of the money markets, in addition to being hard-pressed by the burden of increased carrying charges on borrowed funds. Their inability to float bond issues at the current level of interest means growing financial pressures on local governments. Moreover, the resulting stretch-out of programs to expand and improve public facilities and services means reduced activities for the industries that produce construction materials and equipment for construction workers; it means a loss of job-growth in local government employment.

The tight squeeze is also affecting public utilities. Confronted by record interest rates—and already pressed by much higher costs of fuel—many utilities are postponing the construction of new and improved gas- and electricity-producing plants, although America urgently needs additional energy. The spread of such postponements means increased unemployment among construction workers, cuts in production among supply industries and curtailed job-growth for utility workers.

Aside from the menacing crunch in the money markets, these developments point to the possibility of a further and widespread decline in economic activity, generally, in the next few months.

Large business inventories have been built up in the past year. The spreading cutbacks of private and public investment programs coming on top of persistent weakness in consumer markets and declining residential construction, can result in a change of business activity from inventory-building to inventory-reduction or liquidation. That would mean widespread cuts in production, working hours, employment and income.

In addition to these dangerous troubles, the Federal Reserve-Nixon Administration monetary squeeze is highly discriminatory.

Home building and smaller businesses have been starved for credit, at reasonable interest rates. Savings and loan associations and mutual savings banks have been confronted by the large-scale withdrawal of funds. Many local governments and public utilities have been squeezed out of the money market. But there has been a continuing flow of credit for other less useful and lower-priority purposes.

For example, Governor Andrew Brimmer of the Federal Reserve reported, in an address on July 17, 1974:

"In the first five months of the year (which is about the same as saying in four months following the end of capital outflow restraints), total foreign assets held by U.S. banks and by U.S. agencies and branches for their own account increased by about one-third. In dollar terms, the increase was about $8½ billion and brought the level to $34 billion. Almost all of that increase represented credit extended to foreigners. A very small amount was accounted for by the increase in direct investment in bank branches, subsidiaries, or other affiliates abroad."

Moreover, Governor Brimmer pointed out that only a minimal portion of that large outflow of loans to foreigners was for export credits, which could be of some positive use to the American economy.

What is needed is a quick and drastic change in America's monetary policy—for an easier policy, generally, and lower interest rates, combined with a selective monetary policy.

Available credit should be allocated on the basis of the purpose of the loan. The extension of available credit should be eased for high-priority social and economic purposes and tightened for low-priority objectives.

These views are spelled out in the following statement of the AFL-CIO Executive Council, adopted as its meeting in Chicago earlier this week.

STATEMENT BY THE AFL-CIO EXECUTIVE COUNCIL

THE HIGH-INTEREST RATE PERIL TO THE AMERICAN ECONOMY

The Nixon Administration's monetary policy, enforced by the Federal Reserve System under the chairmanship of Dr. Arthur Burns, is putting the American economy through the wringer of a severe tight-money squeeze and the highest interest rates in over 100 years. The main beneficiaries are the major big-city commercial banks, whose profits are soaring.

This policy has pushed the national economy to the brink of disaster. A depressed home-building industry, declining national production and increased unemployment have been added to runaway inflation. The threat of business failures, drawn-out recession and continuing inflation hang over the nation, as a result of the present money-crunch.

The prime interest rate, which the commercial banks charge on loans to the major corporations, jumped from 6 percent in early 1973 and 8¾ percent in the first-half of last March to 12 percent at present. This is a rise of 100 percent in the past 18 months and 37 percent in five months.

This spectacular rise of interest rates is adding sharply to inflationary pressures. It is directly boosting prices throughout the economy, as business passes on increased interest-rate costs. The Burns' cure for inflation—creating slump conditions—is depressing productivity and adding to upward pressures on unit costs and prices. In the name of fighting inflation, Dr. Burns has made the Federal Reserve an engine of inflation.

These interest rates are boosting the taxpayer's burden. Interest payments on the federal debt rose $5.8 billion between fiscal years 1973 and 1974—much of it due to higher interest rates.

The Federal Reserve policy is building in higher costs for many years in the future. Payments on principal and interest for a 25-year, $25,000 mortage at a 10 percent interest rate, for example, are $227 a month. That is $66 a month more, for 25 years, than a similar mortgage at 6 percent. So, at the end of 25 years a $25,000 mortgage will cost $68,000, or $19,800 more that it would at a 6 percent rate.

The goal of the Federal Reserve is to further slow down the economy, which has been in an inflationary recession since the final months of 1973. Its "success" will boost unemployment, which has already risen from 4.1 million or 4.6 percent of the labor force in October 1973 to 4.9 million or 5.3 percent in July. Even Administration spokesmen predict unemployment can go as high as 6 percent by the end of 1974—approximately 650,000 more unemployed—and, under these conditions, it may go higher. The tightening squeeze can eventually reduce the rate of inflation only by putting the American people through the suffering of a depression or extended recession.

Soaring interest rates, combined with sharply rising land costs, have already depressed home-building. Prices of homes and rents for new apartments have risen sharply. Credit for builders' loans is drying up and available only a very high rates. Moreover, the upward spiral of interest rates, led by the major commercial banks, has resulted in the large-scale withdrawal of funds from savings and loan associations and mutual savings banks, which are the main source of mortgage money.

Housing starts fell 13 percent in 1973 and, in the first-half of 1974, dropped 31 percent below the same period last year. Building permits have fallen even more sharply in recent months, pointing to a further decline in housing starts, which will add to the housing shortage that already exists.

The high-interest rate squeeze is creating a further weakening of economic activity. Major cities and counties have found it impossible to float needed bond issues at current interest rates, resulting in the postponement of improvements in community facilities and services, as well as curbing the growth of job opportunities.

Public utilities, confronted by these interest rates and high fuel costs, are cutting back plant expansion despite the need for additional gas and electricity

facilities—adding to the 10.2 percent unemployment rate among construction workers and curbing the expansion of jobs for utility workers.

Such cuts in private and public investment—combined with depressed residential construction and continued weakness in retail sales—pose the danger of widespread reductions of the large inventories business accumulated in the past year. The result could be cancellation of orders for goods in the coming months and a general drop in production, working hours and employment.

Moreover, the Federal Reserve policy is discriminatory. It favors the powerful big-city commercial banks, wealthy money lenders and money-laden major corporations. It hits workers and consumers, home-builders and home buyers, communities, smaller businesses and even those corporations, like public utilities, that need lower-interest loans.

While home-building, community facilities and the normal operations of many businesses have been starved for available credit, there has been a continuing flow of loans for other purposes, such as land speculation, hoarding and foreign borrowers. For example, Governor Andrew Brimmer of the Federal Reserve reported, on July 17, 1974:

"Since the abolition of capital controls at the end of January, there has been a sizable outflow of funds from the United States. Banking institutions have been a major source of this outflow. During the first five months of this year, these institutions increased their foreign assets by $8½ billion—to a level of $84 billion. This gain was larger than that recorded during the full year 1973. Virtually all of the increase represented credit extended to foreign borrowers. . . .

"Moreover, so far this year, only a small share of the rise in bank loans to foreigners has been associated with export financing. Instead, it appears that—with the termination of nonexport foreign lending restraints—banks have de-emphasized export financing and intensified their interest in developing other foreign lending and investment opportunities."

The Federal Reserve policies are a dire threat to the well being of the American people. An immediate and thorough change in the nation's monetary policy is essential.

There is an urgent need for much lower interest rates, combined with a selective monetary policy based on social and economic priorities. The extension of available credit should be eased for high-priority objectives and tightened for low-priority purposes.

Therefore, the AFL–CIO Executive Council:

*1.* Urges the Congress to take immediate action to direct the Federal Reserve System to allocate available bank credit on a selective basis—to allocate a significant portion of available bank credit, at reasonable interest rates, for such priority purposes as housing, community facilities and expansion of essential public utility plants and to curb the flow of credit for such activities as gambling casinos, land speculation, hoarding, foreign loans and foreign subsidiaries of American companies.

The Federal Reserve System should also be directed to provide a sufficient expansion of money and credit, at lower interest rates, to encourage the needed expansion of economic activity and job opportunities.

*2.* Urges establishment of a direct lending program by the federal government to provide mortgages at reasonable interest rates for middle-income housing, as well as expansion of existing programs of assistance for low- and moderate-income housing, which have been curbed in the past two years.

*3.* Calls on the Congress to establish a fair and equitable means of raising the required volume of federal revenue to meet the government's obligations for maintaining its operations and expanding essential programs.

Elimination of the major loopholes in the federal tax structure and adoption of an excess profits tax can raise as much as $30 billion of additional revenue. Proposals for further tax cuts for business, which Administration and big business spokesmen are advocating, should be rejected.

The average taxpayer will be able to obtain a genuine tax break when everyone—the President and big business, as well as the worker—pays his fair share of the federal tax burden.

*4.* Reiterates our request to the Congress to enact government controls on exports of agricultural and other products in short domestic supply—to be maintained until shortages are ended and inflationary pressures on the prices of such products subside.

Effective government regulation of the commodity exchanges, including margin requirements, is needed to curb price-boosting, excessive speculation and profiteering.

The government should rebuild America's stockpile reserves of agricultural products and raw materials, which have been depleted in the past two years. The reestablishment of such reserves to adequate levels as rapidly as feasible is necessary to serve as a price-stabilizing factor, as well as for national security and to help meet domestic or foreign emergencies such as disasters, shortages or famines.

STATEMENT BY THE AFL-CIO EXECUTIVE COUNCIL ON COST OF LIVING TASK FORCE, CHICAGO, ILL., AUGUST 5, 1974

President Nixon's newest collection of public relations gimmicks to halt inflation prove his Administration to be completely bankrupt of ideas about America's major economic problem.

The President says American families should buy less and save more, neglecting the fact that many families not only can't buy what they need or save anything but are going into debt, paying today's inflated prices.

He makes no comment on the fabulous profits of America's corporations, paced by the profit-hungry oil companies. He says nothing about the highest interest rates in a century, which have a major impact on the cost of everything consumers must buy and the rents they pay.

His latest gimmick is a proposal to Congress for new legislation to establish a Cost of Living task force to "monitor" wages and prices. This is the President's most hollow proposal yet.

His task force would be composed only of Cabinet officers and Presidential economic advisers, the same crowd which had created the current mess. He has no need for legislation to establish an additional monitoring device. The executive branch already has, at its instant disposal, all of the government's statistical gathering machinery—the Labor Department, the Commerce Department, the Treasury Department and the Council of Economic Advisers—which constantly monitor the economy. All the President need do, if he weren't looking for gimmicks, is to ask these subordinates for the information he seeks.

Labor needs no reminder of its responsibilities. For 30 months the income of our members are rigidly controlled while everything they bought went up and up and the profits of our employers skyrocketed.

We need no reminders from Richard Nixon and Arthur Burns, whose policies brought about the very inflation and recession that now plague America. These policies have brought the economy to the edge of disaster.

The new Nixon Cost of Living Task Force would be composed of the same crowd from big-business and big banks. Their policies have been followed by the Nixon Administration ever since January 20, 1969. Their proposals, now, can mean only more of the same—further troubles for the American people, who have had enough of sky-high profits and interest rates while the average worker's buying power is down to where it was nine years ago.

What America needs is a new monetary policy to establish lower interest rates and available credit for such high-priority purposes as housing, and excess profits tax and elimination of loopholes in the tax structure and measures to restore confidence. What America does not need is new Nixon gimmicks and tricks.

STATEMENT BY THE AFL-CIO EXECUTIVE COUNCIL ON HOUSING, CHICAGO, ILL., AUGUST 5, 1974

Results of the Nixon Administration economic policies are most apparent in the housing sector. The combination of inflation, recession and unemployment, which characterizes the entire economy, has affected residential construction drastically.

As compared with a year ago, the average price of a comparable new house is up 10 percent, effective mortgage interest rates have risen from 7¾ to 9¾ percent, and the consumers home ownership costs, which reflect the upsurge in mortgage interest rates as well as home prices, have advanced by 11 percent.

In addition to high prices and interest rates, the Administration's phase-out of low- and moderate-income programs since early 1973 has contributed to a sharp reduction in housing market demand and construction. Housing starts during the first half of this year were 31 percent below the comparable part of 1973, and the 1973 annual housing starts total was 13 percent below 1972. An unemployment rate of 10.6 percent among construction workers has contributed significantly to the overall unemployment rate of 5.3 percent.

Price inflation and the cut-back in Federally assisted home production have also shifted production toward the high end of the price scale. Less than 5 percent of new homes sold are now priced at under $20,000 and less than 30 percent at under $30,000. The median new home sales price is up to about $36,000. As a consequence, most of the American families have been priced out of the housing market. It would now require an $18,000 income to meet total homeownership costs on a home with a $30,000 mortgage, which rules out about three-fourths of American families.

Nevertheless, the Nixon Administration persists in relying upon the general tool of tight money to fight inflation, ignoring the consequence in terms of unemployment and reduced living standards. The 1974 annual rate of 1.6 million housing starts is barely keeping pace with the annual increase in households over the past two years. It does not allow for replacement of an estimated 700,000 units lost from the housing supply annually due to demolitions, fire, flood and other causes, nor does it begin to allow for units to accommodate the mobility and migration of the population. The overall production deficiency that results creates housing shortages which breed more inflation.

The gap between housing production and housing need has been further intensified by widespread conversions of existing rental properties to condominium ownership status. In the Washington metropolitan area, for example, it is expected that by the end of 1974, one out of ten existing rental units will have been converted to condominiums. In some instances the monthly carrying charges for a converted unit are greater than the previous rents by $100 or more per month. The conversion of rental units to condominiums has presented a major problem for families—particularly low- and moderate-income households—who find themselves being forced out into a tight, high cost housing market. The conversion dilemma is another illustration of the impact of inflation: landlords, faced with rising property taxes and rapid increases in utility costs, see increased rents as the only means of keeping pace with costs; tenants, finding their incomes shrinking while day-to-day living costs continue to rise, resist rent raises; landlords then choose to leave the rental business and opt for the immediate and high profits possible through conversion and sales. The question of where low- and moderate-income households will find adequate housing is totally ignorded. For such people, the Administration's decision to impound housing assistance dollars that could be providing new housing opportunities constitutes the final insult.

The increasing proportion of new housing construction for condominium sale is also raising problems. It is estimated that as much as 25 percent of all owner-occupied housing units sold in this country in 1974 will be condominiums. While condominiums are advertised as the means by which homeownership dreams can be realized, they often end up being a nightmare for potential homeowners who find themselves faced with escalating management and recreational fees under long-term contracts, in addition to normal monthly mortgage payments. There is no adequate consumer protection at Federal, state or local governmental levels.

Despite belated recognition of a need to reverse the harmful deterioration of the housing situation, the basic position of the Administration has not changed. The few actions that the Administration announced earlier in the year to provide additional support for the mortgage market have been inadequate to revive housing from the state of depression into which it has sunk. The Administration has refused to utilize established subsidized housing programs under which substantial numbers of units for low- and moderate-income families were produced in prior years. It has opposed a meaningful extension with additional authorized funding for the programs, in pending legislation. These programs were suspended for new approvals in January 1973, following scandals which resulted from incompetent program management, including a lack of consumer counseling and a lack of Federal surveillance to prevent fraud.

In lieu of these programs, the Administration has proposed a single program—the revised Section 23 public housing leasing program—to provide for the construction of low- and moderate-income housing. This program is an untried vehicle whose viability has been questioned in many quarters. Even if it should prove workable, it will take many months before the new program can result in a sizable volume of production. During the interim, the country suffers from a housing production shortage in relation to basic housing requirements, while large numbers of construction workers remain unemployed.

The AFL-CIO Executive Council urges that the following steps be taken in

order to bring residential construction back to a level in line with the needs of the American people:

The Administration should use the remaining unused contract authority for housing assistance payments to make new commitments that will support the construction of additional units under the Section 235 homeownership assistance and Section 236 rental housing assistance programs. It should also utilize such additional authority as the Congress may enact in support of conventional low-rent public housing and assisted housing for the elderly.

The Congress should enact sufficient additional contractual authority for annual assistance payments under the conventional public housing, Section 235 and Section 236 programs that would permit those programs to be fully implemented during fiscal years 1975 and 1976.

The Congress should enact pending legislation that would permit direct loans and housing assistance payments to provide housing for low- and moderate-income senior citizens.

The Congress should enact pending legislation that would permit direct loans and housing assistance payments to provide housing for low- and moderate-income senior citizens.

The Congress should enact proposed legislation that would provide for middle-income home mortgage financing at lower interest rates than those presently available, through mortgage purchases by the Government National Mortgage Association.

The Congress should adopt legislation to protect American families from abrupt displacement from apartment houses being converted to condominiums, and to protect consumers who purchase condominiums against hidden, long-term charges.

---

AMERICAN FEDERATION OF LABOR
AND CONGRESS OF INDUSTRIAL ORGANIZATIONS,
*Washington, D.C., August 14, 1974.*

Senator LLOYD BENTSEN,
*Chairman, Subcommittee on Financial Markets,*
*Senate Committee on Finance,*
*Washington, D.C.*

DEAR MR. CHAIRMAN: At the hearing on August 8, I promised to provide you with information on what other countries do in the form of selective monetary measures, based on the economic and social objectives of those national governments.

In December 1970, the Banking and Currency Committee of the House published a study by a group of professors of the Massachusetts Institute of Technology, "Activities by Various Central Banks To Promote Economic and Social Welfare Programs."

In May 1972, the House Banking and Currency Committee published another study by a group of MIT professors, "Foreign Experience With Monetary Policies To Promote Economic and Social Priority Programs."

In the summary and introduction of the May 1972 publication, the authors state:

"All western industrialized countries seem to face the same fundamental monetary problem. In the absence of government policies to the contrary, the large corporate business sector of the economy is the preferred sector for lending from financial institutions. In the queue for loanable funds the corporate sector universally stands first. When credit squeezes arise, funds are increasingly channeled into loans to this sector. As a result, general monetary policies designed to raise interest rates and tighten credit availability do not affect all sectors of the economy evenly. Housing, agriculture, state and local governments, small business, and underdeveloped regions find that they must carry the burden of general monetary policies designed to deflate the economy.

"As a result, most industrialized countries have reestablished the neutrality of general monetary policy by devising specific countervailing privileges for sectors low in the queue for loanable funds.

"In addition many countries have designed policies to create preferred sectors in the economy."

The United States appears to be the only industrial country of the world that does not engage in monetary measures to offset the discriminatory nature of a restrictive aggregate monetary policy.

Although foreign monetary measures cannot be transferred mechanically to the United States, I believe that these studies clearly indicate the potential for selective monetary measures in the U.S. It is the conviction of the AFL-CIO that selective monetary measures, based on social and economic priorities, are long overdue in this country.

Sincerely yours,

NAT GOLDFINGER,
*Director, Department of Research.*

Senator BENTSEN. The committee is very pleased to have before it this morning Mr. Gordon Corey, vice chairman of Commonwealth Edison Co.; Mr. Herbert B. Cohn, vice chairman, American Electric Power Co.; John F. Childs, senior vice president, Irving Trust Co.; John Thompson, vice president and treasurer of Consolidated Edison Co., of New York; Mr. John P. Cornell, senior vice president and chief financial officer, Columbia Gas System.

Mr. Cohn, why do you not proceed with your comments?

## STATEMENT OF HERBERT D. COHN, VICE CHAIRMAN, AMERICAN ELECTRIC POWER CO.

Mr. COHN. Mr. Chairman, in accordance with the request of the subcommittee I have filed a lengthy statement, and as I understand it, the subcommittee desires that we start with a summary, a brief summary. Of course, I will be delighted to do that.

Mr. Chairman, we believe that these hearings are most timely. The current financing problems of the electric utility industry are the most difficult it has had to face since the early thirties. We face an effective prime rate for short-term borrowings of about 14 percent. Rates for high-grade bonds and preferred stocks are at about 11 percent. In many cases, pretax coverage of interest is inadequate to permit the sale of new bonds.

In several recent cases even where the coverages were available, no bids were received for bonds and preferred stocks. Consolidated Edison's passing of its common dividend in April of this year accelerated the deteriorating market for common stock. Most common stocks are now selling substantially below book value, and in such a sale of additional common creates dilution and further market deterioration. This has led to a rash of curtailments and stretchouts of construction projects. This in turn has created layoffs and unemployment and the threat of inadequate power reserves in the future.

As I am sure the chairman knows, a hearing was held yesterday before the Senate Interior Committee. One of the witnessess undertook to try to compile a list of the curtailments and stretchouts which had been announced to date. His figure which he, as I understand it, presented at that hearing was that some 65,000 megawatts, 65 million kilowatts of capacity were going to be affected by a curtailment or a stretchout. Now, we can use a figure of $300 per kilowatt which I believe is a significant understatement in terms of dollars per kilowatt to try to translate that into dollars.

If we did translate it into dollars using the $300 per kilowatt figure it would come to something in the neighborhood of $20 billion which is being affected in terms of a curtailment or stretchout.

Senator BENTSEN. What does this mean to the consumer ultimately?

If you do not put these generating plants onstream what does it lead to—brownouts and that type of thing?

How do you translate that?

Mr. COHN. Senator, I think there is a substantial chance that it will lead to trouble 3, 4, 5 years hence when the plants which are being curtailed were intended to be brought into operation. What is happening is that the utilities, primarily because of the financing problems, have felt that they just could not afford, just could not finance many of these new facilities. And what they have said is, we have no choice but to take our chances with a reserve which is considerably less than we think is prudent and reasonable.

Senator BENTSEN. Mr. Cohn, I promise you if that takes place 3 or 4 years from now they will blame management for poor planning.

Mr. COHN. I am sure that is so, Senator, I am sure that is so, despite the fact that we are doing everything we possibly can to prevent it.

Senator BENTSEN. I understand.

Mr. COHN. Now, the reasons for the current situation include: First, inflation in all of the costs incurred in the utility business, but with particular emphasis on interest rates which have more than doubled in the last few years and fuel costs which have more than doubled in the last 12 months. Incidentally, interest costs and other capital costs which are influenced by interest rates represent about 30 percent of our total costs. Fuel costs represent about 25 percent. So these are very important costs in terms of our total operations.

Senator BENTSEN. The interest costs are 30 percent of your costs?

Mr. COHN. That is right, interest and other capital costs.

Senator BENTSEN. And fuel costs are 25 percent of your costs?

Mr. COHN. That is right, sir.

Senator BENTSEN. That helps get it in perspective.

Mr. COHN. The second reason for the current situation—and it is a most important one, perhaps the primary one—is the failure of the regulatory commissions to act promptly and realistically to allow increased revenues to cover increased costs.

Senator BENTSEN. Do you anticipate that increased rates will diminish the trend of increase in usage by consumers?

Mr. COHN. Senator, I think to a limited extent, yes. I suspect that the reduction in usage will be much less than is generally thought to be the case. Using studies that were carried out in the past, you may get a fairly high rate of elasticity—the technical word that is used. But I think myself that the reason for that is that the consumer who had an alternative when faced with higher rates for one form of energy could go to the form of energy that would give him a lower rate.

But when there is no alternative, in my judgment he is not going to turn out the lights when he wants to read or do something or other around his home. I do not think the consumer is going to dispense with his television set or with refrigerators or air conditioners or many of the other things that are based on the use of electric power.

Now, I think there will be some reduction. But I do not think it will be very large, because the consumer really does not have any alternative available. And I am thinking now in terms of the alternatives which used to be available of gas or oil. Those alternatives are much less available in most parts of the country.

A third reason for the current situation has to do with the need for increasingly larger construction programs and increasingly larger amounts of new capital.

40-544 O - 74 - 4

Fourth, internal generation of cash, which used to supply 60 percent of new capital requirements, now provides in the case of many companies only 25 percent or less. What this means in the case of those companies is that their capital requirements must be obtained, to the extent of about 75 percent of total need, in the public marketplace.

Senator BENTSEN. What multiple is your stock selling for? What price-earnings multiple?

Mr. COHN. The stock of the company that I am associated with, Senator?

Senator BENTSEN. Yes.

Mr. COHN. Between six and seven times.

Senator BENTSEN. Six and seven times.

Mr. COHN. Six and seven times earnings, that is right, sir.

Senator BENTSEN. At six times earnings you would have to have an investment, I guess, before taxes, if you are putting your money into it, you would have to pay what, in the area of 30 percent?

You cannot go to the equity market, really.

Mr. COHN. We would have to get—the market is saying that the investors in our common stock expect a return after taxes of something on the order of 15 or 16 percent.

Senator BENTSEN. I am talking about before taxes.

Mr. COHN. Well, assuming we were paying taxes at a 50 percent rate, you are absolutely right, Senator. It would be 30 percent.

Senator BENTSEN. There are not many of those around.

Mr. COHN. I do not know of any, Senator.

Senator BENTSEN. Go ahead.

Mr. COHN. The fifth reason for the current situation—and this is perhaps a very sensitive subject, but it seems to me it is about time it got talked about a good deal more—has to do with increased environmental requirements, which in many cases we believe to be wholly arbitrary and to represent a substantial overkill, imposing capital and operating expenditures of literally billions of dollars which are nonrevenue producing.

A sixth reason has to do with pretax coverage of interest, which has gone down from over five times less than 10 years ago to the point where coverage for many companies is at the margin of two times and in some cases below two times. The significance of the two-times figure is that in many indentures you must meet the two-times interest test in order to be able to sell new bonds. This has led to a flood of downratings of bonds and preferred stocks, and as I have indicated, where interest coverage requirements specified in the indentures cannot be met, the utility cannot sell additional debt securities.

The combination of these factors produces a snowballing effect, the greater the problems the less interest there is in buying utility securities and the less capital there is available for investment in utilities.

Now, there have been a number of concrete proposals to deal with the current situation, and with the chairman's permission I would like to summarize those very briefly.

First, and I think most important, the regulatory commissions ought to take the necessary action to eliminate the regulatory lag and promptly to allow the increased revenues necessary to cover increased costs. I understand this is perhaps not within the jurisdiction of the

subcommittee. But I gather the subcommittee is asking for our thoughts on all the things that ought to be done, and this, I suspect, is the most essential. The necessary action would include allowing rate increases to become effective immediately, subject to refund of any amount later found to be excessive after the appropriate hearings were conducted.

This requirement for refund would protect the consumer, but allowing the rate increase to become effective immediately would eliminate a large part of the regulatory lag which is a major problem.

Second, allowing automatic escalation clauses for fuel, purchased power, taxes and environmental costs—these are costs which are very largely beyond the control of the utility and there is not any place the utility can derive money to pay for these costs except in the rates that it charges.

Third, encouraging increased internal generation of cash by authorizing increased depreciation and normalization of liberalized tax depreciation and the investment tax credit.

The use of future test years and the inclusion of construction work in progress in the rate base.

Allowing realistic rates of return to reflect the fact that prime rates for short term borrowings are at an effective rate of 14 percent and rates for bonds and preferred are at 11 percent. And as the Senator indicated just a moment ago, common stocks selling at six to seven times earnings reflect an investment requirement of pretax earnings of 15 percent or more on common stock.

Now, in the face of all of that, rates of return of 8 to 8.5 percent, which are the rates which are generally being allowed, are in my judgment absurd and totally inadequate.

A second set of proposals has to do with reexamination of broad Federal policy in certain areas. First, high interest rates, which Mr. Goldfinger talked about. This is, as I have indicated, a very substantial part of our problem. Just to take my company, 1 percent in the short-term interest rate costs us in the area of $8 million. Every percentage point by which the short-term interest rate is reduced will increase our net by $8 million. And I say that because we are in a position where we are not now paying Federal income taxes.

Secondly, the imposition of the arbitrary environmental requirements——

Senator BENTSEN. Let me ask you this, now:

If you are in a position where you are not paying Federal income taxes, why would you want to do something to further accelerate depreciation, or why would you be interested in doing something more in an investment tax credit if you are not now paying income taxes?

Mr. COHN. Senator, let me say first that what I mentioned a minute ago about depreciation and the investment tax credit, what I was suggesting there was that the regulatory commissions ought to allow——

Senator BENTSEN. Oh, I see.

Mr. COHN [continuing]. An increase in book depreciation and a normalization of the tax credit. This would help to generate increased cash, assuming the revenues were allowed to cover those costs. I will come shortly to discuss proposed tax changes——

Senator BENTSEN. And if they looked at that depreciation schedule as though it were based on replacement cost of equipment, too, that would make a great difference.

Mr. COHN. This would make a very great difference, Senator. Book depreciation would be increased very substantially. Internal cash would be increased, and our outside requirements for capital would be reduced.

The second point that we think needs to be looked at and ought to be looked at by the Congress has to do with the policies that are being followed in what we regard as the imposition of arbitrary environmental requirements involving expenditures in the billions, and I am not suggesting in the least the sabotage of the environmental program. We are for the objectives of the environmental program. But we think there has been a dreadful overkill and we think that requirements have been imposed with absolutely no thought of the costs involved.

Now, I do not know whether the Senator has heard this one, but I remember reading some time ago an estimate by, I guess it was the Council on Environmental Quality, of the cost of meeting the environmental requirements over the next 10 years. The number that was used, and I believe this was about a year ago—so I believe it a substantial understatement in terms of inflation since, plus the fact that the environmental people have had a pretty good record for understanding costs—but the figure that was used was $275 billion in the next 10 years. This is a CEO estimate.

In the context of the problems we face today we think a real good look ought to be taken at that. The problem there, we think, is that the people who administer the environmental program have said, and perhaps properly so, that they have no responsibility in terms of what it costs or what the benefits are, and I am not aware that anybody looks at that aspect and I think that somebody ought to.

Senator BENTSEN. Well, cost-benefit ratios ought to be considered in any of these programs, and that was written into the water quality law and I helped write it into it on cost-benefit ratios.

But they do not have such a provision in the Clean Air Act?

Mr. COHN. That is right, sir. That is right.

Senator BENTSEN. Go ahead, please.

Mr. COHN. The third area of broad Federal policy has to do with skyrocketing fuel costs which we believe have been caused by a demand very much in excess of supply, and the fact that governmental policies actually discourage rather than encourage the increased supply of domestic fuels.

Now, this is taking place day by day in respect to the one domestic fuel that we have in large supply, to wit: coal. Everything that Congress does seems to discourage greater production, and we respectfully suggest that someone ought to take a good look at the actions which should be taken to encourage the increased production of coal. This would make a great difference in the costs of electric utility operation for those companies that use coal. And that represents a substantial part of the total industry.

Senator BENTSEN. Thank you very much, Mr. Cohn.

I think we agree that we certainly want to clean up the air and we want to clean up the water, and I do not think industry would

do it without laws requiring it. Look at the corporations. Say you have a division head down here. He is going to go invest $10 million in pollution devices, raise the cost of production in his division voluntarily. He is not going to do it just because he wants that water cleaned up and that air cleaned up if his competitor does not have to do it, and therefore, I think you need the laws. But the laws have to be realistic and you have to have the cost-benefit ratios involved. You do not want to spend incredible sums of money to do the ultimate, one-tenth of 1 percent, in cleaning up water, in cleaning up air and at the same time substantially lower the standard of living of all your people by the financial burden that is put on. And that is why I agree that the cost-benefit ratio ought to be important.

Mr. COHN. Senator, you stated precisely what our point is, in that respect. I do have some specific proposals in the tax field, if I may.

Senator BENTSEN. All right, sir, if you could summarize them so these other gentlemen could testify.

Mr. COHN. Yes, sir. We have five proposals that might be considered in the tax to deal with the financing problems of the electric utilities.

First, allow the electric utility industry the same tax credit available to other industries. I suspect you know that the Ways and Means Committee has at least tentatively agreed with that proposal and has at least tentatively agreed that the 4 percent figure that is now available to the electric utilities should be raised to 7 percent which is applicable to all other industries.

Second, extending the governing dates relating to accelerated amortization of pollution control facilities. I believe the Ways and Means Committee has also adopted that.

Third, extension of the carryback and carryforward periods in the Code. Many of the utilities with the most difficult financing problems now have net operating losses for Federal income tax purposes. This is true of the company with which I am associated. The objectives of existing and proposed tax benefits cannot be realized by such utilities unless there is an extension of the carryback and carryforward provisions.

Fourth, an amendment of the Code to reinstate a rule issued some years ago—we think this is a particularly interesting, imaginative and constructive proposal—a ruling issued some years ago which allowed a utility to have two classes of common stock, one paying cash dividends and the other paying stock dividends of an equivalent value, with the receipt of the stock dividends not being regarded as taxable income. This could be most helpful in generating substantial additional internal cash and additional common stock equity.

Fifth, authorizing electric utilities to issue tax-exempt bonds to finance essential facilities. This would reduce interest charges in comparison with conventional bonds by about 250 basis points.

Senator BENTSEN. You say allow utilities to issue tax-exempt bonds?

Mr. COHN. Yes, sir. I know this is a drastic proposal, Senator, but it does not represent too much of an extension from what is now permitted, and that is the use of governmental agencies to issue bonds to finance pollution control facilities for the utilities. Now, this is a drastic proposal, but these are drastic times, and there are other very drastic proposals which have been made, and I believe this one would be more desirable than some of the others.

Senator BENTSEN. The problem you have with that, as you have with all tax-exempt bonds and securities, is having some people having substantial incomes and not paying taxes, and that hurts the credibility of the tax system, but go ahead.

Mr. COHN. Well, that completes the list of the proposals that I have with respect to the Internal Revenue Code.

There have been proposals also made for Federal guarantees and Federal direct loans where the utility is unable to obtain capital on a reasonable basis in any other way. The only thing I would like to say about that is that, if any such proposals were to be adopted we think it is important that any such Federal assistance should be conditioned upon action by the regulatory commissions to authorized revenues, earnings, and coverage which would cover all of the interest charges and enable the utility thereafter to attract its capital in the public market.

Thank you, sir.

Senator BENTSEN. Thank you very much.

[The prepared statement of Mr. Cohn follows:]

PREPARED STATEMENT OF HERBERT B. COHN, VICE CHAIRMAN, AMERICAN ELECTRIC POWER COMPANY ON FINANCING PROBLEMS OF THE ELECTRIC UTILITY INDUSTRY

My name is Herbert B. Cohn. I am Vice Chairman of the Board of American Electric Power Company and a member of its Executive and Finance Committees. I am also Chairman of the Utility Financing Committee of the Public Utility Law Section of the American Bar Association. Prior to joining American Electric Power in 1948, I served on the staff of the Securities and Exchange Commission from 1936 to 1942 and from 1946 to 1948.

This statement is submitted on behalf of American Electric Power Company, which is the parent company of the American Electric Power System. The AEP System operates in portions of seven states in the east central part of the country and is one of the largest of the country's electric power systems.

These hearings are most appropriate and timely. The current financing problems of the electric utility industry are the most difficult it has had to face since the depression of the early thirties.

It is helpful, I think, first to summarize briefly the reasons for the current problems and to give some indication of their extent, and then to discuss some of the proposals which have been made to deal with them.

I.

The reasons for the current problems include:

1. Inflation in all of the costs incurred in the electric utility business. These include, of course, the kind of inflation in wage rates and in the cost of equipment and supplies which have been experienced in all other businesses—with particular emphasis on construction labor costs which have escalated so rapidly and which have so greatly increased the costs of the utilities' large construction programs.

There are two costs which have been particularly devastating in their effect on the electric utility industry. These are the unprecedented rise in interest rates (which have more than doubled in the last decade) and the skyrocketing costs of fuel (which have more than doubled in the last year).

Because of the capital-intensive nature of the electric utility industry (the ratio of capital investment to annual revenue being about 4½ to 1), interest charges and other capital costs now represent about 30% of an electric utility's total costs. And fuel represents about 25% of such costs.

Two examples from AEP's experience will illustrate the extent and effect of these increased costs.

(a) Through the 1960's the cost of large-scale power plants was less than $150 per kilowatt. The cost per kilowatt of a new coal-fired plant today is about $300, with nuclear plants costing substantially more. In the same period, the cost of capital has more than doubled; thus fixed charges associated with a kilowatt of capacity have more than *quadrupled*.

(b) To ensure reliable power supply, AEP tries to maintain a 90-day supply of coal at its power plants. This now represents about 9 million tons. Coal was $6 a ton only four years ago. Spot coal has now reached $40 a ton or higher and AEP's average prices are about $18, resulting in an *increased* cash requirement (by reason of the increase from $6 to $18 per ton) of over $100 million just to maintain its coal piles.

2. Unlike other businesses, regulated electric utilities cannot immediately adjust the price of their product to cover such rapidly increasing costs. Revised rate schedules must first be submitted to and approved by the regulatory commissions. There have been regulatory lags—of sometimes two years or more—associated with hearings and a decision on such applications; and regulatory commissions are frequently reluctant to authorize large increases even where fully justified. The result has been that increased revenues have lagged far behind the pace of increasing costs.

3. The combination of increasing requirements for electric power and rapidly increasing costs for essential new facilities has led to increasingly larger construction programs and increasingly larger needs for new capital.

4. Internal generation of cash which in the early 1960's supplied about 60% of new capital requirements now provides, in the case of many companies, only 25% or less. This means that such companies must now obtain 75% or more of their new capital requirements by new financing.

5. Increased environmental requirements have imposed capital and operating expenditures of literally billions of dollars to provide and operate the non-revenue-producing facilities to meet such requirements.

6. Increasing new capital requirements at increasing interest rates have reduced the industry's pre-tax coverage of interest charges from over 5 times less than ten years ago to less than 3 times today, with many companies very close to 2 times or less currently. This, in turn, has led to a flood of downratings of bonds and preferred stocks and has led to further increases in interest and dividend rates. Most utility indentures and preferred stock provisions require that specific coverage tests (typically two times coverage of interest) must be met before additional bonds or preferred stock may be sold. And, in some cases, these tests cannot now be met.

7. All of the foregoing tends to produce a snowballing effect. The greater the problems, the less interest investors have in investing in regulated utilities and the less capital is then available for such investment.

Within the last few months the utilities have had to face a prime rate of 12%, plus compensating balances, which represents an effective rate of about 14%; interest rates on what normally have been regarded as high-grade bonds of 11%; and in some recent cases, even where there was adequate coverage or preferred, an inability to obtain any bids at all for such offerings.

Con Edison's passing of its dividend on its common stock in April of this year accelerated the deteriorating market for electric utility common stocks; and most such common stocks are now selling significantly below book value. Under such circumstances, the sale of additional common stock creates significant dilution and further accelerates the deterioration.

The accumulation of these factors has led to a rash of curtailments and stretch-outs of previously announced construction projects because of the inability to finance them; to lay-offs and the unemployment created by such curtailments and stretchouts; and to the threat of inadequate reserves to provide the electric power requirements which will be needed in the future.

## II.

There has been a growing recognition of these problems and there have been a number of proposals advanced to deal with them.

Such proposals can be subdivided into four categories, with perhaps some overlapping: first, more expeditious and more realistic action to authorize rates which will cover these increasing costs; second, revisions in certain general policies of the Federal Government; third, modifications in the Internal Revenue Code; and, fourth, direct Federal assistance in financing. I will discuss each of these in turn.

### 1. INCREASING REVENUES TO COVER INCREASING COSTS

The primary cause of the utilities' financing problems and the primary solution relate to the fact that revenues are not being increased as much or as fast as costs or as is needed to attract and obtain new capital requirements.

Retail rates, which provide the bulk of electric utility revenues, are regulated by the State Commissions. Those Commissions (and, insofar as wholesale rates are concerned, the Federal Power Commission) must act much more rapidly and more realistically on applications for increased rates.

More specifically, some of the actions which should be taken include:

(a) Adoption of procedures to permit new rates to become effective immediately, or with as little delay as possible, subject to subsequent hearings and an obligation to refund any increases not found to be justified. This would solve a large part of the regulatory lag problem and would—through the requirement for refunds of rates found to be unjustified—fully protect the consumer.

(b) Permitting automatic escalation clauses in areas where utilities have little or no control over costs. These include such costs, for example, as fuel (for which such escalation clauses are now generally permitted), purchased power, taxes, and the very large costs incurred in complying with environmental requirements.

(c) Permitting the utility to increase internal cash generation. This can be done, for example, by allowing increased revenues to cover higher depreciation rates and normalization of liberalized tax depreciation and the investment tax credit.

(d) Use of future, rather than past, test years and inclusion of construction work in progress in the rate base. Rates are set for the future. But, in a period of rapid inflation, a reasonable return on the basis of a past test year will, almost by hypothesis, be inadequate when applied to a future rate base and future costs.

(e) Allowance of realistic rates of return. At a time when the effective prime rate is close to 14%; interest rates on first mortgage bonds and dividend rates on preferred are at 11% (when such securities can be sold at all); and when common stocks are selling at market prices of 6–7 times current earnings, indicating an earnings requirement of 15% or more—allowable returns of 8% or 8½% are obviously far short of covering the cost of capital and are certainly no way to attract new capital.

2. REEXAMINATION OF CERTAIN GENERAL POLICIES OF THE FEDERAL GOVERNMENT

There are three areas in the field of broad Federal policy (apart from taxes and direct financial assistance) in which action could be taken which would greatly alleviate the financing problems of the electric utility industry:

(a) First, a major cause of these problems has been the unprecedentedly high interest rates and cost of capital. The monetary policies followed by the Federal Government have been a major reason for such high costs of capital. We, of course, understand that there are many competing considerations influencing these policies. But it is the fact that anything which could be done to reduce interest rates and capital costs would be of major help in alleviating the financing problems of the electric utility industry.

(b) Second, we do not believe there is yet a full appreciation of the extent to which rigid and arbitrary environmental requirements under rigid and arbitrary timetables are requiring the expenditure of billions of dollars and the use of large amounts of capital and of other scarce national resources and are making a very significant contribution to the forces of inflation. EPA has estimated that, over a ten-year period, these expenditures may aggregate $287 billion.

The capital expenditures imposed on the electric utility industry to comply with these requirements are particularly burdensome and, more important, the justification for the enormous expenditures required is particularly questionable. Very large amounts of money are being spent day-by-day in the construction and operation of nonrevenue-producing facilities where we are convinced the costs greatly exceed the benefits.

For the most part, those charged with the administration of environmental requirements disclaim any responsibility or authority to balance costs and benefits. And, where any consideration is given to economics, there is invariably an overstatement of benefits and a gross understatement of costs.

Anything which can be done to bring rationality and good sense into environmental requirements and to compel a balancing of costs and benefits by an objective government agency, with authority to bring about results consistent with such an evaluation, would be of major help in alleviating the utilities' financing problems.

(c) Third, the almost unbelievable skyrocketing of fuel costs is primarily a reflection of demand in excess of supply.

An obvious answer is to encourage the increased production and use of domestic fuels. But the fact is that, at the Federal level, there has either been inaction or delay or action taken to increase, rather than decrease, the obstacles to such increased production.

There seems to be virtual unanimity that the increased production and use of domestic coal are highly desirable as an important part of the solution to our energy problem, as well as in reducing pressures on fuel costs. Yet action at the Federal level threatens to restrict the use of more and more of our coal; increasingly rigid operating requirements are being imposed to make it more difficult to mine the coal; and there is a continuing embargo on making available the Federally-owned low-sulfur coal in the West.

Federal action to remove obstacles and to encourage the increased production and use of domestic coal and other domestic fuels, and thus to bring down the cost of fuel, could be most helpful.

### 3. TAX PROPOSALS

There are at least five proposals for modification of the Internal Revenue Code:

(1) Equality of treatment with respect to investment credit—Both as a matter of essential fairness and to help deal with its financing problems, it has been proposed that the electricity utility industry be allowed the same 7% investment credit available to other industries.

We believe this should be done. It would provide help for some companies at the present time and perhaps for more companies in the future. It should be pointed out, however, that—unless there is an extension of the carryback and carryforward periods along the lines of the third proposal discussed below—in cases where the financing problems have been particularly acute, this parity of treatment with respect to the investment credit will be of little immediate help because such utilities are likely to be in a financial condition where they are not now paying any significant Federal income taxes.

(2) Extending dates for accelerated amortization of pollution control facilities—It is proposed that there be an extension in the governing dates of existing provisions permitting the taking of accelerated amortization for non-revenue-producing pollution control facilities. It has also been suggested that the definition of pollution control facilities be broadened by interpretation or, if necessary, by legislation.

Here again, both proposals are warranted. But—unless the carryback and carryforward periods are also extended—they are likely to be more useful for the financially healthy utility paying significant Federal income taxes than for the utility with major financing problems.

(3) Extension of carryback and carryforward periods—The carryback and carryforward periods provided in Section 172 of the Internal Revenue Code of 1954 should be extended to five and seven years, respectively, for regulated electric utilities.

Many of these utilities are now in the position of having net operating losses for Federal income tax purposes; and they face the prospect of additional net operating losses in future years. Since the taxable income of such utilities has been decreasing over the past several years, only minor portions of these losses can be applied as loss carrybacks to the preceding three taxable years. Thus, many of the tax benefits provided in recent years, such as the ADR system of depreciation, amortization of pollution control facilities and the like, and some of the other tax benefits which have been proposed to help alleviate the financing problems of the electric utility industry, will merely produce loss carryovers. And, unless the present economic situation is substantially reversed, they may well not be usable within the present carryforward period. The net result is that the objectives of these tax incentives could not be realized, and would be frustrated, in the case of many electric utilities having the most acute financing problems.

The proposed extension of the carryback and carryforward periods, in addition to helping to deal with current financing problems, would restore and make meaningful for such utilities the tax incentives provided to encourage the continuance of capital investment in productive facilities.

There is a very close precedent for such a change among the existing exceptions in Section 172 which include, for example, lengthened carryover periods for certain regulated transportation corporations, presumably because they had been faced with a situation similar to that faced today by many electric utilities.

(4) Amendment of section 305 to restore prior ruling encouraging electric utilities to issue stock dividends under circumstances where receipt of such dividends would not be regarded as taxable income—Another very helpful proposal would involve amendment of Section 305 of the Code to reinstate a ruling issued some years ago holding that, under the particular circumstances, the receipt of stock dividends would not be regarded as taxable income. Under this ruling, an electric utility company was permitted to have two classes of common stock, identical in all respects except that cash dividends were paid on one class and stock dividends of an equivalent value were paid on the other class. This made it possible to give the stockholder the option to take either the stock dividend class or the cash dividend class; and it encouraged many stockholders to exercise the stock-dividend option.

Common stocks of electric utilities have been purchased by many stockholders for income and on the basis of the cash dividends. As a practical matter, therefore, any reduction in the cash dividend will have a highly adverse effect on the market value of the common stock and on any future efforts to sell additional common stock which is essential to support new debt and preferred stock financing.

There are, however, a substantial number of stockholders, and many potential stockholders who do not now purchase utility securities, who would rather have an increase in their capital investment than cash dividends and who would be receptive to stock dividends if such stock dividends were not treated as taxable income.

To the extent that a stock dividend class of stock was taken up by the stockholders, the utility would be able to retain the cash dividends which would otherwise have been paid out on such stock and would, to that extent, increase both its internal generation of cash and its common stock equity. This would alleviate, in a significant way, two principal causes of the present financing problems of the electric utilities: first, the reduction in the internal generation of cash as a percentage of new capital needs (this would be automatically increased in a substantial degree); and, second, the need to go so often to the market to sell large amounts of common stock (this need would be reduced by the amount of the stock dividends).

Accordingly, we believe this proposal could be most helpful and we recommend that it be given very serious and favorable consideration.

(5) Authorizing electric utilities to issue tax-exempt bonds to finance essential facilities—Utilities are now permitted to arrange for financing of pollution control facilities through the issuance by government instrumentalities of tax-exempt bonds. It has been proposed that electric utilities be permitted to issue their own tax-exempt bonds to finance electric utility facilities which the appropriate regulatory commission has found to be essential to provide adequate and reliable electric power.

The saving in interest charges between a tax-exempt bond and a taxable bond of similar quality has been about 250 basis points. This would represent a significant saving in the interest rate and, since less interest charges would be incurred, it would also help in meeting coverage requirements. We appreciate the problems this approach raises but it would appear to be a simpler and less drastic solution than Federal guarantees or loans.

#### 4. PROPOSALS FOR FEDERAL GUARANTEES AND DIRECT LOANS

At least two proposals have been made for Federal assistance in financing that portion of the electric utility industry which is not now receiving such assistance:

(a) The first of these, which has been proposed by the Chairman of the Michigan Public Service Commission, calls for legislation to authorize the Federal guarantee of new utility debt securities. This proposal has been advanced not only to reduce the interest rate on such debt (such reduction being estimated by the Chairman to be in the range of 100 to 150 basis points) but also encourage utilities to increase their debt ratios from the current 50% to 60% or 65% of total capital to as much as 85%.

(b) The second proposal is to authorize a Federal instrumentality to act as a lender of last resort in making loans directly to electric utilities.

In each case, these proposals would provide for financial assistance only on a showing that the utility was not able to obtain capital on a reasonable basis in any other way.

If the financing problems of the electric utility industry persist, these proposals for Federal financing assistance should be given expedited consideration.

The required showing—that the utility was not able to obtain capital on a reasonable basis in any other way—could only be made in those cases where the regulatory Commissions were not acting responsibly with respect to rates and not authorizing revenues, earning and coverage adequate to attract new capital in the marketplace. Accordingly, the granting of any such Federal assistance should be conditioned upon action by the regulatory Commission or Commissions involved to authorize revenues, earnings and coverage which would enable the servicing of all securities outstanding, including the securities guaranteed by the Federal Government and any Federal loans, and which would enable the utility, thereafter, to attract new capital in the marketplace.

CONCLUSION

In sum, the underlying reasons for the current financing problems of the electric utility industry include:

1. The skyrocketing inflation in their costs, and particularly in current interest rates and cost of capital.
2. The inability to obtain prompt regulatory authorization to increase revenues to cover rapidly increasing costs.
3. Increasing needs for new capital.
4. The substantial reduction in the percentage of new capital requirements represented by internal cash generation.
5. Large capital and operating expenditures for nonrevenue—producing facilities to comply with rigid and arbitrary environmental requirements.
6. Increasing difficulties in meeting minimum coverage requirements which must be satisfied to permit the issuance of new bonds and preferred stocks.
7. A rapidly deteriorating market for electric utility common stocks.

There are a great many steps which can and should be taken to alleviate these problems. They include:

1. More expeditious and more realistic action to authorize rates which will cover increasing costs.
2. Reexamination of Federal policies relating to high interest rates, rigid and arbitrary environmental requirements formulated without any consideration of cost-benefit analyses, and the importance of encouraging the increased production and use of domestic coal.
3. Amendments to the Internal Revenue Code which would (a) provide the electric utility industry with equal treatment with respect to the investment credit; (b) extend the governing dates of provisions permitting accelerated amortization for pollution control facilities; (c) amend Section 172 to extend carryback and carryforward periods; (d) amend Section 305 to restore a prior ruling and permit stock dividends to be issued by electric utilities under circumstances where receipt of such dividends would not be regarded as taxable income; and (e) permit electric utilities to finance essential facilities by the sale of tax-exempt bonds.
4. Federal guarantees or direct loans on a showing that a utility was not able to obtain capital on a reasonable basis in any other way.

Each of the foregoing would be helpful in alleviating the financing problems of the electric utility industry. We believe each merits the serious consideration of the Subcommittee.

Senator BENTSEN. Mr. Corey, if you would testify, please?

## STATEMENT OF GORDON COREY, VICE CHAIRMAN, COMMONWEALTH EDISON CO.

Mr. COREY. Yes.

Senator, I have turned in a fairly voluminous testimony, and I will not summarize that in detail. I will simply say that I covered two general subjects, first, the financial plight of the electric power companies, the electric power industry which Mr. Cohn has gone over in great detail; and second, suggested remedy which we at Commonwealth think would go a long, long way toward helping the present situation.

Today's Wall Street Journal carried an announcement that Mr. Cohn's own company, American Electric Power, has announced plans

to cut the construction budget by about $1 billion. I believe it quoted Mr. Cook as saying, "we just do not have the earnings to carry out all of these projects."

Yesterday's Wall Street Journal carried an article announcing a cutback by Baltimore Gas and Electric Co. of one-third to one-half of their 1975 construction budget. Nearly every day, someone else, some other electric company announces a construction budget cut.

I myself have a list of some 21 large electric power companies that have cut their construction budgets recently.

We at Commonwealth Edison are perhaps one of the stronger companies financially. We have only cut our construction budget from $4,900 million down to $4,600 million, but I can assure you that before the year is out we will have to cut it some more unless we are able to do something about the stock market and are able to market common stock.

I am chairman of a Technical Advisory Committee on Finance, a committee advisory to the Federal Power Commission which is working on an update of the National Power Survey. The chore of our committee is to look at the financing problem of the electric power industry over the next few years as well as over the longer pull. We have been working very hard on it for a long while. There are some very good men on the committee, including Mr. Childs who is here this morning, and Dr. Glover from Harvard Business School, Ed Kennedy, senior partner of Lehman Brothers, and many others. But yesterday afternoon we got the first of the final runoff of a computer run which we have been working on for a long, long while, and this computer model has been used for EPA and also for a number of electric companies that are interested in where things are going, and I might just mention some tentative figures that came off of the computer run.

They were that new money requirements for the electric power industry for the next 5 years, 1975 through 1979, depending on what assumptions we make as to growth, will vary between a low of $16½ billion a year, and a high of $26 billion a year, depending on whether we assume low growth or something we have called historic growth. We have also tried zero growth, but nobody believes quite that that is realistic, and we have also tried some very high growth figures which bring you outside this range.

Senator BENTSEN. When you say historic growth, is that an extrapolation of the present trend curve of growth?

Mr. COREY. I will give you exactly what it is. Last year we had a growth rate in the electric industry of 9.4 percent. That is 1973, that is peakload growth over 1972, showed an increase of 9.4 percent. The historic growth assumptions used 3 percent for 1974, because that is kind of an optimistic figure for this year, 5 percent for next year, 7.2 for the rest of the 1970's. The low growth figure assumes zero for this year, 3 percent for 1975, and 5 percent for the rest of the 1970's.

The point I am making is that up until this year, and this all appears in my testimony, up until this year the electric power industry had not raised as much as $10 billion a year new money. Last year it approached $10 billion. That is 1 percent of GNP. Five years ago our new money requirements approximately one-half of 1 percent of GNP. Our low growth assumptions come up with $16½ billion for the next 5 years.

I am emphasizing this because of your question a few moments ago as to the effect of elasticity of demand on higher prices. I believe that even if we get a substantial dampening in demand, we will still have an enormous capital raising problem, and I for one am not sure we can meet it.

I emphasize again that Commonwealth Edison is probably in as good shape financially as any other large electric power company. We are generating more than $300 million a year in cash internally, but we are scheduled to be spending $4½ billion in the next 5 years. That is nearly $1 billion a year, and we have to raise something on the order of $100 to $150 million in new common equity money every year.

Now I come to our suggested remedy. Mr. Cohn touched upon it very briefly, and that is that we have to find some way, even for the relatively solvent companies, to market new common stock. We believe in a simple change, a relatively simple change in the Internal Revenue Code to reestablish a right which existed prior to 1969, that is, a right to somehow or another enable cash dividends to be reinvested in the same company in the same class of securities without tax. There are several ways of doing this. The Citizens Utilities plan involves two kinds of stocks.

Senator BENTSEN. You say that was permitted prior to 1969?

Mr. COREY. I will tell you what the situation was. Prior to 1969 Citizens Utilities, and I believe it was early in the 1960's or perhaps late in the 1950's, Citizens Utilities applied for permission to establish two classes of stock, class A stock which paid cash dividends, class B stock which paid stock dividends, and to make the two classes of stock convertible into one for another. The Treasury people at that time—and I am going back in history—were reluctant to allow this, but finally when the application was amended so that class B stock was convertible into class A; but class A was not convertible into class B, they allowed this and a ruling was issued, and Citizens Utilities as a result has not had to issue any common stock since then, and they have a fat common equity part of their capital structure. A good many of their stockholders at that time elected to take the class B stock dividend type stock.

After that, Treasury people reviewed the matter and were reluctant to extend it to others.

Senator BENTSEN. In effect, they were converting an ordinary income to ultimate capital gain tax.

Mr. COREY. That is right. Well, let me put it in a little better light than that, Senator. If we can draw a parallel with companies like IBM, Xerox, the oil industry generally, the steel industry generally, and in fact a very large portion of American industry, General Motors for example—these companies pay out a substantially lower portion of their earnings in cash dividends and they generate enough cash internally so that they do not have to go out on the market and sell common stock from time to time. The electric companies—largely, I think, because of the kind of stockholders we have, and the fact that over a long period of years we have not been able to show the kinds of growth rate in earnings that most industrials have been able to show—have had to resort to high cash dividend payout and our stock is selling on a yield basis, cash dividend yield basis. There is no way, for Commonwealth Edison today, that we can cut our $2.30 cash dividend, which

represents about a 70-percent payout, without having the kind of disastrous effect occur in the market that occurred when Consolidated Edison Co. passed their cash dividend in May.

Senator BENTSEN. What percentage yield is that on the present market price of stock, approximately?

Mr. COREY. Are you talking about the yield or price-earnings ratio?

Senator BENTSEN. Whichever you want.

Mr. COREY. The price-earnings ratio for us is nine.

Senator BENTSEN. Is what?

Mr. COREY. Nine.

Senator BENTSEN. All right, now, percentage of yield on stock?

Mr. COREY. Our dividend yield is approximately 10 percent—$2.30 and the price of stock a week ago was $23. The price I noticed yesterday was $25, or a little under 10 percent today.

But this illustrates the disfavor that utility stocks have fallen into, and when I say that we have to raise $150 million, we at Commonwealth, $150 million of new common equity money each year in order to sustain the construction budget that we have, I am presenting a very difficult thing in today's stock market. But the kind of tax change that I have suggested, which might take any number of different forms, would, in my opinion, enable us to generate from existing stockholders about $50 million of reinvestment of dividends a year instead of our present $7 or $8 million reinvestment, an improvement of about $40 million a year, and I am sure that it would—I am assured by my investment banking friends that it would provide the customer representative, the salesmen for Merrill Lynch and others, to have some new basis for selling electric utility stocks. This would provide almost an ideal mechanism for a man's retirement. He could buy Commonwealth Edison stock, elect the stock dividend, and upon retirement, elect the cash.

This almost completes my testimony. I have just one small point I would like to make.

You were discussing with Mr. Goldfinger earlier the need for accelerating public works, and it occurred to me as you were discussing it, we have a desperate need to do something to prevent further construction cutbacks in the electric power industry. As I said, we at Commonwealth have made a modest cutback, about 2 or 3 months ago, when we canceled one generating station. We are going to have to face up within the next month or two or three at the latest to a complete reexamination of our long-run construction program because of the enormous difficulty in raising new funds. Thank you very much.

Senator BENTSEN. Thank you very much.

[The prepared statement of Mr. Corey follows:]

PREPARED TESTIMONY OF GORDON R. COREY, VICE CHAIRMAN OF COMMONWEALTH EDISON CO.

Exhibit A attached hereto is a statement entitled, "The Financial Problems of the Electric Power Industry," which details the financing problems faced by our industry—the most capital intensive of any industry in the U.S. economy.

We in the electric power industry must invest about $4.25 in plant for each dollar of revenue. We raise over $10 billion a year through the sale of new money securities—a third of all the new money raised through the sale of U.S. corporate securities. The $10 billion-plus thus being raised currently by our industry equals nearly one percent of the Gross National Product. Moreover, the electric power industry's share of the total amount of new money raised, and the portion

of the Gross National Product this share represents, have both risen rapidly in recent years.

The capital investments of the industry are distinguished not only by their size but by their character. They are extremely long-lived as compared to those of other industries. Book depreciation rates, for example, are in the range of two to four percent.

Historically, the investor-owned segment of the electric utility industry has been able to meet its large capital requirements by paying competitive rates of return in the securities markets and maintaining appropriate capital structures with 40 to 45% of total capital consisting of equity.

Because of the capital-intensive nature of electric utilities, the long-life of their facilities and the large amounts of equity they need, the penalities the income tax imposes on capital investment have a particularly severe impact on our business. The current inflation—especially construction cost inflation—has magnified this impact. Rapidly rising construction costs have far outpaced the ability of the electric utilities to meet a major share of their construction requirements with internal cash generation.

Investors are not blind to these problems. They see that rising construction expenditures and money costs are eroding coverage on debt securities, restricting returns available on equity and threatening the dividend yields which have attracted a major portion of the investment in electric utility stock. If deterioration continues, there will be more insurances like the forced purchased by the State of New York of Consolidated Edison generating stations. The need to raise utility capital will not be eliminated. The task will be simply transferred to the government, utility services will be priced without full regard for the market cost of capital, and the utilities' share of the tax burden will be transferred to other taxpayers.

What to do about it?

In my opinion, based upon projections of capital needs for the future—affected by continuing inflation and a steadily declining ability to meet construction costs through internal cash generation—there is a strong possibility that the electric power industry will have to raise not 1% of GNP but 1½ or 2% of GNP within the next four or five years. However, the new money needs of the electric power industry have already increased from ½ of 1% of GNP to 1% of GNP in a short space of only five years, and the result has been—as I have already pointed out—a marked deterioration in utility credit. Consequently, the further projected shift in the allocation of the nation's new money capital resources to the electric industry may well be too great to be accomplished.

Today, for example, we are faced with the worst stock market that I have seen in my experience as a businessman. Yet we at Commonwealth Edison are faced with the necessity of raising over $100 million a year through the sale of new common stock. This is in addition to approximately half a billion dollars of debt money required each year.

We are not going to be able to do this—and we are one of the stronger electric utilities financially—without a significant increase in internal cash generation coupled with a marked improvement in the market for electric utility stocks. We simply must find some way of attracting additional investor interest in these stocks, which are now in considerable disfavor.

Both of these objectives—an increased rate of internal cash generation and an improved market for electric utility stocks—could be helped materially by a relatively simple and logical change in the federal tax laws—an amendment of the Internal Revenue Code to permit stockholders of electric power companies (and possibly other U.S. corporations which need additional new capital for plant modernization and expansion) to elect to receive their dividends in the form of either non-taxable stock dividends or taxable cash dividends. Let me explain.

## PROPOSED AMENDMENT OF THE INTERNAL REVENUE CODE

Prior to 1969, it was possible, under certain circumstances, for shareholders to choose between receiving taxable cash dividends and non-taxable stock dividends. Under the provisions of the Internal Revenue Code, adopted in 1969, however, if a shareholder has an opportunity to choose between cash and stock, the stock dividend or its equivalent is fully taxable. As a practical matter, therefore, the pre-1969 choice is no longer offered.

It is proposed to eliminate or modify the present restrictions to allow a moderate degree of choice between stock and cash dividends without invalidating

the tax-free status of the stock dividends. This could be accomplished in a variety of ways, as follows:

(i) By offering a single security which would yield either taxable cash dividends or non-taxable stock dividends at the option of the stockholder;

(ii) By offering two securities, one bearing taxable cash dividends and the other non-taxable stock dividends, with the holder able to convert from one to the other—a so-called class A and B stock plan, similar to that now used by Citizens Utilities Company, or

(iii) By providing that cash dividends re-invested in new stock of the same class in the same firm, in accordance with a dividend re-investment plan, would not be taxable at the time of the dividend distribution.

I do not propose to specify which type of change would be best suited to the objectives of Congress and the Treasury Department—or whether the changes would be made available to all taxpayers or merely the electric utility industry. But I do wish to point out that adoption of the proposal in one form or another would go a long way toward resolving the electric industry's current financial problems.

This is because the electric utilities typically have high dividend payout rates and, therefore, reducing cash dividend payout would add materially to their equity capital. Moreover, electric utilities have historically sold a large part of new issues of common stock to their own stockholders, so that one would expect an excellent response to the privilege of receiving tax-free funds for reinvestment.

DETAILED DISCUSSION OF THE OPTIONAL STOCK DIVIDEND PROPOSAL

Most electric power companies now pay on the order of 70% of earnings on common stock in the form of cash dividends. Although this represents a large portion of internally generated cash foregone, such high dividend payout is essential to maintain stock prices and, therefore, to sell new issues of stock on reasonable terms—witness the huge drop in Consolidated Edison's stock price after it passed its dividend last April.

This cash dividend outflow could be reduced—and the utilities could maintain or improve the price of their stock if they could offer shareholders an option of taxable cash dividends or nontaxable stock dividends, with the right, even though limited, to change options.

If such a plan were available to Commonwealth Edison shareholders, and even if shareholder participation in the plan represented only 40% of the stock, common equity cash generation would be increased by over $40 million annually, thus reducing new common stock issue requirements by an estimated 30%. If participation in the plan exceeded 40%, the benefit would be even greater.

We believe that 40% participation is a conservative estimate. At least one historical yardstick tends to support this belief. In the years 1959–64, the Company paid a combination of cash and stock dividends on its common stock. Stockholders, however, had an election under which their stock dividend could be sold to provide cash. But only about 10% of the stock distributed as a stock dividend was thus sold—90% of our shareholders took stock.

We expect that other companies would benefit in similar measure. In 1973, investor-owned utilities paid out about $5 billion in common dividends. If any significant percentage of these could have been converted to stock dividends, a sizeable portion of the roughly $6 billion in new equity money raised by these companies in that year could have been raised from this source instead.

With construction budgets far outstripping internal cash generation, electric utilities are in critical need of help in improving internal cash generation and enhancing the attractiveness of their stock. However, they cannot help themselves by terminating or sharply reducing cash dividends and substituting stock dividends. This would spell disaster for utility stock prices. The Consolidated Edison experience makes this clear.

SUMMARY

In short, it is recommended that the Senate Finance Committee give serious consideration to a stock dividend option of the type described herein. As indicated in Exhibit B, this proposal is supported by the Edison Electric Institute, representing the entire investor-owned electric utility industry.

[Exhibit A]

## The Financing Problems of the Electric Power Industry

The passing of Con Ed's dividend was only the most visible signal of the growing financial problems of the electric power industry. The underlying weakness of the industry results from a combination of (1) a growing need for external financing and (2) a declining availability of credit.

### A. GROWING MONEY NEEDS (TABLE I)

The electric power industry's new money needs have increased from less than $5 billion a year, five years ago, to more than $10 billion a year today—an increase from ½ of 1% of GNP to approximately 1% of GNP. Electric power financing today constitutes about a third of all new money raised by industry in the capital markets.

The industry's new money needs are expected to continue to grow—possibly doubling again and reaching $20 billion by 1980 if oil remains in short supply (requiring expanded nuclear plant construction) and if environmental requirements continue to rise.

### B. RISING COSTS

The cost per kilowatt of new power plant construction has doubled since the mid-1960's and is expected to double again by the early 1980's. (Table II)

At the same time, interest and preferred dividend costs have reached a new high.

### C. DECLINING CREDIT

1. So far this year, Standard and Poor's have downgraded the ratings of 17 electric utilities, and Moody's have downgraded 14 electric utilities—in each case the highest number on record. (See Table III. Also see the June 17 *Chicago Tribune* news story accompanying Table III.)

2. Interest coverages have been cut in half during the last five years and appear to be continuing to drop (Table IV). In some cases bond indenture coverage requirements cannot be met, making it impossible to sell more bonds.

3. Most electric utility common stocks are selling below book value—some far below (Table V). Such stocks are not attractive to investors generally. This will make it difficult to raise the $3 to $5 billion a year of common equity money required in the years to come.

4. Several electric utilities have had to postpone or revise securities offerings due to unfavorable market conditions. Prevailing high interest rates, lack of competitive bidding, limitations imposed by bond indentures, and unwillingness of investors to commit funds under traditional safeguards have all contributed to chaotic securities markets.

### D. PROMPT RATE RELIEF NEEDED

Electricity prices must be raised to levels adequate to pay the new higher costs. Current regulatory procedures were not designed for periods of rapid inflation. Regulatory delays coupled with rapid inflation mean that utilities never in fact earn rates of return as high as those intended by commissions.

Improved regulatory procedures should include the following:

1. *Faster rate reviews*. General rate case proceedings should be speeded up where possible by tighter scheduling.

2. *Expedite "make-whole" proceedings*. These should be used more often to make up for attrition in earnings subsequent to a formal proceeding. Under such "make-whole" proceedings, the rate of return and rate base questions need not be tried all over again.

3. *Interim increases*. Prompt allowance of interim increases is also essential—pending the completion of long and complex formal proceedings. Interim increases should *not* be made subject to future refund if the needed financial benefits are to be achieved.

4. *Automatic adjustment clauses*. Maximum use of fuel and environmental cost adjustment clauses is essential to meet rapid or unexpected cost increases.

5. *Future test periods*. Use of future test periods should be encouraged so that rates can be set in view of what the future holds in the way of further inflation.

40-544 O - 74 - 5

6. *Fair value rate base.* Use of fair value rather than original cost rate base will also help assure that inflation is taken into account in establishing rates.

7. *Encourage more selective GSA participation in rate cases.* The General Service Administration should be encouraged not to actively oppose *all* rate increases as a matter of course, whether meritorious or not. This often results in unnecessary delays.

E. OTHER STEPS

1. Power plant siting and nuclear licensing delays have made enormous contributions to the decline in earnings of the electric power industry. For a large base load nuclear unit, such delays often cost $1 million a week or more. A successful acceleration of such proceedings would be of important long-run benefit to both the industry and its customers.

2. Careful analyses of the cost-benefit aspects of various environmental requirements may well indicate areas where proposed new requirements cannot be cost justified.

3. Unusual tax burdens on the electric power industry should be relieved. This is one of the few industries which is allowed only a 4% investment tax credit instead of 7% credit—presumably because it does not "need" the higher credit. Also, few other industries carry as large a burden of local taxes, often ranging between 10% and 20% of electric revenues for big city companies. Finally, since the industry is the most capital-intensive of all (Table VI) it is the most burdened by the corporate income tax—which is levied in rough proportion to equity investment.

4. Consistent with the above, new tax burdens such as the proposed sulfur emission tax should not be imposed.

F. HOW GOOD REGULATION HELPS

1. In Indiana four of the major investor-owned electric utilities (Indianapolis Power & Light, Northern Indiana Public Service, Public Service Company of Indiana and Southern Indiana Gas & Electric) earned well over 13% on common equity in 1973, with one company in excess of 15%.

2. In Ohio two major companies (Ohio Edison and Toledo Edison) earned well over 13% and two others (Cincinnati Gas & Electric and Cleveland Electric Illuminating) earned nearly 13% in 1973.

3. In Louisiana one major company (Central Louisiana Electric) earned 14.75% and another (Louisiana Power & Light) earned 13.82% on common equity in 1973.

4. Charles Benore, a well-known investment analyst, has pointed out the important benefit of raising common equity return to the 13 to 15% level—at a nominal cost to customers in the long run. (See Attachment VII—p. 84.)

5. Even under the adverse circumstances of this year, none of the companies mentioned in the preceding paragraphs have had security deratings. Moreover, these companies have been able to maintain market prices generally close to or slightly above book value. Thus they have significantly better ability to raise new capital than those which have been realizing lower returns on equity.

TABLE I.—ELECTRIC INDUSTRY NEW MONEY NEEDS

| | New money (billions) | Percent GNP |
|---|---|---|
| 1966 | $2.6 | 0.3 |
| 1967 | 3.4 | .4 |
| 1968 | 3.8 | .4 |
| 1969 | 4.9 | .5 |
| 1970 | 7.9 | .8 |
| 1971 | 8.8 | .8 |
| 1972 | 8.8 | .8 |
| 1973 | 9.1 | .9 |
| 1974 | 13.0 | 1.0 |
| 1975 | 13.5 | |
| 1976 | 15.0 | |
| 1977 | 16.1 | |
| 1978 | 17.4 | |
| 1979 | 18.0 | |
| 1980 | 20.0 | 1.0(?) |

Sources: "Electrical World," Mar. 15, 1974; "Public Utilities Fortnightly." Jan. 31, 1974; Irving Trust Co., "Financing Calendar Supplement," Mar. 1, 1974; "Survey of Current Business."

TABLE II.—RISING POWERPLANT CONSTRUCTION COSTS—COMMONWEALTH EDISON CO. (NEW GENERATING UNITS)

| Station | Type | Service date | Cost per kilowatt |
|---|---|---|---|
| Joliet | Fossil | 1965-6 | $98 |
| Kincaid | do | 1967-8 | 116 |
| Dresden | Nuclear | 1970-1 | 144 |
| Powerton | Fossil | 1972 | 232 |
| Quad Cities | Nuclear | 1972 | 160 |
| Zion | do | 1973-4 | 277 |
| Powerton | Fossil | 1975 | 231 |
| Collins | do | 1976-8 | 264 |
| Will County | do | 1977-8 | 299 |
| LaSalle | Nuclear | 1978-9 | 370 |
| Byron | do | 1980-1 | 441 |
| Braidwood | do | 1980-1 | 446 |

TABLE III.—CHANGES IN ELECTRIC UTILITY RATINGS, JANUARY-JULY 1974

| Date of new issue: Company bonds | Moody's | Standard & Poor's |
|---|---|---|
| Feb. 5: Union Electric Co | | AA to A. |
| Mar. 6: Public Service Co. of New Hampshire | A to Baa | A to BBB. |
| Mar. 7: Consolidated Edison of New York | A to Baa(1) | BBB to BB (Apr. 27). |
| Mar. 21: Connecticut Light & Power | Aa to A (2) | AA to A. |
| Apr. 2: Wisconsin Power & Light | | AA to A. |
| Apr. 9: Hartford Electric Light Co | Aa to A (2) | AA to A. |
| Apr. 18: Western Massachusetts Electric | Aa to A | AA to A. |
| May 1: Cleveland Electric Illuminating | | AAA to AA. |
| May 7: Columbus & Southern Ohio Electric | Aa to A | |
| May 14: Detroit Edison | Aa to A | AA to A. |
| May 28: Ohio Power Co | A to Baa | |
| June 3: [3] Boston Edison | A to Baa | |
| June 3: [3] Delaware Power & Light | Aa to A | |
| June 4: Central Illinois Light Co | | AA to A. |
| June 13: Delmarva Power & Light | Aa to A | AA to A. |
| June 21: Long Island Lighting | | AA to A. |
| June 26: Virginia Electric & Power | Aa to A | AA to A. |
| July 17: Consumers Power Co | Aa to A | AA to A. |
| July 23: Toledo Edison Co | | AA to A+. |
| Changes | 13 down; 0 up | 15 down; 0 up. |
| Preferred stock: | | |
| Jan. 29: Southwestern Public Service Co | | A to AA. |
| Mar. 21: Connecticut Light & Power | | AA to A. |
| Apr. 9: Hartford Electric Light Co | | AA to A. |
| Apr. 18: Philadelphia Electric Co | | AA to A. |
| June 11: Florida Power Corp | "aa" to "a" | AA to A. |
| June 22: Virginia Electric & Power | | A to BBB. |
| July 26: [3] Consumers Power Co | "aa" to "a" | A to BBB. |
| Changes | 2 down; 0 up | 6 down; 1 up. |

[1] Rating suspended May 13, 1974.
[2] Rerated by Moody's in July, 1974.
[3] Announcement of rerating.

## MORE BOND RATING SAGS LIKELY

(By Alvin Nagelberg)

The credit ratings of a record number of electric utilities have been downgraded since January 1 and experts believe the trend will continue for some time.

The downward revisions have hit other types of corporations, too, but haven't centered on another industry to the same extent as the electric utilities.

A rating reduction, a judgment that the quality of the investment has slipped, is a reflection of a problem that seems to be summed up in an equation.

The rising capital requirements of corporations plus high interest costs equal a rising debt load that is not being matched by earnings.

But Robert Davis of Moody's Investor Service, one of the main organizations that rate long-term debt of corporations, warned that it's too simple to say ratings are affected only by debt load.

"We look at cash flow, stability of earnings, and the quality of assets," he said.

In the case of the electric utilities, the problems are many. Standard & Poor's Corp. said "the industry's unrelenting operating problems, the energy shortage, sharply higher interest rates, and the weakening of shareholder confidence in the wake of Consolidated Edison's recent dividend omission have converged to bring the nation's most capital-intensive industry into a period of serious financial difficulties."

S. & P. has downgraded the ratings of 13 electric utilities thus far in 1974—a record. Moody's has downgraded 26 corporations—mostly electric utilities—the highest number in the memory of officials.

Roy Weinberger, associate manager of corporate finance department of S. & P., said in an interview that the biggest factor affecting corporate credit today is inflation.

"Corporations need greater amounts of capital to run at the same level of a few years ago and if they are expanding they need even more capital. With money rates at high levels, it becomes difficult to finance growth and when there is financing it is difficult to meet the fixed charges [of the debt]."

The utilities are faced with additional problems, including restrictive regulation on rate increases and huge capital expenditures for generating facilities that won't produce income for six to 10 years.

A June S. & P. industry survey also pointed out that kilowatt sales have slumped and fuel costs have soared.

Five years ago, the utilities could generate internally half the funds needed annually for construction, dividends, and debt. Today, it's 25 to 30 per cent, so there is great pressure to go into the capital markets.

"Today, the common stock of many electric utilities is selling below book value," Weinberger said. "That's a quick way to be put out of business. It makes it difficult to find new investors."

Yet, experts say the industry must sell $2 billion to $3½ billion of additional common stock a year for the foreseeable future.

Huge capital outlays will require the companies to sell $10 billion to $13 billion of permanent securities a year, however many companies are bumping the limits at which earnings will cover the debt. And the downgrading of ratings of bonds, which forces the utilities to sell the securities at higher interest rates, makes matters worse.

Though Davis says that the downgrading trend is not pronounced among industrial firms, experts are watching closely discount merchandisers whose thin profit margins are sensitive to additional debt loads. The petroleum industry also is being followed closely because of the huge capital requirements firms face for oil exploration ventures and pipeline construction.

Weinberger disclosed there has been an increase in applicants for new bond issues. "The year started with a bang at a record pace, slowed to a whimper, and has been picking up in the last week or so," he said.

He speculated that many executives "don't expect the inflation to be reduced significantly very quickly. The businessmen may be willing to borrow at 8 per cent for 30 years because they are convinced the dollars will be devalued over the period," he said.

"We're seeing firms that haven't been there for years coming into the long-term market," Davis said. "Their capital requirements have expanded."

"Their inventories cost more today and they're willing to finance part of it in the long-term market," he said, because "inflation will enable them to pay back the debt with cheaper dollars."

UNDERSTANDING THE RATING SYSTEM

Moody's Investors Service has an alphabet rating system with triple A bonds judged to be the best quality. Double A are high quality, and single A have favorable investment attributes.

Triple B bonds are medium grade, double B bonds have speculative elements, and single B "lack characteristics of the desirable investment." There's also a C category.

The downgrading from double to single A or from the A to B category results in higher financing costs for the issuer of the bonds because the corporation will have to pay a higher interest cost to lure investors.

TABLE IV.—INTEREST COVERAGE RATIOS/INVESTOR-OWNED UTILITIES (BEFORE TAXES)

| Year | Ratio |
|---|---|
| 1965 | 5.28 |
| 1966 | 5.04 |
| 1967 | 4.65 |
| 1968 | 4.26 |
| 1969 | 3.72 |
| 1970 | 3.11 |
| 1971 | 2.95 |
| 1972 | 2.95 |
| 1973 | 2.84 |

Sources: "Electric Utility Review," May 1974, Baker, Weeks & Co. Inc. (p. 20)

TABLE V.—COMPARISON OF BOOK VALUE AND PRICE OF COMMON STOCK OF THOSE ELECTRIC COMPANIES INCLUDED IN MOODY'S UTILITY AVERAGE

| | Book value Dec. 31, 1973 | Market price Aug. 2, 1974 | Percentage of price to book value |
|---|---|---|---|
| Consolidated Edison Co., New York | 31.02 | 7¾ | 25 |
| Detroit Edison Co | 20.00 | 9¾ | 49 |
| Boston Edison Co | 31.71 | 16½ | 52 |
| Philadelphia Electric Co | 20.95 | 11⅛ | 53 |
| Northeast Utilities | 12.83 | 7 | 55 |
| Baltimore Gas & Electric | 26.15 | 14⅜ | 55 |
| Carolina Power & Light Co | 22.68 | 12¾ | 56 |
| Florida Power Corp | 30.71 | 17½ | 57 |
| Central Hudson Gas & Electric Corp | 24.07 | 13¾ | 57 |
| Delmarva Power & Light Co | 15.25 | 9 | 59 |
| Southern California Edison Co | 28.77 | 17⅞ | 62 |
| Dayton Power & Light Co | 18.65 | 13⅜ | 72 |
| Pacific Gas & Electric Co | 27.81 | 21⅛ | 76 |
| Utah Power & Light Co | 33.96 | 26 | 77 |
| Pennsylvania Power & Light Co | 22.30 | 17⅝ | 79 |
| Central Maine Power Corp | 16.15 | 12¾ | 79 |
| Commonwealth Edison Co | 27.03 | 23¾ | 88 |
| Houston Lighting & Power Co | 24.19 | 22 | 91 |
| Tampa Electric Co | 13.11 | 12 | 92 |
| Cincinnati Gas & Electric Co | 17.69 | 16⅜ | 92 |
| Indianapolis Power & Light Co | 19.13 | 18⅛ | 95 |
| Public Service Co. of Colorado | 12.60 | 12 | 95 |
| Idaho Power Co | 25.67 | 24⅞ | 97 |
| Cleveland Electric Illuminating Co | 23.79 | 23½ | 99 |

TABLE VI.—PLANT INVESTMENT PER DOLLAR OF ANNUAL REVENUE

| Item | Amount |
|---|---|
| Electric power | $4.25 |
| Telephone | 2.83 |
| Railroads | 2.67 |
| Gas | 2.00 |
| Steel | 1.08 |
| Oil | .73 |
| Automobiles | .67 |

Source: Based upon latest available data, generally relating depreciated plant investment at Dec. 31, 1973, to revenues from sales for the year 1973.

[Attachment VII]

ELECTRIC POWER INDUSTRY INVESTMENT OUTLOOK

A 3 to 4% rate of growth in earnings for the 1973–1978 period is above our current expectations, and given the current state of investor disappointment towards the group, it might even require a higher potential return and associated earnings per share growth to rebuild investor confidence. If the industry could earn 13% on its common equity instead of the 11% assumed in our projections, the outlook for the common stockholder would improve materially as can be seen in Table 21 which appears below.

TABLE 21.—COMPARISON OF RATE INCREASE REQUIREMENTS, COMMON STOCK FINANCING, PRE-TAX INTEREST COVERAGE, AND CHANGE IN EARNINGS PER SHARE WITH AN 11 PERCENT AND A 13 PERCENT RETURN ON YEAR END, 1973 COMMON EQUITY

| | 11 percent case | | | | | 13 percent case | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Return on common equity (percent) | Rate increase required (billions)[1] | Common stock financing | Bond interest coverage | Percent change EPS | Return on common equity (percent) | Rate increase required (billions)[1] | Common stock financing[2] | Bond interest coverage | Percent change EPS |
| 1978... | 11.0 | $3.0 | $3.9 | 2.6 | 5.0 | 13.0 | $3.8 | 2.5 | 2.9 | 13.4 |
| 1977... | 10.7 | 2.9 | 3.6 | 2.6 | 4.8 | 12.0 | 3.5 | 2.7 | 2.8 | 12.6 |
| 1976... | 10.4 | 2.4 | 3.3 | 2.5 | 4.7 | 11.0 | 2.8 | 3.0 | 2.6 | 11.1 |
| 1975... | 10.1 | 1.8 | 3.0 | 2.5 | 8.1 | 10.1 | 1.8 | 3.0 | 2.5 | 8.1 |
| 1974... | 9.5 | 1.5 | 2.6 | 2.5 | −10.0 | 9.5 | 1.5 | 2.6 | 2.5 | −10.0 |

[1] Equal to ½ of previous years rate increase grants plus ½ of current year.
[2] Same capitalization ratios as in 11 percent case.

The difference between an 11% return on common equity and 13% is less than $2 billion over the 1974–1975 period, or 16% more rate relief than required for the 11% return on equity case of $11.6 billion. And for the investor the improvement is substantial; coverages improve, common stock financing is substantially reduced, and earnings per share (shares sold at 0.8X book value) grow at a 6.6% annual rate between 1973 and 1978 instead of 2.3%.

There have been no indications, however, that regulatory commissions are willing to grant returns on common equity of 14% to 15% which would be necessary after regulatory lag to realize a 13% return on equity. Therefore, if utilities are to be able to raise the large sums of necessary equity capital, the rate of inflation will have to drop considerably. At lower rates of inflation, investor confidence in the earnings and dividend growth of the industry would improve and interest rates could drop which in turn would help the price-to-book ratio of the industry. In our judgment, a decline in the gross national product price deflator to 4% or below would help the industry to accomplish its financing chore; 5% perhaps; and 6% or more, probably not unless sufficient rate relief were granted or some form of state or Federal assistance was extended.

[Exhibit B]

EDISON ELECTRIC INSTITUTE,
*New York, N.Y., July 25, 1974.*

Hon. FREDERIC W. HICKMAN,
*Assistant Secretary for Tax Policy, Department of the Treasury, Washington, D.C.*

DEAR MR. HICKMAN: In connection with the consideration your office currently is giving to tax measures affecting the electric utility industry, the Edison Electric Institute offers the suggestion set forth below, which previously has been discussed with you. The Institute is the principal national association of the investor-owned electric utility companies whose members directly serve about 78 percent of the ultimate customers for electric service in the United States.

Ours is the most capital intensive of all industries, and the supply of capital is the greatest problem with which we are presently contending. The current inflation has magnified the problem. An evaluation of the problem by Dr. Irwin M. Stelzer, President of National Economic Research Associates, Inc., appears in the May/June 1974 issue of the EEI Bulletin, a copy of which is enclosed. Rapidly rising construction costs have far outpaced the ability of the utilities to meet a major share of their construction requirements with internal cash generation.

As a consequence of this situation, several alternative financing techniques are being considered. One of these techniques involves the issuance of two series of common stock. Both series would be identical except that cash dividends only would be paid on one series and stock dividends at an equated cash value would be paid on the other. Also, the series of stock which calls for stock dividends would be fully convertible into the cash dividend-type at the holder's option. Currently, under Section 305(b)(2) of the Internal Revenue Code of 1954, a stock distribution paid under this arrangement would be taxable in the same manner as a cash distribution.

We respectfully submit that Section 305 of the Internal Revenue Code should be amended so that a stock distribution of the type discussed, made with respect to stock of a regulated public utility, be treated as a nontaxable distribution in a manner comparable to the rules in existence prior to 1969.

We would be glad to provide any additional data you might require for the support of this purpose. Please let me know if further information is desired.

Sincerely yours,

W. DONHAM CRAWFORD,
*President.*

Senator BENTSEN. Mr. Childs, would you proceed?

Mr. Childs is the senior vice president of Irving Trust Co.

## STATEMENT OF JOHN F. CHILDS, SENIOR VICE PRESIDENT, IRVING TRUST CO.

Mr. CHILDS. Mr. Chairman, I am not an economist, and I speak primarily as a financial adviser. I am supposed to talk about the financial plight of the utilities.

Mr. Cohn has covered my subject extremely well. I agree with everything he said. The industry is in a very serious plight.

I have changed my notes and would just like to supplement some of the things he said in order to save time.

Senator BENTSEN. If you are not an economist, maybe I can get a positive commitment on some of the things you are saying. I always liked Harry Truman's story about economists. They always say "on the other hand." And he said, what I really want is a one-armed economist.

Mr. CHILDS. Well, you know, my definition of an economist is somebody who is willing to be wrong more than 50 percent of the time without bothering his conscience. So I am not an economist.

Senator BENTSEN. All right.

We have several economists back here.

Mr. CHILDS. Well, I say that to all my good friends who are economists.

In the first place the utility industry was an extremely attractive industry in the 1960's, and the reason it was an attractive industry was because it self-generated its earnings. It did not have to ask for rate increases. The utilities did not earn a lot of money, but the fact that there was no regulatory lag made them attractive as far as the investors were concerned.

I think it is important for everybody to realize that the plight of the utility industry was not caused by the utility industry. It is not something they did bad financially. In the 1960's utility companies followed a sound financial policy. Some of them talked about 60-percent debt ratios and some of them let their debt ratios increase a little, but at the end of the 1960's the industry was in a super-strong financial position. Almost all of the debt, by volume of debt, was rated either triple A or double A.

The reason the industry ran into trouble was because of all of the things Mr. Cohn has talked about. It is primarily due to regulatory lag in the face of inflation.

Since the industry ran into trouble, I think it is important to appreciate that the industry has done a tremendous job in financing. They have surmounted great difficulties in raising capital. I know of one company that has reduced its debt level from 57 percent to 50 percent in spite of all the financial difficulties. They should be highly commended.

Is this industry doomed? This is not a railroad industry. It is not an industry that is economically unsound. It is completely viable. It is an underpriced commodity, and if industry could price the commodity the way it should be priced, this industry would attract capital and attract it very fast. It would be a haven for the investors.

What if things do not improve? I am in complete agreement with Mr. Cohn on the question of what is going to happen. This industry has got to provide service, it says so in their franchises. But if they cannot get the capital, there is no way they can order equipment. The consumers do not realize it, but there is not going to be any power available 3 years from now. You will not feel it in the next year or two, but the equipment they are failing to put in now is going to kill the consumers 3 years from now. It is going to hurt our entire country, and it is going to add to the unemployment situation.

What to do about it. There is no free lunch in economics. Either the consumer is going to pay it through taxes or Government financing, or the consumer is going to pay it through rate increases.

People in management are getting condemned today for the rate increases. There is nothing that management hates more than rate increases. It is a difficult job to get rate increases. If management could avoid it, they would be delighted. All through the 1960's they did not raise rates and in fact they lowered them.

Regulatory lag—part of regulatory lag is natural. You have to have a poor rate of return before you go into a rate case. After you get into a rate case it takes 11 months to complete it. By the time you finish, inflation will cause your original request to be too late and too little.

Some regulators are just dragging their feet. When a company obviously needs a $50-million rate increase and they ask for a temporary rate increase of $25 million to tide them over, and regulatory agencies drag their feet, that is inexcusable.

Regulation is in a horrible position today because the newspapers and the local politicians are the whipping boys. I have the greatest respect for them and I think some of them are doing a great job, a masterful job, but some are dragging their feet.

Other approaches—The investment tax credit is good, and some of those things being suggested are good. But Government guarantee of debt I think would be wrong, and I do not think it would do any good. I do not think it would help the common stockholder, nor would it help the preferred stockholder.

Mr. Cohn mentioned tax-free bonds. I believe when you have a viable industry, you should subsidize it. If you do, then you ought to do it for all industry because all industry is having trouble raising capital today.

Class A and B common stock messed up the capital structure. There are other ways to do it. You might give a tax-free dividend on dividend reinvestment. I would not object to that. But I would like to see it for all industry because, as I have said, all industry is having trouble raising capital today.

We have bank loans to the utility industry. I do not see light at the end of the tunnel. I see sparks of hope and maybe the situation will improve. One of the greatest things that could happen is the reduction in interest rates, and the economists are forecasting lowering interest rates by this fall.

Thank you.

Senator BENTSEN. They were forecasting those in January, too, for this summer.

Mr. CHILDS. Yes, sir, they were forecasting this all along.

Senator BENTSEN. Senator Hansen?

Senator HANSEN. Thank you very much, Mr. Chairman.

Mr. Childs, you have spoken of regulatory lag, the delay involved in getting approval of new electricity rates.

What program would you suggest to solve this problem of lag?

Mr. CHILDS. Immediate interim rate case. Mr. Cohn went over them I think in great detail. Interim rate cases with no delay whatsoever, and an increase up to the rate of return that the Commission allowed in the last rate case immediately, subject to an accounting review. In other words, give it to them, and then if they fudge somewhere in their expenses, do that. Use a future-looking year. In other words, it does not make any sense to use a past year. You have got to use a forward year, a forward rate base. This can be done. The problem is, the pressure from the local politicians and from the newspapers making the consumers think that the utilities are bleeding the poor consumer, and this is not the case.

If you take and compare electric rates, even with all of the increases that are being requested, the electric utility industry—and I am sure it is true of the gas industry and the telephone industry, even after all of these increases, if you go back from the war to now, the fact that the utility industry had no increases all during that period—this is the cheapest service that the consumer is getting. It is a viable, strong industry and it ought to be done this way and not through tax gimmicks.

Senator HANSEN. Thank you, Mr. Chairman. I have no further questions.

Senator BENTSEN. Thank you very much, Mr. Childs.

[The prepared statement of Mr. Childs follows:]

PREPARED STATEMENT OF JOHN F. CHILDS, SENIOR VICE PRESIDENT, IRVING TRUST CO.

THE FINANCIAL POSITION OF THE ELECTRIC UTILITY INDUSTRY

*My background*

My principal job is advisor to all types of companies on corporate finance. For many years I have worked closely with utility companies. I have run seminars on corporate finance that have been attended by most of the top utility executives and State utility regulatory commissioners. I am currently working with electric utility companies and commissioners and I am thus able to observe the problems the industry faces.

*The electric utility financial picture*

In the 1920's the electric utility holding companies got in a bad financial mess. As a result the Public Utility Holding Company Act of 1935 was enacted and the financial abuses were eliminated.

After World War II, the industry started to experience growth and as a consequence there developed a large demand for capital. At first, it appeared questionable whether the market would be able to supply the equity capital. One of the first common stock issues was an offering by the Southern Company. That issue was successful and from then on there was an increasing interest in electric utilities by investors, and the industry was able to finance their capital requirements readily.

The industry raised $28 billion in the period 1960–1969 with relative ease. Investors were looking at electric utility stocks as growth stocks and common stocks were selling at low yields, good price—earning ratios, and at good premiums over book value.

However, starting in the 1970's electric utility stocks began to deteriorate and a final climax occurred with the announcement of April 23, 1974 of the elimination of the common dividend by Consolidated Edison. Electric utility stocks were already at poor levels at that time but they then sank even further.

The serious deterioration of the financial position of electric utility companies occurred very fast and unexpectedly. It has been a major shock to Wall Street and investors, both individuals and institutions.

Fortunately, as I have stated, the industry started out in a strong financial position, with reasonable debt levels and bonds well rated at either AAA, AA or A. If it had not started out in a strong position many companies would be on their backs today. The reasons for the present situation are many:

1. The high cost of borrowed money.
2. The increase in cost of oil due to the Arab embargo.
3. Inflation of all other operating costs.
4. Increase in construction costs.
5. Operating problems with atomic plants.
6. The need for pollution control investments which produce no revenues.
7. Conservation of electricity on the part of consumers which slowed revenues' growth.
8. Inability to get prompt and adequate rate relief.

Today, the financial picture is serious, and in fact very serious.

Most company stocks are selling below book value—many as low as 50% of book value. They are selling at low price-earnings ratios around 7 times, and yields are very high, ranging from 8% to 18%. The principal thing attracting investors today is the yield, because earnings do not offer much prospects of growth.

Since dividend yield is so important, the cut of the common dividend by Consolidated Edison raised questions in investors minds as to whether other companies might follow.

By no means are all companies in the same position; some are far worse off than others. Utility analysts grade electric utility company stocks as to their outlook. Unfortunately, there are certain companies which are being put in a category close to the dire situation of Consolidated Edison.

The problem of raising capital has been highlighted by:

One company being unable to sell a 12% preferred stock. Some common offerings having to be reduced or postponed. Coverages of interest charges falling so low that some companies can't sell bonds because of indenture restrictions.

Bond ratings deteriorating at a rapid pace; some companies now being BBB and even BB.

The institutional investor has practically given up buying utility common stocks because of concern for the industry. It is the little investor who is now supplying the common equity money. It is grossly unfair to ask the small investors to put his vital savings into utility commons unless his investment has hopes of surviving.

The electric utility industry has been the bright spot in inflation since World War II. There were practically no increase in rates until recently and in fact some companies reduced rates; utility bills increased primarily due to greater use of electricity. From 1945 to 1973 the consumer price index increased 147%. Even with the rate increases which electric utilities are now requesting, electric service is economically underpriced. If the companies were not hindered from raising rates by regulatory lag, the companies could be made sufficiently profitable so that they would be able to raise the necessary capital.

The electric utility industry is a highly capital intensive business. It requires about four times as much capital per dollar of sales as an industrial company. Its internal generation of cash is small. Therefore, the electric utility industry requires tremendous financing in order to provide the customers with service.

Our entire economic fabric is dependent on the electric utility industry. Our economy can't function without electric power, and a large portion of the savings of our nation are invested in utility securities. The long run interest of all types of consumers—industrial, commercial, and domestic—is to have power. It is inevitable, if the companies are unable to raise capital that power will not be available to meet their needs.

Because each consumer is a voter, there is an opportunity for local politicians to arouse consumers unfairly. This adds to the problem of getting adequate rate

relief. It should be in the best interest of our country to have the consumers understand that rate increases are necessary in order that the power will be available.

The regulatory authorities are in a difficult position because of the pressure they receive from consumer groups. Unfortunately, because of the problem of regulatory lag, the returns which utilities are earning are not even equal the rates that regulation has said they should earn.

The solution is not easy but it is obvious. What is necessary is to give faith to investors that common stock dividends will be maintained and increased, and this can only be done by prompt and adequate rate increases.

With regard to new enrichment plants, it is realized that the electric utility industry may have to bear some of the burden in one way or another. However, because of their current financial difficulties, some companies are having to consider cutting back on their capital requirements. Therefore, at present, the added burden of directly financing the enrichment plants would be more than they could handle.

Of course, if the industry were able to get back on its feet with adequate earnings the picture would be more hopeful.

Senator BENTSEN. Mr. Thornton, would you proceed with your testimony, please?

Mr. Thornton is vice president and treasurer of Consolidated Edison Co. of New York.

## STATEMENT OF JOHN V. THORNTON, VICE PRESIDENT AND TREASURER, CONSOLIDATED EDISON CO. OF NEW YORK

Mr. THORNTON. Consolidated Edison provides electricity to New York City and Westchester County. We have become kind of exhibit A in the past few months since in April of this year we omitted our common stock dividend for the first time in 89 years; and in order to relieve the cash shortage which we had, we made arrangements for selling two of our new plants, our plants under construction, to a State agency, the New York State Power Authority, and that process of sale is now going along.

There has been some modest improvement in our overall outlook which enabled us to resume payment of a common dividend, a reduced common dividend for the third quarter, but, though our immediate crisis has moderated, we are by no means out of the woods. We are not at present able to sell new stock or new bonds, and we are financing our construction program through short-term bank loans, and it is quite apparent that we cannot indefinitely finance in that way.

So it is particularly essential from our point of view that investor confidence be restored, not only in the industry generally, but in our company in particular.

And I endorse certainly the suggestions which have been made by some of the preceding speakers, that the only fundamental way in which investor confidence is going to be restored is for the State regulatory agencies to grant realistic rate levels which will enable the companies, including our company, to earn substantially higher returns in order to attract capital.

If we do not get adequate rates, we simply are going to be unable to obtain financing through the conventional channels. We, like the other companies that were mentioned, have cut back our construction program already. That is in addition to the fact that we are transferring several of our plants to the Power Authority, and these cuts pose a threat to reliable service in future years, and if we can-

not raise money externally we are going to have no alternative but to make further construction cuts, and these further cuts are certainly going to be felt in drastically reduced, endangered service in the years to come.

In fact, as we look at the situation in our service territory, at least, we do not think consumers are going to stand for reduced service, and we believe that unless the private utilities are going to be able to finance, that inevitably the State or the city or the Federal Government or some combination of the three is going to have to come in to meet these needs.

Now, what are the things that can be done? Several of them have been mentioned already, and I will just refer to them very briefly and perhaps give some of our outlook on them.

First of all, on environmental considerations, unlike many companies, we are required to burn essentially imported oil, so-called 0.3 percent very low sulfur oil, enormously high cost oil. In fact, our fuel bill is much higher than that of most other utilities: nearly 40 cents out of every dollar we collect goes for fuel. In fact, if you add together fuel and our local, State, and city taxes, about two-thirds of every revenue dollar goes out just for fuel and local-State taxes.

If we were permitted to burn, say, 1-percent sulfur oil instead of 0.3 percent, we could save our consumers many millions. We would not make anything on it. The savings would go directly to the consumers through the fuel adjustment clause, but we could save our consumers millions of dollars and thereby relieve some of the pressure on us which comes about as we have to seek additional rate increases.

In the case of water pollution, mention was made before of cost-benefit ratios. Well, we have not seen much consideration of cost-benefit ratios, at least in these preliminary regulations which have been issued by the Federal EPA. We have estimated that the regulations would require us to spend in the next 5 years $1½ billion; that is, additional money on top of our existing construction program to do, among other things, protect fish in the East River and the Arthur Kill; and assuming that such protection of fish in industrial rivers is a laudable objective, we raise the question whether it is a matter of such primary social urgency at this time when it is already difficult enough to raise money to keep the lights on in New York, not to mention financing the subways in New York and constructing the desperately needed housing in New York.

Senator BENTSEN. Is that thermal pollution principally?

Mr. THORNTON. Thermal pollution would be the main consideration, yes. It would be largely the cost of erecting these enormous cooling towers along the East River and some of the other local streams.

I have mentioned in my prepared remarks certain tax possibilities which have been alluded to already, and I will not cover them again. Actually, most of the tax breaks would not help us because we are in a nontaxed position, but nevertheless, we do endorse them as being sound on principle. We think that Congress has got to begin to think perhaps about more direct assistance to utilities in procuring the capital they need. And unlike Mr. Childs, who believes this proposal is not worthy of serious consideration, we think that the proposal for Federal guarantees of utility debt securities is worth consideration.

That is a proposal that has been made by a number of people, including particularly Commissioner Rosenberg of the Michigan Public Service Commission, and this guarantee would be financed by a small surcharge paid by the issuing utility, and should be self-financing.

Now, we would not be proposing such a thing in normal times, but as I think Mr. Cohn said, these are drastic times, and we think a Federal guarantee is something that has got to be looked at.

After all, we do have the FDIC in the case of people who make deposits, lend money to savings banks. We do have the FHA. We have the VA-guaranteed mortgage. Indeed, we have had a recent issue of Israel bonds guaranteed by the U.S. Government. So that we think it would not be so terribly extraordinary to guarantee utility loans, and we think that would go a long way toward restoring investor confidence.

The savings from such a guarantee for the consumer are subject to considerable dispute among our economists. Chairman Rosenberg has made a rough estimate that if the $80 billion—and that is the low figure that Mr. Corey mentioned before—if the $80 billion required by the utility industry in the next 5 years were financed under his proposal, he estimates there would be a saving over the life of the bonds of some $63 billion. Now, that figure has been discounted by others. We do not think the saving is so important as the factor of making it possible for the indebtedness to be floated, and absent some such measure, it may not be possible for the indebtedness to be floated in the amount needed at least.

We also think that Congress ought to direct further attention to the possibility of increasing the availability of tax-exempt industrial development bond financing. That is available under present law for pollution control facilities. It is also available for facilities used for the "local furnishing" of electricity, gas or water.

We have a specific proposal that affects our company, probably only our company, in the entire country, with respect to the definition of "local furnishing" of electricity, gas or water.

Local furnishing has been interpreted under the Treasury Department regulations as being limited to one city, one county, or at most two contiguous counties, and simply as a historical anachronism, we have a situation in New York City where New York City, the one city, is technically five counties. The counties have very little to do in the way of governmental function, but there are five counties. Therefore, when you add New York City and Westchester County together you have six counties, and we are technically out from under this regulation, and the impact of that is considerable in connection with this sale that I mentioned of two of our plants to the State power authority. It means that the State power authority cannot finance the plants through industrial development bonds but will have to use straight Government bonds, and that means that there will be less flexibility in arranging the power contracts. It will mean, apparently, that the benefit of this low-cost power authority power will go largely to governmental consumers whereas we think it would be more equitable if the benefits, the lion's share of the benefits, were flowed through to all consumers, including governmental consumers and other consumers.

A leading economist has recently warned that the wolf is really at the door for the electric utility industry. Certainly he is not only at our door, but he is inside the house, and none of the remedial measures that I have mentioned or the other speakers have mentioned are going to be a substitute for higher rate levels. It is clear, I think, and I think everybody who has looked at this problem objectively agrees, that higher rate levels are essential, but if some of these other measures were introduced as well, it would help to keep these higher rate levels as low as reasonably possible.

I have a prepared statement which I would like to have incorporated in the record.

Senator BENTSEN. That will be included in the record.

Senator Hansen?

Senator HANSEN. Thank you very much, Mr. Chairman.

Mr. Thornton, if I understood you correctly, Con-Ed has sold two of its plants to the State authority.

Is that essentially what you said?

Mr. THORNTON. The sale has not actually been consummated. It is a complex transaction. We are in the process of arranging for the sale of two plants, yes, sir.

Senator HANSEN. This was done simply because of your inability to raise a sufficient amount of money to go ahead with them and to have the necessary working capital that your operation requires?

Mr. THORNTON. That is correct, sir. We did not desire to do it. It was forced on us, at least we thought the economic necessities of the case forced us to do it, yes, sir.

Senator HANSEN. If you had your druthers, would you prefer that the authorities, who are vested with rate changing on rate-raising authority, permit your rates to go up. Would this be the first and the best solution you think could be given to this problem? Or do you still feel—I do not mean to put words in your mouth—that these other devices, such as the Government guaranteeing your bonds and so forth, be part of it, too, if I understood you correctly?

Mr. THORNTON. Well, I think in theory I would say, Senator, that we would opt, we would opt for higher rate levels. There is no question in economic theory that higher rate levels would draw the capital to our industry. I guess what concerns us, however, is whether the realities of regulation are going to permit adequately high rate levels, particularly in areas such as our own where rates are already very high—our electric rates are among the highest in most categories anywhere in the Nation, with good reason for it, but obviously that leads to an increase—understandably—in consumer resistance. So I would say yes, that we believe that higher rates are the answer, provided the regulatory authorities will move not too little and too late as they have in the past instances in many cases.

Senator HANSEN. I have just come, Mr. Chairman, from sitting in on a hearing upstairs before the Interior Committee, which is being addressed by I think Mr. Rosenberg. He was there, and I heard some of the other witnesses testify.

Let me ask you. I gather that there is, at least among some people, a belief that Americans may be profligate in their use of electricity in the normal marketplace concept of that problem. It is argued that if rates go up it will tend to discourage excessive use and might reduce peak loads, and thereby reduce somewhat, at least, the requirement

that Con-Ed and others are now faced with in trying to supply a generating capacity to take care of peak loads.

Would it be your feeling that there would be this cause and effect relationship if rates were to go up and people had to pay the extra rate? Would they not be inclined to consume less electricity?

Mr. THORNTON. Yes. I believe so. There is considerable debate, as Mr. Cohn mentioned, about the elasticity of demand in these institutions. We believe, in New York City where rates, as I say, are quite high, that we are already noticing an impact through these higher rates on demand, that people are being more careful and less profligate so that we think that this is a rather unique situation in that we think that the economic needs for higher rates, and the environmental considerations for cleaner air, cleaner water, and conservation of natural resources coalesce.

Senator HANSEN. Mr. Chairman, I might just make one final observation. I appreciate the chance to comment. I think everyone in the country is at heart an environmentalist. A few years ago it was a common situation to hear speakers damning industry, damning business, and saying that all we had to do to clean up the environment was to pass some tough laws to make industry shape up. The company you represent, or the industry, rather, of which you are a part, oftentimes has been pointed out as one of the prime offenders of clean air and clean water. It has been my feeling that in the ultimate, the person who flips the light switch on is going to have to pay for all of the pollution controlling devices that we install which are admittedly very expensive whether it is in factories or powerplants or wherever.

I subscribe to the feeling realistically that the public is entitled to have whatever degree of a pollution-free environment it wants, but it ought not to be under any illusions as to who is going to pay the bill.

Do you share that view?

Mr. THORNTON. I think there is no question about it, Senator. There just is nobody else to pay. The utilities are really simply a pass-through operation in that sense, yes.

Senator HANSEN. Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Senator Hansen.

Thank you, Mr. Thornton.

[The prepared statement of Mr. Thornton follows:]

PREPARED STATEMENT OF JOHN V. THORNTON, VICE PRESIDENT AND TREASURER, CONSOLIDATED EDISON CO., OF NEW YORK, INC.

Consolidated Edison Company is one of the largest, and, by some standards, the largest investor-owned electric utility in the country. Its assets exceed $5 billion and its annual revenue exceeds $2 billion. It is the exclusive supplier of electricity in substantially all of New York City and in parts of Westchester County and it also supplies gas and steam in various parts of its service territory.

It came as a great shock to many, therefore, when in April of this year this giant company omitted its common dividend for the first time in 89 years. This action, as you know, sent shock waves throughout a utility industry that was already having great difficulty in financing its huge capital needs.

The results of our operations for the three months since we omitted the dividend have been encouraging although by no means spectacular. To relieve our cash shortage we are in the process of arranging sales of two plants—Astoria No. 6 and Indian Point No. 3—to a public agency, the New York State Power Authority, pursuant to an enabling act passed by the State Legislature. Although the sales have not been consummated, progress is being made in the various complex steps involved.

The modest improvement in our overall outlook enabled us to resume payment of the common dividend for the third quarter although at a reduced level. On July 23rd we declared a quarterly dividend of 20¢ a share compared to 45¢ a share which we had been paying since 1965.

While Con Edison's immediate crisis has considerably moderated, we are by no means out of the woods. We are not at present able to sell new stock or bonds in the public markets, and, with those markets in disarray, particularly so far as utility securities are concerned, it is questionable whether we shall be able to carry out our original plan to have a public bond issue this fall. At present we have to finance our construction program through short-term bank loans and we expect to continue to do so until such time as funds become available from the sale of Astoria No. 6 and Indian Point No. 3 to the State Power Authority.

It is apparent, however, that we cannot continue indefinitely to finance our construction program through short term bank loans or the sale of assets. It is vitally necessary that investors confidence in the electric utility industry in general and in our Company in particular be restored so that we can once again have recourse to the stock and bond markets to raise new capital.

The best way for investor confidence in the electric utility industry to be restored is for the state regulatory agencies to grant realistic rate levels which will enable the companies to earn substantially higher returns than most of them have been earning. Rate increases are without question required to encourage investors to put the additional funds into our Company necessary to assure continuing adequate service to our customers. For many years, for reasons beyond our control, the return we have been earning has been the lowest of any major electric utility company in the country, and our chronic inability to earn a fair return must be corrected.

I don't pretend that it will be easy for the state regulatory agencies such as the New York Public Service Commission to grant the rate increases which are so urgently needed if the investor-owned industry is to survive. In our own case obtaining adequate rate increases is likely to be particularly hard. Our electric rates are already very high, the highest in the country in most categories. There are very good reasons why our rates are so high, including the enormously increased cost of fuel oil and the crushing burden of state and local taxes which is imposed upon us, but I will not go into that question here. My point is simply that our already high rates inevitably, and understandably, lead to determined resistance by organized consumer groups against further rate increases. This resistance is often encouraged, I might add, by well-meaning but misguided public officials who oppose rate increases without regard to the merits of our applications and at the same time demand improved electric service.

If we get adequate rates from the Public Service Commission, we are hopeful that we shall be able to get back into the normal financing markets in the not too distant future.

The big question, however, is whether we shall get adequate rates.

If we do not get adequate rates, and thus are unable to obtain financing through the normal markets, we shall have to cut back our construction program even more drastically than we have. We do not generate enough funds through depreciation and other internal sources to keep our system whole let alone provide the growth necessary to take care of the increasing demands of our customers. Our construction program for 1974 has already been cut by about $40 million and our program for 1975 by even more than that.[1] This is in addition to the contemplated transfer to the State Power Authority of the cost related to our remaining construction obligations on Astoria No. 6 and Indian Point No. 3. These cuts pose a serious threat to reliable service in future years. Further substantial cuts would invite the danger of widespread blackouts within this decade.

Nonetheless, we cannot spend money we do not have. If we cannot raise the necessary money, we will have no alternative but to make even more drastic construction cuts in 1976 and subsequent years, however serious the threats to reliable service may be. Like any individual, we have to live within our available resources.

If we are unable to raise the money for the construction that is necessary to maintain reliable electric service in New York City, we believe it will inevitably

---

[1] Cuts in construction programs are becoming more and more widespread. The N.Y. Times of July 29, 1974 reports major cuts or deferrals of construction by Consumers Power Company of Michigan, Arizona Public Service, Boston Edison, General Public Utilities, Virginia Electric and Power, Public Service of Colorado, Carolina Power & Light, Detroit Edison, Duke Power, Potomac Electric, Baltimore Gas and Electric, New England Power, and Niagara Mohawk.

follow that the State of New York, New York City or the federal government or some combination of the three will have to perform the necessary construction or at least help to finance it. However unwilling consumers may be to pay rates high enough to finance utility plant construction, we doubt that they are prepared to accept the blackouts and other problems which a failure to perform the construction will inevitably bring.

What can you gentlemen in Congress do to ameliorate the difficult situation facing Con Edison and, to a greater or lesser extent, many other electric utilities in the nation?

There are a number of things Congress can do. One is to take a realistic look at the ever-present problem of accommodating environmental needs and cost considerations. No one disputes the general proposition that better air and water quality is a desirable goal. But when consumers are already being squeezed by an implacable inflation, we think Congress should think long and hard before allowing heavier and heavier cost burdens to be placed on consumers for environmental improvements. For example, our customers, along with many other electric customers in the coastal cities, already pay an enormous premium for the imported .3% low sulfur oil which many electric utilities are required by law to burn. The air these customers breathe is perhaps "cleaner", in some degree at least, but one may legitimately inquire whether they are getting their money's worth. We believe that a change in the environmental regulations to permit the burning of 1% sulfur oil and coal at certain of our stations should be given very serious consideration. It could save our customers many millions of dollars every year.

Water pollution legislation is another example. Our engineers have estimated that preliminary regulations issued by the Federal Environmental Protection Administration would, if enacted, require us—just one Company—to expend some $1.5 billion in the next five years to, among other things, protect fish in the East River and the Arthur Kill. $1.5 billion is equal to a major part of our entire construction program for the next five years—that program we are having such difficulty in financing. Assuming that protecting fish in industrial waterways like the East River and the Arthur Kill may be a laudable objective, is it really a matter of primary social priority when it is already terribly difficult to raise enough money to keep the lights on in New York, to finance new subway lines, and to construct desperately needed new housing?

More realistic pollution legislation can ease the financial plight of utilities by reducing the costs which they bear in the first instance and ultimately pass on to their customers. Congress can also, by various tax law changes, reduce the tax burden on utilities and their customers and make utility securities more attractive to investors.

We support the suggestions which have been advanced by various segments of the electric utility industry and others to increase the investment credit allowable on new public utility construction from its present 4% to 7%—7% being the standard for industrial property generally—and to eliminate or modify the existing limitation which permits the investment credit to be taken only up to an amount equal to 50% of the tax otherwise payable. We think these are sound proposals even though they would be of no present benefit to our Company since our earnings are at such inadequate levels we do not have the opportunity to use the investment credit.

We also support industry suggestions to modify the tax law changes adopted in 1969 which reduced the tax shelter applicable to the dividends of certain capital-intensive industries, particularly the electric utility industry. The 1969 amendment required that the acceleration factor used in computing depreciation for purposes of taxable income be eliminated in arriving at "earnings and profits" upon which the taxability of dividends paid to a company's stockholders depends. The effect of this amendment was to increase the "earnings and profits" available to cover the dividends declared in a particular year, thereby causing less of these dividends to be nontaxable "returns of capital" to the stockholder. As a result of this amendment what would have been, under the old law, a net operating loss for Con Edison for tax purposes in 1973 was converted into a profit, causing part of our preferred dividend for 1973 to become taxable. Restoration of the situation as it existed prior to 1969 would tend to make utility stocks more attractive to investors. In an era when utilities are finding it increasingly difficult to float equity issues it seems a very logical direction for legislation to take.

We also support the suggestion that the three year net operating loss carryback and the five year carryforward provisions be extended in the case of utility companies. This has already been done for certain transportation and financial

companies. Because of our depressed earnings, we have substantial tax carryforwards which we have not been able to use and will not be able to use unless and until our earnings substantially improve. A number of other utilities are in the same position. Because of the five year limitations we are soon going to start losing some of these unused carryforwards which seems most inequitable.

Another thing Congress should do—and in urging this I am aware that others in the electric utility industry may disagree—is to begin to think about more direct assistance to utilities in procuring the capital they need.

One proposed method of federal assistance, which our Company believes very promising, is that suggested by Commissioner William Rosenberg, Chairman of the Michigan Public Service Commission. Commissioner Rosenberg has proposed a federal guarantee of new debt securities issued by electric utilities. The guarantee would be financed by a small surcharge paid by the issuing utility and therefore should be self-financing.

While one may quarrel with the details of Commissioner Rosenberg's plan, we think the general concept is an idea whose time has come. Nor is it such a radical idea. The depositor who lends his money to a savings bank has his loan insured through the Federal Deposit Insurance Corporation. The bank which lends money to a customer to buy a home often has its loan insured through the Federal Housing Administration or the Veterans Administration. The purchaser of a recent issue of Israel bonds has the assurance of a United States government guarantee of both principal and interest.

If similar protection could be afforded to the investor who lends his money to a utility company, there would presumably be a substantial added incentive for him to do so. Today's investor is concerned about the prospects of the utility industry. He knows its fate is tied to the actions of state regulatory agencies and his confidence in the commitment of those regulators to protect his investment from erosion has been shaken. A federal guarantee could go far towards restoring his confidence and the cost of such a guarantee should not be burdensome to either the Government or the companies.

The extent of savings to the consumer by such a guaranty system is a subject of considerable debate. Chairman Rosenberg has estimated that a differential of 1½% could exist between interest rates on federally guaranteed utility bonds and conventional A-rated utility bonds and that incremental financing could be done on a guaranteed basis with 80% debt and 20% equity instead of the conventional basis of about two-thirds debt and preferred stock and one third common equity. He believes this would avoid the need for utilities issuing very much new common stock because retained earnings would provide the bulk of the 20% equity. Based on 1972 conditions he has calculated that, if the $80 billion principal amount of new construction and refinancing required in the next five years were financed under his proposal, the savings in capital cost—and hence to the consumer in rates—would be approximately $2.1 billion per year after 1977 and $63 billion over the 30-year life of the bonds.[2]

As I say, the magnitude of the savings to consumers by a federal guarantee is a matter as to which experts differ.[3] In our view, however, even if the savings are much less than Chairman Rosenberg estimates, this is not as important as the added investor confidence which the federal guarantee would provide. The real question is whether the facilities required for adequate electric service can be built at all—at least in certain parts of the country—in the absence of a federal guarantee.

Another area to which we think Congress should direct its attention is the possibility of increasing the availability of tax-exempt industrial development bonds for utility financing. At present such tax-exempt financing, which, of course, is cheaper than conventional utility financing, is available for the financing of pollution control facilities and for facilities which are for the "local furnishing" of electricity, gas or water.

So far as pollution control facilities are concerned, we urge that, either through Internal Revenue Service action or legislation, the concept of pollution control be liberally interpreted in the case of nuclear plant facilities. The Internal Revenue Service has been looking into this matter for several months now and a resolution is sorely needed. Here again our Company's personal interest is not extensive since we are not heavily involved in nuclear plants but the industry as a whole would, we believe, be benefitted by a liberal interpretation.

---

[2] Rosenberg, Federal Financing of Electric Utilities in the Wake of Con Ed, mimeo, May 24, 1974.

[3] See Stelzer, Electric Utilities' Capital Supply the Regulator's Challenge, Edison Elec. Inst. Bull, p. 98 (May/June 1974).

We would also hope that Congress would authorize an extension of the deadline for installing new pollution control facilities on old plants in order to qualify for a five year amortization for federal tax purposes. The present deadline is January 1, 1975 and, in our view, should be extended to, say, January 1, 1980. Such an extension would continue the practice of allowing pollution control facilities required to be added to old plants by new anti-pollution requirements to benefit by the fast tax write-off. While this too would be of little direct benefit to us because at present we cannot use further tax deductions, there are other companies it would help.

Of immediate and special concern to us—and probably uniquely to us—is the enactment of federal legislation or at least an amendment to the regulations of the Treasury making a relatively minor change in the definition of the local furnishing of electric service for purposes of tax-exempt industrial development financing.

Under existing Treasury Department regulations tax-exempt industrial development bonds cannot be issued by the New York State Power Authority to pay for its acquisition of Astoria No. 6 and Indian Point No. 3 from Con Edison. Although such bonds can be issued to finance facilities used "for the local furnishing of electric energy", "local" is defined by the regulations as being limited to a "city", a "county" or at most "two-contiguous counties". Con Edison's service area consists of New York City and one contiguous county but technically New York City consists of five counties. We do not, therefore, fit the literal reading of the regulation though we do, we believe, come within its spirit. We are attempting to get the regulations amended so as to include our service territory of New York City and Westchester within the definition of "local".

Unless this change is made, the Power Authority will not be able to finance the acquisition of our plants through tax-exempt industrial development bonds and it will instead have to finance through straight government bonds. If the Authority is given the flexibility of financing through industrial development bonds, it will make it easier to structure the contracts for the use of the power from the plants to insure that the benefits from the lower cost power are flowed through equitably to all the electric customers, tax-exempt and tax-paying, in our service territory.

CONCLUSION

A leading economist recently warned a conference of public utility commissioners that "The wolf is *really* at the door" for the electric utility industry, that "Most of the companies in the electric utility industry are facing a severe financial crisis", and that "there are sound reasons for believing that without regulatory relief many, many companies will soon not be able to sell common stock—i.e., they won't be able to raise the capital they need." [4]

None of the remedial measures I have discussed today, including a federal guarantee of utility indebtedness, will be a substitute for higher rate levels. Without rate relief, all the other remedies taken together will not be sufficient. Electric energy is no longer a cheap commodity. If this country is to have an adequate supply of electricity in future years, further price increases are essential and inevitable.

Senator BENTSEN. In the interests of time, we will move on. We have Mr. John P. Cornell here, who is the senior vice president and chief financial officer of Columbia Gas System.

## STATEMENT OF JOHN P. CORNELL, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, THE COLUMBIA GAS SYSTEM, INC.

Mr. CORNELL. Thank you, Mr. Chairman. My prepared statement has already been submitted for the record. I would like to summarize it, though.

Special circumstances confronting gas utilities are worthy of comment because they point clearly to actions which must be taken if the gas industry is to fulfill its role of supplying our Nation with an adequate supply of energy.

[4] Stelzer, Electric Utilities' Capital Supply: the Regulator's Challenge, Edison Elec. Inst. Bull. (May/June 1974).

The Columbia Gas System has had for several years restrictions on gas sales. The system's gas supplies, in historic sources in the year ending October 1975, are estimated to be 11 percent less than in 1973.

This shortfall of historic gas supply is fairly representative of the whole natural gas industry.

If present sources of supply are not substantially augmented, there will be increasing curtailments to our industrial customers. Columbia has for the last several years embarked on a natural gas supply program. The program cannot continue unless large amounts of new capital are available. The system's overall financial requirements for the next 10 years are estimated to be $5.3 billion. A significant portion of these dollars, 30 percent to 40 percent, will have to come from external financing. Historic sources of gas no longer will provide the Nation with the gas supply that it needs. The costly and risky exploration and development of offshore gas reserves, the extension of the reach for gas to Alaska and northern Canada, the importation of LNG from other parts of the world, and the eventual introduction of synthetic gas through the construction of large coal gasification plants are introducing more risks into our business and are rapidly increasing our costs.

These factors are having adverse effects upon the gas industry's ability to raise the needed capital. Because of inflation, holders of capital are unwilling to lend except at rates of interest that will return something over and above the depreciation on the value of their capital by reason of inflation.

The market for issues of new capital has become so chaotic as to border on panic.

As explained in appendix III of the material that I had already submitted, many bond offers of sound gas and electric utilities could not be sold unless the terms of the issues were significantly changed from historic patterns. The issuance of common stock below book value by a regulated company makes it increasingly difficult to maintain, much less increase, the level of per-share earnings.

The current market value of utility stocks reflects a loss of investor confidence. There are numerous reasons for this.

One, regulatory commissions' responses to requests for rate increases have been slow and generally inadequate. Two, in most cases, regulatory commissions allow a return on original cost which fails to recognize inflation in any manner. Three, the financial community generally feels that even those commissions that recognize the financial plight of utilities are unwilling to approve an adequate level of rates because of consumer resistance. Four, because of inflation, utility costs will continue to increase and there is severe concern that rate relief cannot keep current.

There are some urgently needed actions that should be taken. First, dealing with inflation, Congress must recognize that inflation is the fundamental problem. Until inflation is brought under control and the investing public sees some economic stabiltiy, we can expect that new capital will be difficult to obtain and its cost will remain high.

The second item that should be done, a 20-percent investment tax credit for utilities during this emergency. The most immediate need for all utilities is to improve earnings and cash flow. One way that this could be done properly would be to increase the investment tax

credit for regulated gas and electric utilities to 20 percent for a 5-year emergency period.

Attached to my prepared statement as appendix V is an outline of this emergency tax relief.

Three, exempting new gas from the jurisdiction of the Federal Power Commission. It is impossible to continue exploration and development of new gas reserves without relief in producer prices. The FPC has recently announced a nationwide rate for new gas which is effectively 43 cents per MCF in 1974. Columbia cannot continue to raise and invest capital on the basis of these prices. We find ourselves in a situation where we need additional gas supplies in order not only to meet our service obligations to the public but in order to attract investor confidence in gas securities.

Senator BENTSEN. Are you saying that you would stop the exploration for oil and gas unless new gas is deregulated?

Mr. CORNELL. Columbia cannot continue that effort at those prices.

Senator BENTSEN. At 43 cents?

Mr. CORNELL. At 43 cents.

Senator BENTSEN. You cannot make a profit on exploration?

Mr. CORNELL. That is right.

Senator BENTSEN. And you have a history of drilling to prove that? You have got numbers to back that up?

Mr. CORNELL. Our cost on new gas is running considerably above that level.

Senator BENTSEN. Most of your drilling has been out in the Gulf of Mexico?

Mr. CORNELL. We have drilling——

Senator BENTSEN. And the Appalachian area?

Mr. CORNELL. Yes, in the Appalachian area as well.

Senator BENTSEN. Those are both relatively high cost areas, are they?

Mr. CORNELL. Yes, sir. Yes, sir. And, of course, all of our new gas exploration effort is going into the very deep horizons where it is extremely expensive to drill. The cost is considerably above the 43 cents that the FPC has now come out with.

Senator BENTSEN. Well, the cost of drilling a well in west Texas, a 5,000 foot well in Texas, has gone up about 450 percent.

Mr. CORNELL. Yes, sir.

Senator BENTSEN. And that is part of the problem.

Mr. CORNELL. Yes, sir.

Senator BENTSEN. I noticed that you are talking about favoring a change in the offshore leasing provisions to go to an installment-type payment. I think that would help. I think one of the problems is that offshore leasing is pretty well limited to the very major oil companies. They are about the only ones that can afford to play that game with the big bonus payment on the front end. Installment leases could help moderate that some and let some of the medium-size companies in there and get more competition in it, and I think thereby bring on some of that protection earlier. But I think there is another way to do it and I think that is to accept the same kind of offshore leasing deal that the major companies are giving to 11 foreign countries now and that is to give the Federal Government the larger percentage of the production runs above operating costs and after recovery of drilling

costs for capital investment in the well and all. That would mean that you diminish the front-end payments substantially. Economics would dictate that you get your bonus payment down substantially. And then if you found that you would pay more to the Federal Government to take some of the risk out, it seems that would bring a lot of medium-size companies out in there to be able to compete and participate. I think it would accelerate the exploration and, again, I cite the fact they are doing that for 11 foreign countries now.

When you are talking about drilling on public lands or private property, it seems that our taxpayers ought to have just as good a deal as they give foreign taxpayers.

Mr. CORNELL. Yes, sir.

Senator BENTSEN. Take a look at that one.

Mr. CORNELL. I will. Yes, sir.

As an example as to the amount of money that Columbia had in offshore leasing, just this past year, that is, 1973, Columbia invested something like $55 million in offshore bonuses and, of course, it is going to take——

Senator BENTSEN. For Columbia, that is quite a bit of money, is it not?

Mr. CORNELL. For Columbia, that is quite a bit of money.

Senator BENTSEN. I noticed one of the bids offshore off Florida, $100 million was left on the table, a second bid. I would guess Columbia's chocking point was a little less than $100 million, would it not be?

That is why I say it is limited to the very large companies.

Mr. CORNELL. It is that, yes, sir. And of course we have been entering into these lease bids because of that very thing, with several of the other major companies, in partnership with them, but even so, our total amount is substantial.

Going on to——

Senator BENTSEN. Mr. Cornell, if you would summarize, if you would, please, sir, because of some other commitments.

Mr. CORNELL. Yes, sir.

Financing of a transportation system for the Alaskan gas, and this is one of the major problems facing the gas industry now, the $9 billion plus project with the gas coming out of Alaska and down through Canada.

Apart from the problems of prompt rate relief, it is becoming increasingly evident that inflation requires a new look at regulatory approaches with respect to rate base and depreciation, and it is urgent that the regulatory commissions allow rates based on a current value rate base and for rate and tax purposes, depreciation be allowed on the basis of such current value, and I believe this was touched on just a little while ago.

In conclusion, the foregoing types of actions are very essential for gas utilities. Each of the actions would help improve the earnings and long-term financial posture of the gas utilities. Without this improvement investor confidence will continue to decline and the financial problems will become even more difficult.

Thank you, sir.

Senator BENTSEN. Well, gentlemen, you have made a contribution and we appreciate you sharing your concerns with us in the face of these very difficult problems.

We will look at your tax proposals specifically from this committee's standpoint to see what we should do and if we should do something, and some of the members of this committee are on other committees that would get into some of the other phases of it, and they will be looking at the record. So we appreciate very much your appearing before us.

And for your information, the Vice President is meeting with the President in the Oval Room right now, so you might be here on an historic day.

Thank you. We will recess.

[The prepared statement with appendices of Mr. Cornell follows:]

PREPARED STATEMENT OF JOHN P. CORNELL, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER OF THE COLUMBIA GAS SYSTEM, INC.

We are pleased that this Subcommittee is holding hearings with respect to the financing problems of gas and electric utilities since, in our view, it is vital to the Nation that Congress understand the increasingly critical difficulties confronting regulated utilities with respect to financing essential energy-supplying projects.

The problems of financing essential gas procurement programs are similar to those of the electric utilities which are being presented to the Subcommittee by representatives from the electric utility industry. However, some special circumstances confronting gas utilities are worthy of comment because they point clearly to some essential actions which must be taken if the gas industry is to fulfill its essential and important role of supplying our Nation with an adequate supply of energy.

A BRIEF DESCRIPTION OF THE COLUMBIA GAS SYSTEM

The Columbia Gas System serves natural gas directly or indirectly to over four million customers in the seven states of Ohio, Pennsylvania, Kentucky, Virginia, West Virginia, New York, Maryland and the District of Columbia. It supplies over 95% of the gas used in Maryland and about 85% of the gas used in Virginia and the District of Columbia.

The System is engaged in all phases of the natural gas business, including production, transmission, storage and distribution. In 1973, its sales of gas amounted to 1.350 trillion cubic feet.[1] It is estimated that approximately ten thousand industrial customers depend directly or indirectly upon the System for their gas supply.

THE SYSTEM'S FINANCIAL STRUCTURE

Attached to this statement as Appendix I[2] is a copy of the System's latest Prospectus dated July 23, 1974 relating to the sale of 1 million shares of 11¼% Cumulative Preferred Stock, Series A. Reference is made to page 33 of this Prospectus which sets forth the capitalization of the System which totals, as of March 31, 1974, $2,112,000,000. On page 34 of such Prospectus, a breakdown of such total capitalization as between equity, long-term debentures and subordinated bank loans are set forth. As of July 31, 1974 an additional $40 million of debentures and 1 million shares of $50 par Cumulative Preferred Stock are outstanding adding approximately $90 million to the capitalization shown.

It should be noted in connection with the System's long-term debt that most of the System's outstanding debentures provide for an annual sinking fund commencing after the fifth year which retires 70% of the issue by the time of its maturity in the twenty-fifth year. Thus, the low interest bearing debt issued in the years between 1950–1965 is continually being retired. Referring to the tabulation on Page 34, Series A and B, 3% Debentures are presently outstanding in an aggregate amount of $59,700,000. These debentures were originally issued in 1950 in an aggregate amount of $200,000,000 and have been reduced to the present balance through sinking fund redemption. These debentures mature in 1975 and must be retired in full. In succeeding years, in addition to sinking funds, other debentures will mature and thus Columbia will be faced with a continuous program of replacing low interest debt with high interest debt.

---

[1] In addition about 82 billion cubic feet of gas was used in operations.
[2] The above material was made a part of the official files of the Committee on Finance.

The new debt issued since 1965 has significantly higher interest costs which results in a continuous increase in the embedded cost of the System's total debt. For example, between 1965 and today, the embedded cost of total debt of the System has increased from 4.27% to 7.18%. This increase in interest rates applied to presently outstanding debt adds approximately $36,500,000 of annual interest costs in 1974, or approximately ⅓ of such interest costs.

Because of the earnings coverage requirement contained in the Indentures under which the debt was issued, namely annual earnings before income taxes must be at least 2½ times annual interest costs on debt outstanding and to be issued, before additional debentures can be issued, this higher interest cost makes it increasingly necessary to improve earnings. Unless this occurs, then additional debt cannot be issued.

SYSTEM'S GAS SUPPLY

In the Subcommittee's consideration of the financial problems of the gas industry, it must recognize the worsening natural gas supply shortage. The Subcommittee's attention is directed to page 10 of the attached Prospectus which is a General Statement Concerning Gas Supply.

As set forth on page 9 of the Prospectus, Columbia has had for several years restrictions on gas sales. Because of continuing delays in obtaining new supplies and a decline in the volume of gas available from established sources, Columbia Gas Transmission Corporation (Columbia Transmission), the System's Appalachian transmission company, in February 1972 advised its affiliated and non-affiliated wholesale customers that it would be unable to supply any additional volumes for the 1972–73 contract year above the estimated requirements of the 1971–72 contract year. In compliance with an FPC directive, Columbia Transmission filed a limitation of delivery obligation and curtailment plan. In late 1972, the FPC approved this filing to be in effect through July 1, 1974 and in June 1974, the FPC approved the motion filed by Columbia Transmission to extend the plan through April 30, 1975.

Because of such shortages, utility commissions of the states in which the System sells gas at retail, either directly or through wholesale customers, have issued orders to the System's retail subsidiaries imposing restrictions on new loads. Also, in such states, the System's retail companies have issued tariff revisions which establish annual limitations and curtailment procedures applicable to industrial customers.

The System's current estimate is that for the 12 month period ending October 31, 1975 deliveries to the System by non-affiliated pipeline suppliers will be curtailed, pursuant to curtailment plans approved by the FPC, by about 64 billion cubic feet and deliveries from other historic sources will decline approximately 96 billion cubic feet, for a total of 160 billion cubic feet representing approximately 11.0%, of total gas supply in 1973. These reductions in gas supply may be partially offset by an estimated 50.4 billion cubic feet of synthetic gas to be produced by the System's newly constructed Green Springs reforming plant.

If present sources of supply are not substantially augmented, there will be increasing curtailments of industrial customers.

It should be noted that the System's shortfall of gas supply is fairly typical and representative of the natural gas industry.

Columbia must plan to meet not only existing requirements, but growth in demand as well. To this end, Columbia has, during the past several years, formulated and embarked on a major gas supply procurement program. See pages 12–18 of the attached Prospectus. The program cannot continue unless large amounts of new capital are aavilable. Continuation of the supply procurement program will mean that the System's overall financial requirements for the years 1974 through 1983 will be an estimated $5.8 billion, including $875 million for sinking funds and debt maturities. A significant portion of these dollars—thirty to forty percent—will have to come from external financing. Appendix II, attached hereto, portrays the essentiality of being able to raise this new capital. The inability to continue with its major financing program would drastically affect the economy of the System's service area. Many industries would either reduce operations or close down.

THE FINANCIAL IMPLICATIONS OF GAS SHORTAGES AND GAS PROCUREMENT

The gas supply shortage has curtailed any growth in the System's business. Without growth, the ability to absorb higher costs of all kinds and maintain a

satisfactory level of earnings is not possible without significant rate increases. Investors are increasingly concerned whether such increases will be allowed promptly and will be adequate.

With respect to the System's gas procurement program, with its unusually large capital requirements, it should be noted that significant and major new dimensions have been added to the nature of the System's business. Historical sources of gas no longer will provide the Nation with the gas supply that it needs. Costly and risky exploration and development of offshore gas reserves, the reach for gas to Alaska and northern Canada, the importation of LNG from other parts of the world and the eventual introduction of synthetic gas through the construction of large coal gasification plants and related coal mines, are introducing more risks into our business and rapidly increasing our costs both in terms of capital and operations.

All of this is happening at a time of accelerating inflation.[8]

These factors, namely, a gas supply shortage with increasing curtailments of sales to industry and restrictions on growth, unprecedented capital requirements, and an accelerating inflation, are having adverse effects upon the gas industry's ability to raise the needed capital

The historical "selling points" of utility stocks have been based in large measure upon a predictability of stable earnings with expectation of reasonable growth in earnings and dividends. These elements are no longer assured. Not only does the question of the gas industry's existing gas reserves raise questions in the minds of investors, but double digit inflation results in investors being increasingly concerned about the future and reluctant to commit capital to long-term investments. Moreover, because of inflation, holders of capital are unwilling to lend except at rates of interest that cover not only an earning on such capital but also the depreciation in the value of their capital by reason of inflation.

On June, 1974 Columbia sold $40 Million of 9⅞% Debentures at a cost to the company of 10.024% and priced to the public to yield 9.93%. The underwriters were able to sell only 70% of the issue at the original offering price. The balance had to be sold at a price to yield approximately 10.25%.

Since that time, the market for issues of new capital has become so chaotic as to border on panic. Many bond offers of sound gas and electric utilities could not be sold unless the terms of the issue were significantly changed from historic patterns. For example, to keep its debt-equity ratio in balance, on July 8, 1974 Columbia offered for sale at competitive bidding 1 million shares of $50 par value Cumulative Preferred Stock. No valid bids were received. As a result of this, the S.E.C. granted Columbia an exemption from its competitive bidding rule. On July 22, 1974, the Preferred Stock was sold on a negotiated basis with a dividend rate of 11.25% and a cost to the company of 11.54%. The issue has been successfully sold by the underwriters.

The reason for this was that in the original offering the sinking fund for the Preferred Stock commenced in the sixth year and would have retired all the Preferred Stock 25 years from the date of issuance. On the negotiated basis, the Preferred Stock has an annual sinking fund commencing in the sixth year of 10% of the original issue so that the Preferred Stock will be completely retired at the end of fifteen years and has an average life of about 10.5 years. While the Preferred Stock is considered as "equity", it is obviously limited term capital and financing of this type would not be done except as an emergency measure.

Attached as Appendix III is a tabulation of the recent experience by gas companies in issuing long-term securities. Several companies have postponed sales; others have reduced the term of securities to five to nine years.

Marketing common stock at this time poses even more formidable problems. Appendix IV sets forth a tabulation of the current market value and the book value of the common stocks of a number of gas utility companies. It will be noted that with few exceptions, the common stocks of these companies are selling well below book value. For example, the current market value of Columbia's common stock is about 67% of book value. The sale of common stock under these circumstances is highly undesirable. It merely compounds the financial difficulties of a company since it may very well trigger a "domino" effect that will further erode

[8] The effect of inflation on construction costs is greatly increasing the capital needs of all gas industry companies. Utility construction costs have increased almost twice as much as the Consumer Price Index during the last five years. This has a two-fold effect: it increases the amount of new capital acquired, and as these higher cost facilities become operational it increases the cost of service to the consumer.

the market value of the stock. The issuance of common stock below book value by a regulated company makes it increasingly difficult to maintain, much less increase, the level of per share earnings.

We believe that the market value of utility stocks today below book value reflects a loss of investor confidence. There are numerous reasons for this, some of which are:

(i) Regulatory commissions' responses to request for rate increases have been slow and generally inadequate.

(ii) In most cases, regulatory commissions allow a return to be earned only on original cost which fails to recognize inflation in any manner. Also, depreciation is allowed only on such original cost. Thus, the common stock investor has no protection in terms of earnings and resulting market value against such inflation. During a period of inflation, original cost rate base regulation confiscates the investors' capital.

(iii) The financial community generally feels that even those commissions that recognize the financial plight of utilities are unwilling to approve an adequate level of rates because of consumer resistance.

(iv) Because of inflation, utilities' capital requirements and costs will continue to increase and there is severe concern that rate relief cannot keep current. Thus, instead of maintaining and improving earnings, there is a strong likelihood of erosion of earnings.

In summary, in an inflationary society, historical regulatory approaches have resulted in a loss of investor confidence. If such investor confidence is to be restored, so that utilities will be able to finance essential construction, some drastic things must take place—especially in the natural gas industry.

SOME URGENTLY NEEDED ACTIONS

While many steps can and should be taken, we will only discuss briefly a few of these:

1. *Inflation*. Congress must recognize that inflation is the fundamental problem. This, of course, is affecting all segments of the American society. This is not the forum to present the cures for inflation. It is fair to state, however, that the political leadership of this nation must address itself seriously to this problem in a statesmanlike way. Government spending at all levels can be a most important cause of inflation. Aside from government spending, the high level of taxation and governmental deficits, it is not amiss to point out that many of the actions of government result in increasing constantly the cost of doing business. In the final analysis, these costs must be paid for through price increases.

Until inflation is brought under control and the investing public sees some economic stability, we can expect that new capital will be difficult to obtain and its cost will remain high. This, in turn, will increase the cost of energy to the public. It will continually add to the cost of the large capital projects in which utilities must engage. Thus, the gas industry's financial problems revolve in large part around inflation.

2. *A 20% Investment Tax Credit For Utilities*. If the investors' confidence is to be restored, the most immediate need for all utilities is to improve earnings and cash flow. One important way that this could be done promptly would be to increase the investment tax credit for regulated gas and electric utilities to 20% for a five year *emergency* period. We estimate that this would supply to the gas and electric industry approximately $1 billion annually based on 1978 operations. It would improve earnings and cash flow and thus should play a significant role in solving the immediate difficulties of the utilities.

Attached as Appendix V is an outline of this *emergency* tax relief. Our system, along with other gas companies, is urging the House Ways and Means Committee to adopt this emergency tax relief in connection with the Committee's consideration of the current tax reform legislation. It would be helpful if the Senate Finance Committee indicated to the House Committee support for this type of *emergency* relief.

It is pointed out that this is strictly an *emergency* measure. Columbia does not believe that the long term problem of the utilities should be solved by special tax relief which is not available to all tax payers. However, the importance of financially sound utilities to our society is so great and the problems of the utilities because of regulation are so complex that time does not permit that the problems be solved in conventional manners. Thus, special tax relief must be the alternative.

3. *Exempting New Gas From FPC Jurisdiction.* Because of the delays and uncertainties of regulation, it is impossible to continue exploration for and development of new gas reserves without relief in producer prices. The Columbia Gas System has substantial experience, both in the Appalachian Area (which is acknowledged to be a high cost area) and in the offshore area of the Gulf of Mexico, which is also high cost. As the Subcommittee probably knows, the Federal Power Commission has recently announced a nationwide area rate which is effectively 48 cents per Mcf in 1974.

Based on our experience, Columbia cannot continue to raise and invest capital in gas exploration and development activities on the basis of these prices. Thus, we find ourselves in a situation where we need additional gas supplies in order not only to meet our service obligations to the public, but in order to attract investor confidence in gas securities. For this reason, we have embarked on a major program for expanding domestic gas supply. We have urged and supported a massive domestic exploration program on the Outer Continental Shelf. But, *Columbia states categorically that the System cannot continue this effort because of the delays and uncertainties and inadequacies of producer price regulation by the Federal Power Commission.*

Consequently, while recognizing that this is not in the area of this Subcommittee's responsibility, we state as emphatically as possible that a very significant reason for the financial problems of the gas industry will continue until Congress forthrightly faces up to the question of deregulating the price of new gas under the National Gas Act.

4. *Federal Leasing Policies.* A very significant financial problem which relates both to gas supply and inadequate earnings arises from the present bonus system in awarding leases for exploration and development on Federal lands. In brief, the present procedures require that a company desiring to explore and develop new gas reserves must pay on a competitive basis to the Federal government a significant bonus for the lease. In most cases where a lease is acquired, it takes 4–5 years before that lease will produce any revenues. This means that vast sums of capital must be raised at a significant cost on which the producer will earn no revenues for a number of years.

The magnitude of this problem can be realized from the following facts: The Federal government received $2.251 billion in bonuses in 1972 from sales of tracts in the Outer Continental Shelf, $3.082 billion in 1973 and to date in 1974, $2.093 billion. By and large, these vast capital expenditures by private industry have not to date returned any revenues or earnings to the companies that have made these expenditures.

This drain on the capital of companies such as Columbia Gas System and its adverse effect on our earnings cannot continue. We believe that it is imperative that the Federal government recognize immediately that it must modify these procedures in such a manner as to prevent this drain on available capital of the gas industry. We have proposed a system whereby these bonuses could be paid, in effect, on an installment plan. Attached as Exhibit VI hereto is an outline of such proposal, together with a tabulation illustrating its operation in what we believe is a fairly realistic situation in deep water in the Gulf of Mexico.

5. *Financing A Transportation System For Alaskan Gas.* Some of the greatest potential gas reserves available to the American public are located in Alaska. In Prudhoe Bay there are 26 trillion cubic feet of *proven* reserves. The major problem is how to deliver this gas and the potential gas to be found to the markets in the lower 48 states.

Columbia Gas System has been a participant with a large group of producers and pipelines in helping to develop a pipeline delivery system from Alaska, down through Canada and then by pipelines from the U.S.-Canada border in Alberta to the West Coast and to the East. Applications have been filed from this project. It appears that this project will cost, based upon present estimates, $9 billion. If the project is delayed, we can expect higher costs.

Clearly, in today's financial climate, the raising of $9 billion of new capital will be a most difficult undertaking. We question whether it can be done without both the United States and Canadian governments' assistance of some type. We have no proposal to make at this time but to state to this Subcommittee that the U.S. Congress should concern itself with this project.

6. *Reform of Regulatory Approaches on Rate Base and Depreciation.* Finally, apart from the problem of prompt rate relief to avoid erosion of existing levels of earnings, it is becoming increasingly evident that inflation requires a new look at regulatory approaches with respect to rate base and depreciation.

For a number of years, this nation has not had a stable price economy. Even at annual inflation rates of 3 to 5% there is a significant erosion of the investors' capital over a period of years when rates are based on the use of original cost rate base and depreciation for long lived facilities based on original cost. This erosion has now become exaggerated because of the magnitude of inflation. Investors will not continue to be satisfied if they can only expect a return on and a recovery of their investment in terms of the historical dollar cost.

Consequently, it is urgent that the regulatory agencies—especially the Federal Power Commission as it relates to the natural gas industry—allow rates based on a current value rate base and that both for rate and tax purposes, depreciation be allowed on the basis of such current values.

We should state that over the years natural gas has been grossly under priced. As a premium fuel, it has sold at significantly lower rates than less desirable fuels. To give the investor protection from inflation by the use of a current value rate base of depreciation will not raise the cost of gas significantly and it will still remain a real bargain in the energy field.

The foregoing types of action are essential for gas utilities. Each of the actions will help to improve the earnings and long-term financial posture of gas utilities. Without such improvement, investor confidence will continue to decline and the financing problems will become even more difficult.

COLUMBIA GAS SYSTEM—ESTIMATES AND PROJECTIONS OF GAS PROCUREMENT EFFORTS

The following projections represent current estimates of the gas supply which may be secured under the System's gas procurement programs and plans and of the capital expenditures associated with such programs and plans. The projections are obviously subject to many uncertainties and changes, and merely represent the best present judgments of the Columbia management.

*Case A.*—In accordance with our most recent study, which assumes that it will be possible for Columbia to raise the necessary capital, the outlook through 1983 is detailed below under Case A.

*Case B.*—If Columbia is unable to raise new capital, then it must reduce its capital expenditures to an absolute minimum. This will entail the cancellation of all gas procurement projects beyond those for which we have already made commitments. It will also entail a continued freeze on our market requirements throughout the period.

[Appendix II]

| Year | Requirements (BCF) | | Supply (BCF) | | Deficit (BCF) | | Percent industrial curtailment | | Capital expenditures[1] (thousands) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Case A | Case B[2] | Case A | Case B | Case A | Case B | Case A | Case B | Case A | Case B |
| 1974[3] | [2] 1,487 | 1,487 | 1,446 | 1,446 | (41) | (41) | 7.2 | 7.2 | $373,141 | $306,141 |
| 1975 | [2] 1,487 | 1,487 | 1,417 | 1,416 | (70) | (71) | 12.2 | 12.4 | 400,772 | 165,266 |
| 1976 | [2] 1,485 | 1,485 | 1,415 | 1,376 | (70) | (109) | 12.2 | 19.0 | 510,281 | 173,204 |
| 1977 | [2] 1,484 | 1,484 | 1,491 | 1,348 | 7 | (136) | ........ | 23.7 | 483,375 | 106,819 |
| 1978 | [2] 1,481 | 1,481 | 1,474 | 1,258 | (7) | (223) | 1.2 | 38.9 | 415,091 | 90,362 |
| 1979 | 1,496 | 1,481 | 1,479 | 1,168 | (17) | (313) | 3.0 | 54.6 | 473,952 | 93,870 |
| 1980 | 1,667 | 1,481 | 1,667 | 1,200 | ........ | (281) | ........ | 49.0 | 421,365 | 99,351 |
| 1981 | 1,678 | 1,481 | 1,678 | 1,133 | ........ | (348) | ........ | 60.7 | 502,001 | 119,346 |
| 1982 | 1,710 | 1,481 | 1,710 | 1,110 | ........ | (371) | ........ | 64.7 | 437,345 | 118,323 |
| 1983 | 1,696 | 1,481 | 1,696 | 1,058 | ........ | (423) | ........ | 73.8 | 396,303 | 123,855 |
| Total | | | | | | | | | 4,413,626 | 1,396,537 |

[1] Does not reflect the impact on the repayment requirements of an estimated $850,611,000 in debt nor the $24,500,000 required for sinking funds related to preferred stock capital.

[2] Restricted requirements.

[3] Much of the capital required for 1974 has already been raised although at considerable cost and with great difficulty

[Appendix III]

PUBLIC UTILITY FINANCING—GAS COMPANIES

FINANCING DATA FROM JANUARY 1 TO JULY 31, 1974

*February 27*—Brooklyn Union Gas Company sold $30 million of First Mortgage Bonds due 1999 to Salomon Brothers, First Boston, Drexel Burnham and Lehman Brothers at competitive bidding with a coupon rate of 8¾%. The cost to Brooklyn

was 8.68% and the security was offered to the public at $101.531 to yield 8.60%. It was non-refundable for 5 years. This security was rated A by both Moody's and Standard & Poor's. The underwriter's commission was $0.821. This security was originally to be offered in the amount of $35 million.

On the same date Brooklyn Union also sold 200,000 shares of preferred stock (100 par value) at competitive bidding. The dividend rate on this security was 8.92%. It was offered to the public at $101.36 to yield 8.80%. The cost to the company was 8.91%. The sinking fund on this security begins on March 1, 1979.

*March 18*—Consolidated Natural Gas Company offered $50 million of debentures due 1999 at competitive bidding. This security is rated Aa by Moody's and AA by Standard & Poor's. The coupon rate was 8⅝% and it was to be sold to the public at $99.80 to yield 8.64%. The cost to the company was 8.72%.

*March 26*—Texas Gas Transmission Corporation offered $40 million of debentures due April 1, 1984. The security was rated Baa by Moody's and A by Standard & Poor's. Standard & Poor's raised their rating since the last offering by this company. This was a negotiated transaction with Dillon, Read & Co. and the coupon rate was 8¾%. It was offered to the public at $99.25 to yield 8.86%. The cost to the company was 8.99%.

*March 27*—Laclede Gas Company offered $20 million of First Mortgage Bonds due 1999 at competitive bidding. This security was rated Aa by Moody's and AA by Standard & Poor's. It was sold to First Boston. White, Weld & Co., Dillon, Read and E. F. Hutton. The coupon rate was 8⅞% and it was offered to the public at $101.26 to yield 8.75%. The cost to the company was 8.85%. It had a no call provision for 5 years.

*March 28*—Lone Star Gas offered $50 million of sinking fund debentures due 1999 in a negotiated transaction with Goldman, Sachs and Salomon Brothers. The debentures were rated A by both Moody's and Standard & Poor's. It was sold with a coupon rate of 8.95% and was offered to the public at $100 to yield 8.95%. Cost to the company was 9.04%.

*April 3*—Washington Gas Light Company offered $20 million of First Mortgage Bonds due 1999 at competitive bidding. Security was rated A by both rating agencies. The successful bidder was Blyth Eastman Dillon and Salomon Brothers. It bore a coupon rate of 9⅜% and was priced to the public at $101.21 to yield 9.25%. Cost to the company was 9.40%.

*April 18*—Bay State Gas Company offered $8 million of notes due April 15, 1999 in a negotiated transaction with Merrill Lynch. This was rated Baa by Moody's and BBB by Standard & Poor's. Coupon rate was 9⅞% and it was offered to the public at $100. The cost to the company was 10.01%.

The same company offered 40,000 shares of preferred stock, $100 par value, in a negotiated transaction with Merrill Lynch. It bore a dividend rate of 9.95% and was offered to the public at $100. The cost to the company was 10.10%.

Bay State also announced an offering of 150,000 shares of common stock with a par value of $10 which was to be priced at $16 per share in a negotiated transaction with Merrill Lynch. The price to the public was subsequently changed to $15 per share and the number of shares offered was reduced to 100,000. The indicated annual dividend rate was $1.44 per share. The price to the public would yield 9.60%. The price to the company was $13.80 per share.

*May 23*—Peoples Gas and Coke Company announced an offering of $40 million for May 23, 1974 at competitive bidding. The security bore a rating by Moody's of Aa. Prior to the date of issue, the offer was cancelled and a bank loan was substituted for the required funds.

*June 3*—Michigan-Wisconsin Pipeline Company offered $50 million First Mortgage Pipeline Bonds due 1994 at competitive bidding. The issue was rated A by both Moody's and Standard & Poor's. The successful bidder was Dillon Read, Drexel Burnham, E. F. Hutton, etc. It bore a coupon rate of 9⅝% and was offered to the public at $99.625 to yield 9.67%. It was non-refundable for 5 years and the cost to the company was 9.762%.

*June 19*—Columbia Gas System offered $40 million of debentures, Series due June 1999 at competitive bidding. It was rated A by both rating agencies. The successful bidders were Salomon and Halsey Stuart. It bore a coupon rate of 9⅞% and was offered to the public at $99.50 to yield 9.93%. The cost to the company was 10.024% and it was non-refundable for a 5 year period.

*July 8*—Columbia announced the offer of 1 million shares of cumulative preferred stock, Series A, $50 par value at competitive bidding. On July 8 the offer was unsuccessful as no valid bids were received.

It was reoffered on July 22, 1974 in a negotiated deal with Salomon Brothers. The average life of the preferred stock was reduced to a 10½ years. The security

bore a dividend rate of 11.25% and cost the company 11.54%. It was offered to the public at $50 per share to yield 11.25%.

*July 9*—Northern Illinois Gas Company announced an offering of $50 million of First Mortgage bonds at competitive bidding. Moody's rating was Aa. Prior to the date of offering, it was announced that it would be re-offered at a later date.

*July 30*—Michigan Consolidated Gas Company offered $40 million of First Mortgage bonds due 1999 at competitive bidding. Moody's rating was A. It was sold to White, Weld & Co. with a coupon rate of 10⅝%. It was offered to the public at $100 to yield 10⅝%. The security was non-callable for 5 years and the cost to the company was about 10.83%. *Prior to the date of offering, the maturity date of this security was changed from 1999 to 1982.*

*July 22*—American Natural Gas announced an offering of 1,700,000 shares of common stock at competitive bidding. Prior to the date of offering, it was *deferred* to later this year or possibly sometime in 1975.

[Appendix IV]

RELATIONSHIP OF COMMON STOCK MARKET PRICE TO BOOK VALUE (SAMPLE OF GAS UTILITIES)

| Company | Market price of common, July 25, 1974 | Book value per share, December 31, 1973 | Percent market price to book value |
|---|---|---|---|
| Integrated companies: | | | |
| Columbia Gas System | $18½ | $27.46 | 67.4 |
| American Natural Gas | 32 | 34.69 | 92.2 |
| Consolidated Natural Gas | 19½ | 34.10 | 57.2 |
| Lone Star Gas | 20¾ | 17.91 | 115.9 |
| National Fuel Gas | 19⅜ | 32.91 | 58.9 |
| Northern Natural Gas | 49½ | 43.38 | 114.1 |
| Peoples Gas Co. | 26⅞ | 32.65 | 82.3 |
| Average, integrated companies | | | 84.0 |
| Distribution companies: | | | |
| Atlanta Gas Light | 11½ | 15.74 | 73.1 |
| Brooklyn Union Gas | 14 | 21.47 | 65.2 |
| Commonwealth Natural Gas | 15½ | 21.08 | 73.5 |
| Equitable Gas | 24⅝ | 35.69 | 69.0 |
| Gas Service Co. | 9¾ | 14.66 | 66.5 |
| Laclede Gas Co. | 15¼ | 19.92 | 76.6 |
| Minneapolis Gas Co. | 16¼ | 17.24 | 94.3 |
| Northern Illinois Gas | 18 | 20.65 | 87.2 |
| Oklahoma Natural Gas | 17½ | 16.42 | 106.6 |
| Pacific Lighting Corp. | 17 | 25.90 | 65.6 |
| Washington Gas Light | 14 | 29.55 | 47.4 |
| Average, distribution companies | | | 75.0 |
| Pipeline companies: | | | |
| El Paso Natural Gas | 10¾ | 15.08 | 71.3 |
| Panhandle Eastern Pipe Line | 25⅝ | 26.03 | 98.4 |
| Southern Natural Resources | 41⅞ | 32.33 | 129.5 |
| Texas Eastern Transmission | 28⅛ | 26.49 | 106.2 |
| Texas Gas Transmission | 23¾ | 28.25 | 84.1 |
| Transcontinental Gas Pipe Line | 8⅝ | 12.95 | 66.6 |
| Average, pipeline companies | | | 92.7 |
| Average, all companies | | | 82.0 |

[Appendix V]

EMERGENCY TAX RELIEF FOR ELECTRIC AND GAS UTILITIES

The following temporary modifications should be made in the investment credit allowed regulated electric and gas utilities (regulated companies primarily engaged in the furnishing or sale of electrical energy, gas through a local distribution system, or the transportation of gas by pipeline, and any 80-percent or more affiliated companies):

1. The rate of the investment credit should be increased to 20 percent with respect to electrical energy, local gas distribution, and gas pipeline regulated public utility property.

2. The limitation on the amount of investment tax credit which may be claimed by these utilities should be increased from 50 percent to 90 percent of tax liability.

3. The investment credit should be made available in the year capital expenditures are made with respect to section 38 property (which will be electrical energy, local gas distribution or gas pipeline regulated public utility property when placed in service) rather than at the time the property is placed in service.

4. The investment credit should be applied in the foregoing manner where utilities pay bonuses to acquire domestic oil or gas, coal, or uranium leases.

5. The modification should specifically provide that if a regulatory body requires that the benefits be passed through to consumers, the investment credit is not available for tax purposes.

These temporary investment credit modifications would apply for a five year period (1974 through 1978), at the end of which they would be reviewed by Congress to determine whether economic conditions warrant their continuation.

ELECTRIC AND GAS UTILITY INDUSTRIES—ESTIMATED TAX EFFECT OF INCREASE IN INVESTMENT TAX CREDIT TO 20 PERCENT ON QUALIFIED CAPITAL EXPENDITURES

[In millions of dollars]

| | Electric utilities | Gas utilities | Total |
|---|---|---|---|
| 1973 under present law[1] (estimated) | [2] 172 | 82 | 254 |
| 1973 at 20 percent[3] | 860 | 308 | 1,168 |

[1] On transmission construction expenditures 7 percent, distribution 4 percent.
[2] Estimated. Approximately ¾ of credit was not utilized due to 50-percent limitation.
[3] Present qualified items plus lease bonuses.

[Appendix VI]

## Proposed Leasing Procedure

1. In connection with competitive bidding for Federal leases, the bidder shall submit with its bid a certified check for 10% of the bonus offered for the lease. The Bureau of Land Management shall award the lease to that bidder offering the largest bonus. In the event that a bonus bid of $1 million or more is submitted for a lease, the Bureau of Land Management cannot reject the bid on the ground of insufficiency.

2. The purchaser of each tract shall provide within 20 days to the Bureau of Land Management a bond in form satisfactory to assure purchaser's performance of his obligations, including payment of the balance of the bonus, under the purchase conditions outlined below.

3. At the end of each 12 month period from the date of the award of the lease, a payment of an additional 10%, less expenditures made on the lease during the preceding 12 months, will be paid. The amount of the payment shall be credited against the balance of the bonus obligation. Such yearly payments will cease:

A. On any lease on which commercial production has been established within 5 years from the date of the granting of the lease: The balance of the bonus shall be paid, commencing with the first date of commercial production in annual amounts equal to the greater of 25% of the annual revenues, after payment of royalties, from the hydrocarbon reserves produced from the lease, or on an amount equal to 1/5 of the bonus balance as of the date of the commercial production or the end of the fifth year until the balance is paid in full.

B. On any lease on which commercial production has not been established within five years from the date of the awarding of the lease: The balance of the bonus shall be paid in 5 equal annual installments commencing on the fifth anniversary of the lease award.

C. On any lease on which it is determined that the lease is not commercially productive and the lease is surrendered within five years from the date of the awarding of the lease: The bonus balance as of the date of the lease is surrendered shall be cancelled and no further payments required of the purchaser of the lease.

ILLUSTRATIVE COMPARISON OF CAPITAL OUTLAY BY SUCCESSFUL BIDDER UNDER PRESENT AND PROPOSED LEASE BONUS PAYMENT PROCEDURES

[In thousands of dollars]

| Year | Under present procedures | | | Under proposed procedures | | |
|---|---|---|---|---|---|---|
| | Lease bonus | E/D cost | Cumulative capital outlays | Lease bonus | E/D cost | Cumulative capital outlays |
| 1 | 20,000 | 1,300 | 21,300 | 2,000 | 1,300 | 3,300 |
| 2 | | 5,000 | 26,300 | 700 | 5,000 | 9,000 |
| 3 | | 5,200 | 31,500 | 0 | 5,200 | 14,200 |
| 4 | | 6,000 | 37,500 | 0 | 6,000 | 20,200 |
| 5 | | | | 3,460 | | 23,660 |
| 6 | | | | 3,460 | | 27,120 |
| 7 | | | | 3,460 | | 30,580 |
| 8 | | | | 3,460 | | 34,040 |
| 9 | | | | 3,460 | | 37,500 |

NOTES

1. Assumptions used in developing this comparison: Bonus bid=$20,000,000; Exploratory expenses of $2,500,000 and development costs of $15,000,000 were developed on a basis of a deepwater (500–700 ft) tract; Total reserves developed of 200 Bcf produced in 10 yr with production beginning in the 5th yr from the date of the awarding of the lease; and the price received for the gas=65 cents per thousand cubic feet.

2. Under both procedures the Government receives $20,000,000 in lease bonus payments. The royalty payments of about $22,000,000 over the production life of the lease would be the same under either procedure.

[Whereupon, at 12 p.m., the subcommittee recessed, subject to the call of the Chair.]

# APPENDIX

## Communications Received by the Committee Expressing an Interest in These Hearings

---

General Telephone & Electronics Corporation,
*Stamford, Conn., August 20, 1974.*

Re: *Hearings on High Interest Rates and Capital Market Weakness*

Hon. Lloyd Bentsen,
*Chairman, Subcommittee on Financial Markets, Senate Committee on Finance, Washington, D.C.*

Dear Senator Bentsen: During the second day of your subcommittee's recent hearings on high interest rates and capital market weakness, a panel of utility experts addressed the specific problems currently facing the utilities in raising money in the capital markets.

While that panel focused on the problems faced by the electric and gas utilities, these problems are shared by the telephone utilities as well. As you are well aware, the health of our economy as a whole is highly dependent on the ability of the utilities to provide the basic infrastructure for economic development. If the utilities are unable to raise sufficient funds to construct additional needed plant and replace obsolete plant, the economy as a whole will inevitably suffer.

I am submitting on behalf of GTE a statement for the record setting forth the needs of the telephone utilities for legislative and regulatory relief.

As a point of reference, GTE's domestic telephone operating companies comprise the largest independent (non-Bell) telephone system in the United States, serving over eleven million subscribers in more than 7,500 communities of about 21 million population in thirty-three states.

If, after reading the statement, you should have specific questions relative to the telephone industry and its capital needs, I should be pleased to respond. You may find it convenient to transmit these questions through Mr. Malone or Mr. Neumeyer of GTE's Washington office.

Sincerely yours,

Theodore F. Brophy.

### Statement of Theodore F. Brophy, President, General Telephone and Electronics Corp.

#### Introduction

My name is Theodore F. Brophy and I am President and Chief Operating Officer of General Telephone & Electronics Corporation ("GTE") with Headquarters in Stamford, Connecticut.

I am a member of the American Bar Association and a past Chairman of the Public Utility Law Section of that Association.

GTE is the Parent company of more than 60 communications, manufacturing, research and service subsidiaries with operations in 39 states and 18 countries abroad.

GTE's domestic telephone operating subsidiaries comprise the largest independent (non-Bell) telephone system in the United States. The 24 domestic telephone operating companies serve 11,276,000 telephones in more than 7,500 communities of about 21,000,000 population in 33 states.

GTE's net income in 1973 was $338.4 million, 74.8 percent of which was derived from its U.S. telephone operating companies.

As members of the Subcommittee on Financial Markets, you are aware of the critical problems facing the financial markets today. The primary underlying causes of these problems are the continued high rate of inflation and the unprece-



40-844 O - 74 - 7

dented demand for capital in relation to the available supply. These problems have caused high interest rates and have significantly contributed to the weakness in the long-term bond market and a loss of investor confidence in all security markets. While there is no need to discuss the background of these highly publicized problems in detail, this statement will demonstrate how these conditions are particularly injurious to all utility companies. This statement will also recommend specific solutions to these problems in order to insure the availability and continuity of the vital services provided by all utilities including the telephone industry.

The energy crisis has focused the attention and concern of the public on electric utilities, and there is no doubt that they suffer serious economic problems which must be remedied. It must be emphasized, however, that the serious financial problems associated with capital shortages and the high cost of money are common to all highly capital intensive utilities, *including the telephone industry.*

### INFLATION

It is widely recognized that the unprecedented inflation is the root of the problem. For example, during the period 1960 through 1964 inflation in the United States as measured in terms of the Gross National Product (GNP) deflator averaged 1.4% per year, whereas for the period 1970 through 1974 (estimated), the GNP deflator will be approximately 5.7% per annum. This represents a dramatic four-fold increase since 1960 (See Exhibit #1). The current rate of inflation is in excess of 10% per year, and there is little confidence that we can anticipate a substantial decline in that rate in the foreseeable future.

### IMPACT OF INFLATION ON INTEREST RATES

Interest rates consist of two components. One is a real, somewhat static rate, and the other component is an inflation premium which is added to the real rate demanded by the investor to compensate for the expected shrinkage in the value of the dollar. It can be shown that over time the real interest rate has hovered in the area of 3% to 4%. To this real rate must be added an inflation expectation. If this expectation is about 7%, then one can assume that long-term "A" utility interest rates will be in the neighborhood of 10% (See Exhibit #2).

Because utilities must sell large amounts of debt, interest rates have a material effect on their financial well being. Consequently, large increases in interest costs are one of the major problems facing the utility industry today. These costs have increased for two reasons: (1) the increase in rate which is directly associated with inflation, and (2) the increase in the amount borrowed which is largely determined by required capital expenditures. Interest expenses for most public utilities are increasing at a much greater rate than revenues and thus adversely impact the profitability of the company. For example, interest expense for the telephone operations of General Telephone & Electronic Corporation (GTE) has grown at a compound rate of 18.8% annually for the period 1960 through 1973, whereas revenues have grown at a far slower rate of 13.7% per year. As a result, interest as a percent of revenues have increased substantially from 6.1% in 1960 to 10.7% in 1973.

### DEMAND FOR CAPITAL

The very nature of the utility business requires continuous large outlays of capital. Inflation increases the amount of such outlays and accelerates the cost thereof as all industries seek larger amounts of new capital. During the period 1960 through 1973, the investor-owned electric utility companies spent approximately $97 billion on construction, whereas during the same period, the telephone industry spent approximately $87 billion. The pattern of capital expenditures for construction in both of these segments of the utility industry has been quite similar and the rate of expenditures has been accelerating in recent years (See Exhibit #3).

In the future, it is anticipated that both of these segments of the public utility industry will be required to spend far more than they have in the past to meet expanding service requirements. It is currently estimated that the capital expenditure requirements of the telephone industry alone for the six-year period 1974 through 1979 will aggregate more than $95 billion which exceeds the amount spent during the 14-year period from 1960 through 1973. The entire industry is concerned regarding the availability and price of these funds. If the United

States economy is to expand and compete effectively in the world markets, it is mandatory that U.S. utilities be able to attract the capital required to make possible the provision of the vital services demanded by the public. The financial markets are the mechanism through which this required capital must be raised, and the utilities must be better equipped than they currently are to compete effectively in these markets. Also, it is anticipated that the competition for funds will be more severe in the future.

### CAPITAL INTENSIVE NATURE OF UTILITIES

Given unprecedented inflation and fierce competition for capital, the extreme degree of capital intensity of the utility industry becomes an acute problem. One way to illustrate the capital intensive nature of the utility business is to compare revenues and sales generated per dollar of total assets. Electric, gas and telephone companies on the average generate approximately $.25 to $.35 of revenues per dollar of total assets, whereas manufacturing companies generally achieve approximately $1.20 of sales per dollar of total assets employed (See Exhibit #4). Therefore, telephone and electric utilities are required to invest approximately four times the amount of capital in order to generate the same revenues as manufacturing companies.

### CAPITAL GENERATION

Capital is obtained from two sources, funds provided from within the business, known as internally generated funds, and funds obtained from outside the business, known as externally generated funds.

#### INTERNALLY GENERATED FUNDS

*A. Retained Earnings*

Retained earnings, (i.e. net income less dividend payments), provide only a relatively small portion of the total capital requirements for public utilities. There are three reasons for this: (1) the large capital requirement in relation to income; (2) inadequate net income because of too low a return currently being earned on equity investment; (3) the large dividend payments as a percentage of net income required by the investors in this industry.

The capital requirements of GTE telephone operations for 1973 were 4.4 times the net income from telephone operations. Rate of return on equity has declined largely because inflation and high interest rates have not been sufficiently offset by the rate increases granted by the regulatory authorities, thus reducing net income and cash flow.

Generally, return on utility equity has declined since 1966 while interest rates skyrocketed and regulatory commissions have historically allowed the telephone utilities a lower rate of return on equity than they have allowed most electric utilities (See Exhibit #5). These conditions must both be remedied. In the future, utilities must receive a higher rate of return on equity than previously allowed or many will be effectively excluded from the financial markets. For example, in order to preserve the integrity of the existing capital and to attract new sources of capital, the need for a current return on equity for GTE's telephone operations of at least 15% is clearly indicated.

Retained earnings are reduced as dividends are increased. The shareholder's concern with inflation and alternative investment opportunities, afforded by debt securities and preferred stock, has increased his expectation as to dividend payments. As dividends have been increased to meet the inflation concerns of shareholders, the cash flow of most companies in the industry has been reduced. This, in turn, has resulted in an increased demand on the capital markets. Because of inadequate cash flow, dividend payments currently required will place severe financial burdens on many utilities. Evidence of this fact was the omission of its common stock dividend by Consolidated Edison in the first quarter of 1974.

Another major depressant on retained earnings is the regulatory lag, i.e., the length of time between the application by a utility for rate relief and the granting of such relief. Faced with high capital demands, a double digit rate of inflation and record high interest rates, the response of most of the regulatory commissions to rate applications has been one of procrastination and delay. For example, during the period January, 1972, through June, 1974, the time span between the date of filing for rate relief and the date of the order granting rate relief for GTE averaged approximately eleven months and ranged from a low of three months to a high of twenty-five months (See Exhibit #6). This only covers applications wherein orders have already been received, and there are

numerous other applications still awaiting decision. It should also be noted that in the case of the shortest time between filing and order, i.e., three months, GTE's application was denied and no relief whatsoever granted. Even when rate orders are finally issued, the rate of return allowed is generally woefully inadequate, and the rate specified is rarely earned because the rates have generally been based on historic test periods which have already been invalidated by the upward forces of inflation.

*B. Depreciation*

Depreciation is a very important factor relevant to internally generated funds. Current depreciation rates for both rate-making purposes and tax purposes are clearly not adequate to recover the replacement cost of utility, plant and equipment in the face of inflation. The inadequacy of depreciation rates is particularly injurious to cash flow and thereby puts a further and unjustifiable burden on capital markets.

*C. Investment Tax Credit*

To further compound the cash flow problems, the utility industry is allowed an investment tax credit of only 4% as compared with the 7% allowed other industries. This discriminatory action has saddled utilities with a built-in disadvantage when compared to other companies competing in the same capital markets. Utilities require much *more*, not *less* capital than industrial firms, and they do not have the flexibility to defer or time their construction programs to offset reductions in cash flow or poor market conditions.

In summary, because internally generated funds fall far short of meeting capital requirements, utilities must place a far greater dependence on external financing than other companies.

EXTERNALLY GENERATED FUNDS

*A. Long-Term Debt*

The major external source of long-term finance for utilities is the sale of securities. The utility industry is characteristically a high-leveraged industry, but the economic problems of recent years have required an increase in the degree of leverage to the point where many companies have now exhausted their flexibility with regard to additional sale of debt. In addition, the declining financial health of the industry has created a widespread reluctance on the part of investors to purchase further amounts of long-term debt securities of public utilities.

This disenchantment is evident by the recent increase in the number of negotiated, as opposed to competitive, offerings. The Securities and Exchange Commission recently recognized this problem and is currently allowing utility holding companies to sell their securities in negotiated public offerings as opposed to competitive offerings. In addition, more restrictive investor imposed terms and conditions of utility debt offerings have sharply increased the cost of servicing the securities. Furthermore, many utilities have reached, or are approaching, the point where the sale of additional debt securities is blocked by the legal provisions contained in indentures under which existing debt was issued. These factors have combined to limit severely the use of the long-term debt market for many public utilities.

A major requirement of an investor in corporate debt securities is the interest coverage provided by its earnings—the ratio of pre-tax net income to interest expense. Interest coverage for utilities has precipitously declined since 1968. For example, the interest coverage of electric companies has declined about 30% from 4.4 times earnings in 1968, to 3.1 times earnings in 1973. For approximately 1,700 companies, comprising the United States Independent Telephone Association (USITA), the coverage has declined from 3.6 times in 1968 to only 3.1 times in 1973, the same as the coverage for electric utilities. The decline in coverage has been even more dramatic for American Telephone & Telegraph Company (AT&T), falling from 7.3 times in 1968 to less than half of that coverage in coverage, there have been many downgradings in the ratings of public utility 1973 (See Exhibit #7). Largely as a result of this precipitous decline in interest debt issues during the past several years. For example: since 1970, Standard & Poor's has downgraded the bond ratings of sixty-two (62) electric and telephone utilities, and during the same time frame, they have raised the ratings on only seven (7) companies. The downgrading of a corporation's securities not only results in a substantial increase in interest cost on new issues, but also causes a contraction in the number of potential investors. These factors,

unless corrected, can lead to a further downgrading in rating. For example, since 1970, the ratings on the debt securities of the Boston Edison Company have been downgraded from "AAA" to "BBB" by Standard & Poor's Corporation.

*B. Common Equity*

Common stocks of utility companies are selling at historically low price/earnings multiplies. For example, the P/E ratios of AT&T, GTE and Moody's twenty-four electrics, have declined more than 50% since 1966 (See Exhibit #8).

Most utility stocks are selling below book value, and as a result, each sale of additional common stock dilutes the existing shareholders' equity. Because regulatory commissions establish utility rates on the basis of return on investment, earning power of each existing share is also reduced. Perceiving this dilution in earning power, investors revise downward the value they place on the stock. This action causes further erosion in the market price of the stock, with the result that subsequent issues must be sold at even a greater discount from book value.

On July 12, 1974, of 106 utilities listed on the New York Stock Exchange, approximately 80% were selling below book value, and the median company was selling at approximately 75% of book value (See Exhibit #9). Even further deterioration has taken place since July 12, 1974, and now most of the leading telephone utilities stock, e.g., AT&T, GTE, United Telecommunications, Southern New England Telephone & Telegraph, Rochester Telephone, Pacific Telephone & Telegraph, New England Telephone & Telegraph, Mountain States Telephone & Telegraph, Cincinnati Bell and Continental Telephone, are presently selling for less than book value.

Studies have shown that the inadequate return on equity is an important, if not the most important, problem that faces the utility industry and directly affects the relationship of market to book value. In order to have a viable utility industry, able to serve the long-term needs of the public, it is mandatory that utility companies sell at a reasonable premium above book value. Under current economic conditions, a return on equity of approximately 15% is generally required if a utility's common stock is to sell at or above book value, assuming current debt to equity ratios.

*C. Preferred Stock*

Because of the poor, current market for common equities and the continuing need for funds, many utilities have turned to the issuance of preferred stock to satisfy their need for equity funds. While preferred stock equity financing may sometimes be an acceptable substitute for common stock equity financing, the source of such funds is limited. Unlike bond interest, preferred stock dividends are not deductible for tax purposes and therefore reduces cash flow to the full extent of the dividend paid. Many utilities are forced to market preferred stock, despite the high cost, because of limitations on the amount of debt they can sell and the higher cost of selling common stock.

*D. Short-Term Debt*

Another potential source of externally generated funds is short-term debt; however, this source is not a satisfactory long-range soluton to the financing of the capital requirements of the utility industry. Under current market conditions, the cost of short-term debt is not only extraordinarily high, but the liquidity position of utilities is also of great concern to all and a threat to the long-term health of the industry. Anything but the highest grade of commercial paper is extremely difficult to market. In fact, A. G. Becker, a leading commercial paper dealer, indicates that the sale of commercial paper, Grade 2, i.e., Median Grade, is down approximately 30% since the first of the year, whereas sales of Grade 3 paper, below Median Grade, is off 60% or more. Intensifying this problem, some commercial banks have reached the limit of their ability to extend lines of credit, and short-term money is extremely difficult to obtain.

## CONSTRUCTION CUTBACKS

In order to reduce some of the pressure for external funds, many utilities have found it necessary to cut back construction programs. For example, Michigan Bell has already launched an austerity program to cut approximately $2 million a month from its construction budget. Because of high interest costs and a regulatory lag. General Telephone Company of Ohio has also found it necessary to severely curtail its construction program so that construction expenditures will not exceed the amount of cash generated internally. *The New*

York Times, of August 11, 1974, reported that approximately $2 billion of capital expenditure cutbacks were also contemplated by electric and gas utility companies. Although a necessary expedient, it must be recognized that, in the long run, these cutbacks are not an acceptable alternative to adequate earnings and will adversely impact service.

Capital conservation programs, based on the cutback of construction programs, will, of necessity, require an extension of facility and productivity margins; will curtail essential upgrade programs; and will cause an undesirable reduction in the labor force.

PROPOSED SOLUTIONS

The utilities are faced, then, with two major problems, both of which demand immediate solution. The first is inadequate cash flow, and the second is inadequate return on equity. Both of these major problems must be remedied soon in order to enable all utilities, including telephone, to continue the provision of adequate public service.

REFORM CONSIDERATIONS

To mitigate the formidable problems faced by the utility industry, we recommend changes in three areas:

(A) Reform in the Federal tax laws.
(B) Reform in rate-making procedures.
(C) Reform in accounting practices, particularly for rate-making purposes.

*A. Federal Tax Reform*

The following tax amendments are recommended:

(1) The first and most important reform is the elimination of the discrimination against electric and telephone utilities in the current law represented by the investment tax credit of only 4% as against 7% for other industries. As we urged at the time the investment tax credit was enacted, and more recently in a presentation before the Department of Treasury, equitable treatment of the utilities is necessary, and it is entirely proper that they receive the same investment tax credit that is made available to other industries. This action should be taken promptly and made effective at the earliest possible date, and no later than January 1, 1974. The urgency of this proposal is supported by Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, who, in testifying before the Joint Economic Committee urged that, "The Administration must move more swiftly to aid the troubled utilities industry by boosting the investment tax credit for utilities to 7% from 4%."

The elimination of the existing investment tax discrimination, i.e., the increase of the investment tax credit from 4% to 7% for the utility industry, would add significantly to the industry's cash flow. In the case of GTE, this would improve the cash flow by approximately $150 million for the years 1974 through 1978.

(2) Not only should the investment tax credit for utilities be raised to the current rate for industrial companies but, the investment tax credit for all corporations should be increased to 10%.

(3) Related to these two recommendations is the need to eliminate the 50% limitation on the use of the investment tax credit insofar as public utilities are concerned. The 50% limitation permits the use of the investment tax credit only to the extent of 50% of tax liability. This penalizes the capital intensive company with the lowest ratio of earnings to capital requirements. Such a penalty, particularly in the case of utilities, is clearly counterproductive. An increase in the investment tax credit to 10% for all corporations, with the elimination of the 50% limitation with respect to public utilities, would provide much needed relief for the utility industry. For GTE, an increase in the investment tax credit from 4% to 10%, and elimination of the 50% limitation, would increase the internally generated cash by $800 million over the next 5 years. Not only would it do this, but it would decrease the dividend or interest requirements, since external financing to the extent of $800 million would be eliminated. This in turn would improve the return on equity and interest coverage.

(4) In order to encourage savings, capital accumulation and investment, and simultaneously reduce discretionary funds available for consumption, it is recommended that consideration be given to permitting automatic dividend reinvestment by shareholders without a tax on the dividends until the stock is sold, at which time a capital gains tax would be paid. An alternative would be to permit the establishment of two classes of stock, along the lines of the

Citizens' Utilities Plan. Under this Plan, stock dividends may be paid exempt from taxation as ordinary income on one class of stock and cash dividends on the other class of stock, with convertibility of one class into the other.

The automatic reinvestment of dividends would open up the market for utility stocks to those stockholders more interested in capital accumulation than in the receipt of cash dividends, while not losing the investment interest of those people interested in cash dividends. While it is not possible to estimate the percentage of cash dividends which would be retained rather than distributed, the cumulative effect would become an important source of internally generated funds.

Permitting dividend reinvestment by shareholders without tax consequence at the time of reinvestment would serve to broaden the participation of shareholders in the reinvestment plans of American Telephone & Telegraph, General Telephone, United Telecommunications and Continental Telephone, each of which companies now have authorized dividend reinvestment plans.

(5) Dividends paid on new issues of preferred stock of public utilities should be deductible for tax purposes. Allowing a corporate tax deduction for dividends paid on new issues of preferred stock would significantly improve the cash flow of many utilities and improve their return on equity. It would also supply required equity at a reasonable cost.

(6) Finally, there must be a comprehensive tax program to encourage the movement of funds from consumption to investment. Such a program will help all U.S. industry to finance the growth in production capacity that is required to reverse the current inflationary trend in the United States (See Exhibit No. 10).

*B. Regulatory Reform*

(1) The primary thrust of regulatory reform must be to obtain a *substantially* higher return on equity. The restoration of a reasonable differential between return on equity and long-term interest rates that will compensate for the added risk element in equity investment is necessary.

(2) In addition to making it possible for the utility industry to earn a reasonable return on equity, it is imperative that steps be taken immediately to eliminate the excessive regulatory lag. There are a number of different mechanisms which might accomplish this objective. For example:

(a) Rate increases should be authorized to go into effect immediately upon the filing of new rates, with a refund bond to protect the customer. Such increases could be limited to a maximum of 15% of existing rates in any 12-month period.

(b) Utilities should be permitted to use a forecasted test period in filing rate applications. Presently, in most jurisdictions, rates are based upon a company's revenue needs as determined by historical operating or earnings results. Consequently, by the time rates are approved and made effective, the effects of inflation have further eroded earnings and the utility fails to earn the rate of return on equity determined to be fair by the regulatory authority. The use of forecasted test period results would facilitate the determination of revenue requirements more in line with current costs of providing service.

(c) Regulatory authorities should be required to issue final decisions with regard to applications for rate adjustments within a reasonable finite period of time after the applicant files an application. This would greatly assist companies in their short and long-range financing plans which must be geared to meet demands for service.

(d) A comprehensive program of automatic rate adjustment procedures should be adopted. Such automatic adjustments should include:

i. Changes in interest rates;
ii. Increases in wages;
iii. Increases in taxes, both income and property;
iv. Increases in approved depreciation rates; and
v. Increases in other specified expense items. (See Exhibit #11.)

Some steps are being taken in certain states in regard to the above. These efforts must be expanded as soon as possible, in order to counteract the damaging effects of inflation.

The effects of regulatory lag were recognized by Dr. Burns before the Joint Economic Committee when he indicated that the Administration must move quickly in urging regulators to speed up decisions on rate increase applications.

*C. Accounting Reform*

Recommended changes in accounting practices for ratemaking purposes must include consideration of the following:

(1) Consideration of the proposal before the FCC for adoption of Equal Life Group (ELG) depreciation should be expedited. This change in accounting should be adopted by all regulatory bodies.

ELG is a refinement of the present vintage group depreciation which subdivides the vintage group (plant placed in service in a single year) into groups consisting of units, each of which are expected to have an equal useful life. This method more nearly matches depreciation expense to the actual useful life of the plant.

(2) The inclusion of construction work in progress in the rate base should be considered. While the allowance of interest during construction increases current earnings, it does not provide any current cash flow. The inclusion of construction work in progress in the rate base for rate purposes would increase the current cash flow. (See Exhibit #120).

CONCLUSION

I cannot emphasize too strongly the fact that the proposed changes in the tax law, regulatory and accounting matters, will only be effective if the benefits are retained by the utilities to strengthen their financial structure and ability to serve the public and if the regulatory commissions are precluded from flowing through the effect to the rate payers in terms of immediate rate reductions. This is also important from the standpoint of protecting the Federal tax revenues and to minimize the revenue loss from the foregoing tax proposals.

The entire utility industry, *including the telephone sector*, is committed to providing required public service. We share with the Congress this responsibility to the American public. We need your enthusiastic endorsement and active support to accomplish the essential reforms discussed in this statement.

LIST OF EXHIBITS

1—Inflation 1960–1974.
2—The "Inflation Premium" in Utility Bond Rates.
3—Construction Expenditures.
4—Comparison of Revenues and Sales Generated per $1.00 of Total Assets.
5—Comparison of Return on Equity-Electrics vs. Telephone.
6—GTE Regulatory Lag.
7—Comparison of Pre-Tax Interest Coverage.
8—Comparison of Price Earnings Ratios.
9—Comparison of Market/Book and ROE of 106 N.Y.S.E. Listed Utilities.
10—Recommended Changes in Federal Tax Laws.
11—Recommended Changes in Rate Making.
12—Recommended Changes in Accounting Practices for Rate Making Purposes.

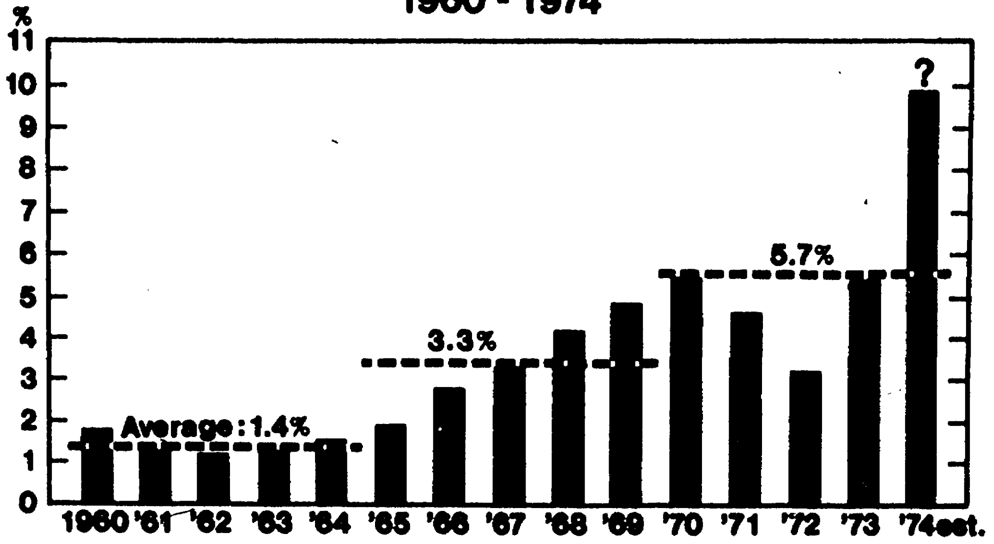
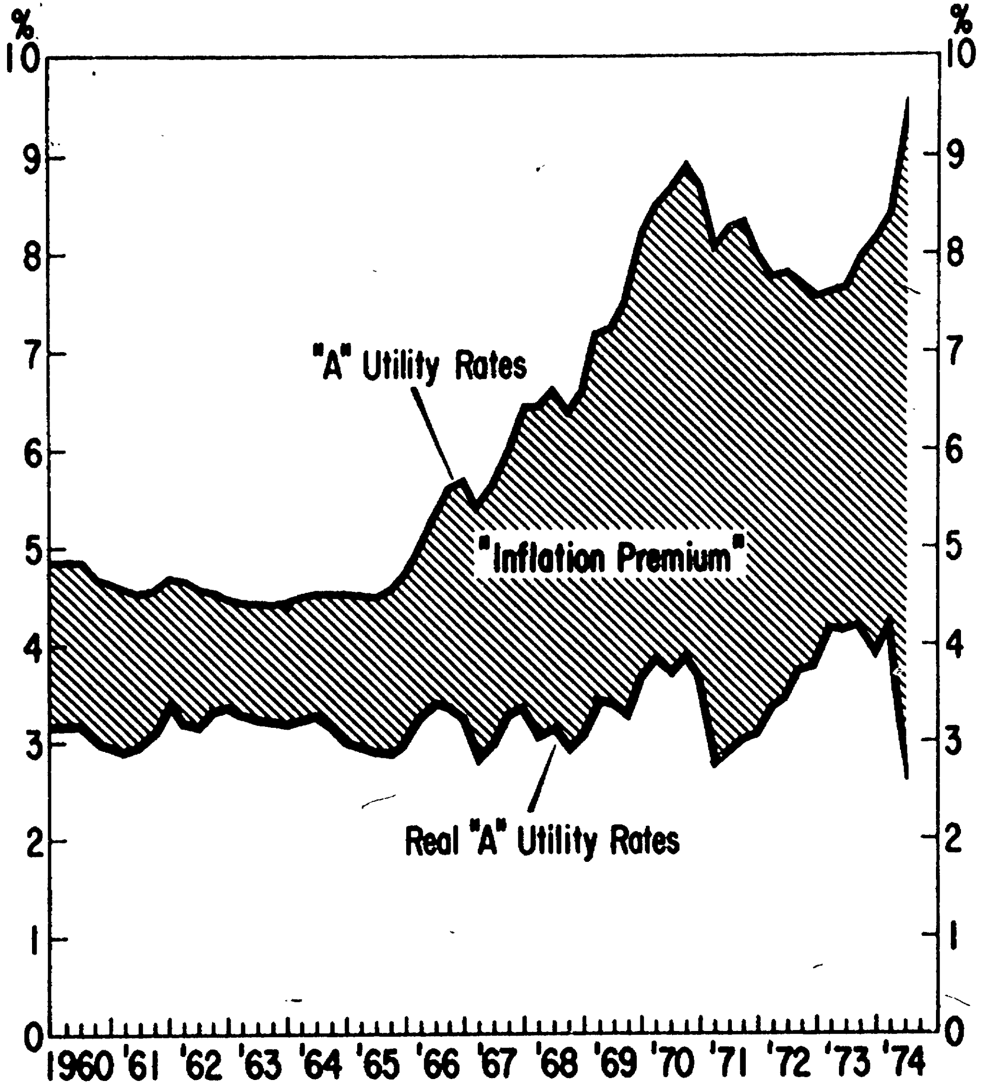



EXHIBIT 1

EXHIBIT 2

## THE "INFLATION PREMIUM" IN UTILITY BOND RATES




Basic Source: Moody's Investors Service and U.S. Dept. of Commerce

EXHIBIT 8

## CONSTRUCTION EXPENDITURES

($ Millions)

| Year | Electrics* | Telephone Industry** |
|---|---|---|
| 1973 | $14,600 (Estimated) | $11,587 |
| 1972 | 13,385 | 10,314 |
| 1971 | 11,894 | 9,438 |
| 1970 | 10,145 | 8,737 |
| 1969 | 8,294 | 7,213 |
| 1968 | 7,140 | 6,033 |
| 1967 | 6,120 | 5,469 |
| 1966 | 4,932 | 5,237 |
| 1965 | 4,027 | 4,769 |
| 1964 | 3,551 | 4,231 |
| 1963 | 3,319 | 3,759 |
| 1962 | 3,154 | 3,557 |
| 1961 | 3,256 | 3,221 |
| 1960 | 3,331 | 3,168 |
| TOTAL | $97,148 | $86,733 |

| Average Annual Growth Rates | | |
|---|---|---|
| 1968 - 1973 | 15.4% | 13.9% |
| 1960 - 1968 | 10.0% | 8.4% |

* Investor-owned Electrics
  Smith, Barney & Co., Incorporated (Using Edison Electric Institute figures)

** Includes companies reporting to the United State Independent Telephone Association (USITA) and AT&T

EXHIBIT 4

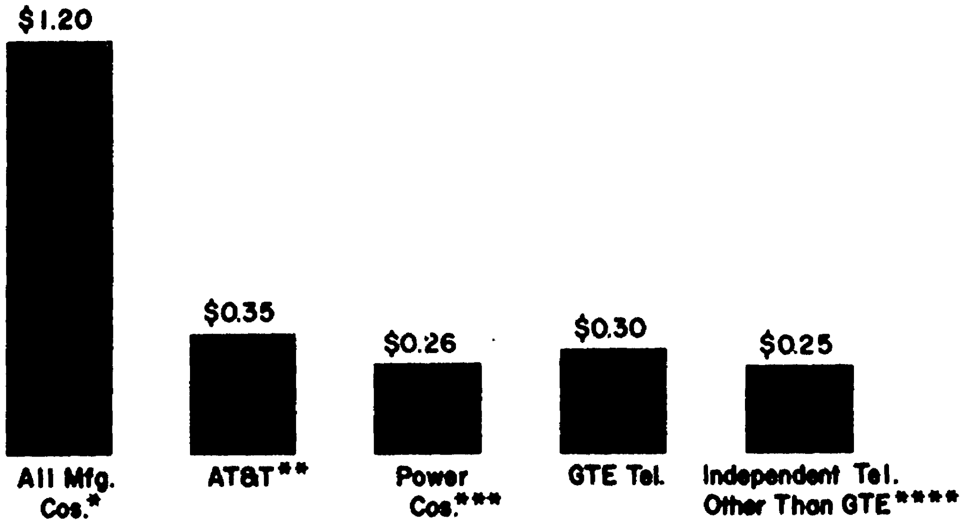
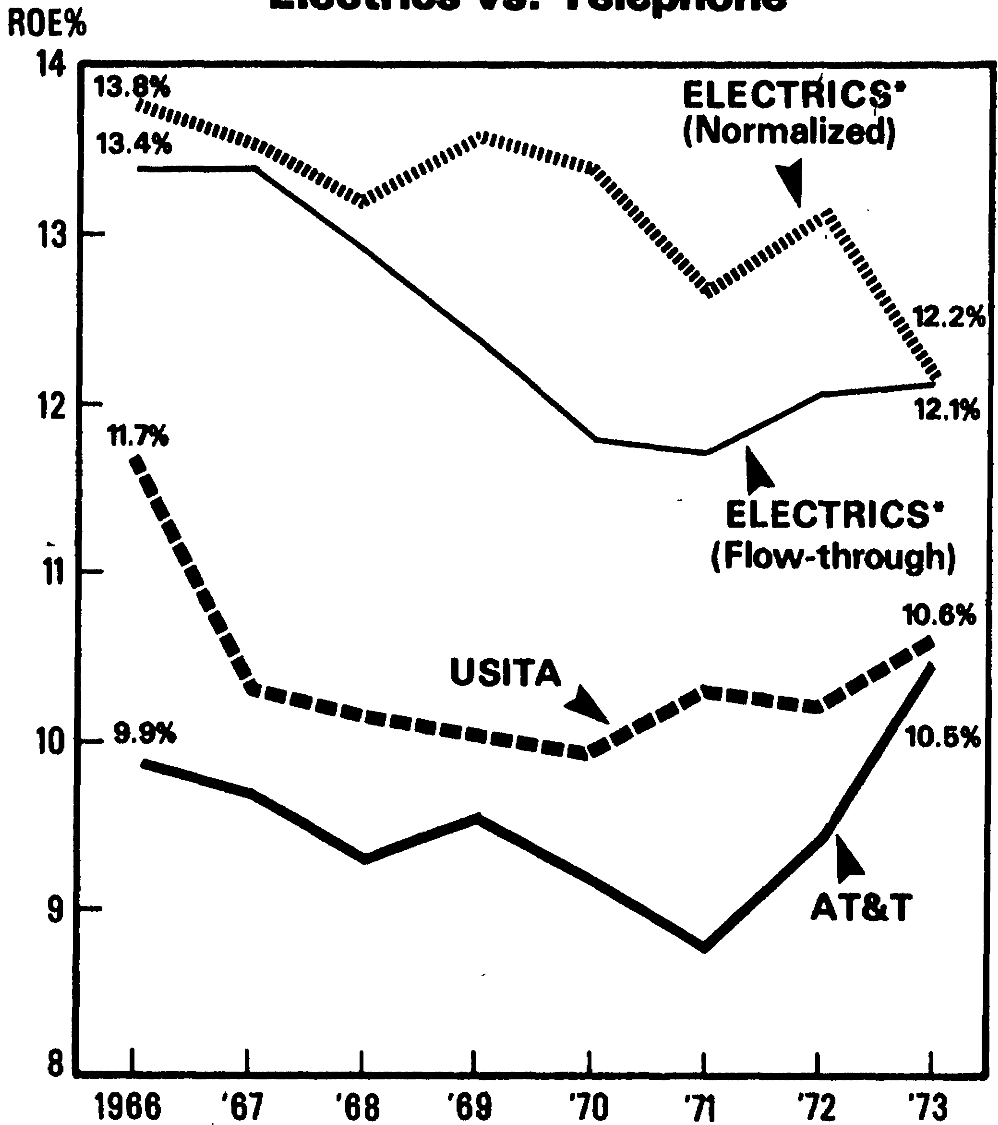


EXHIBIT 5




SOURCES: U.S.I.T.A. STATISTICS, AT&T STATISTICAL REPORT
*PACIFIC GAS & ELECTRIC'S 29 LARGEST STRAIGHT ELECTRICS IN COMPARATIVE FINANCIAL DATA: FIFTY LARGEST UTILITY COMPANIES

EXHIBIT 6

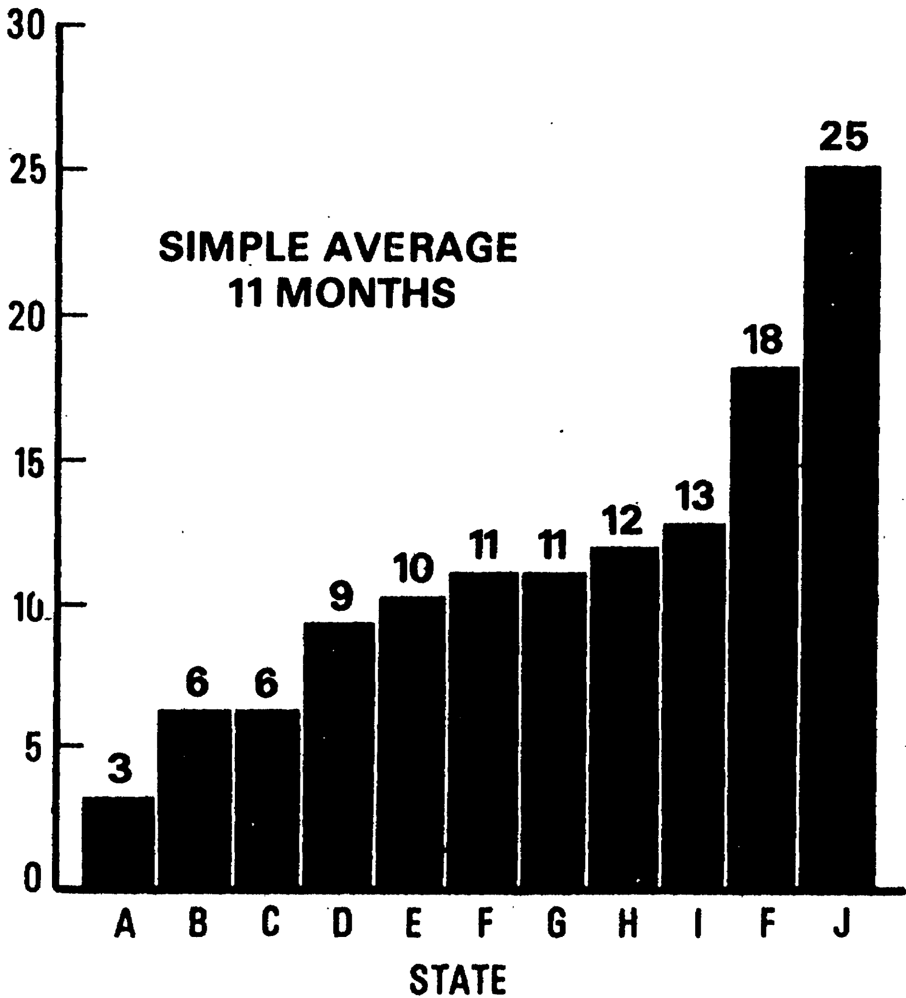
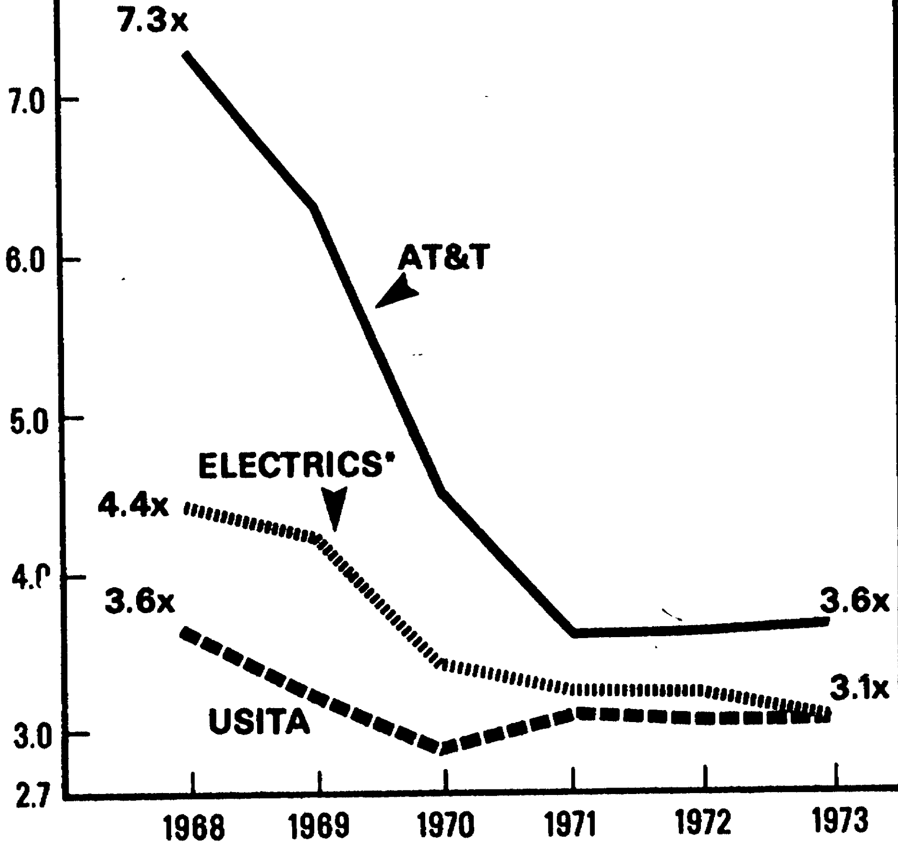


EXHIBIT 7

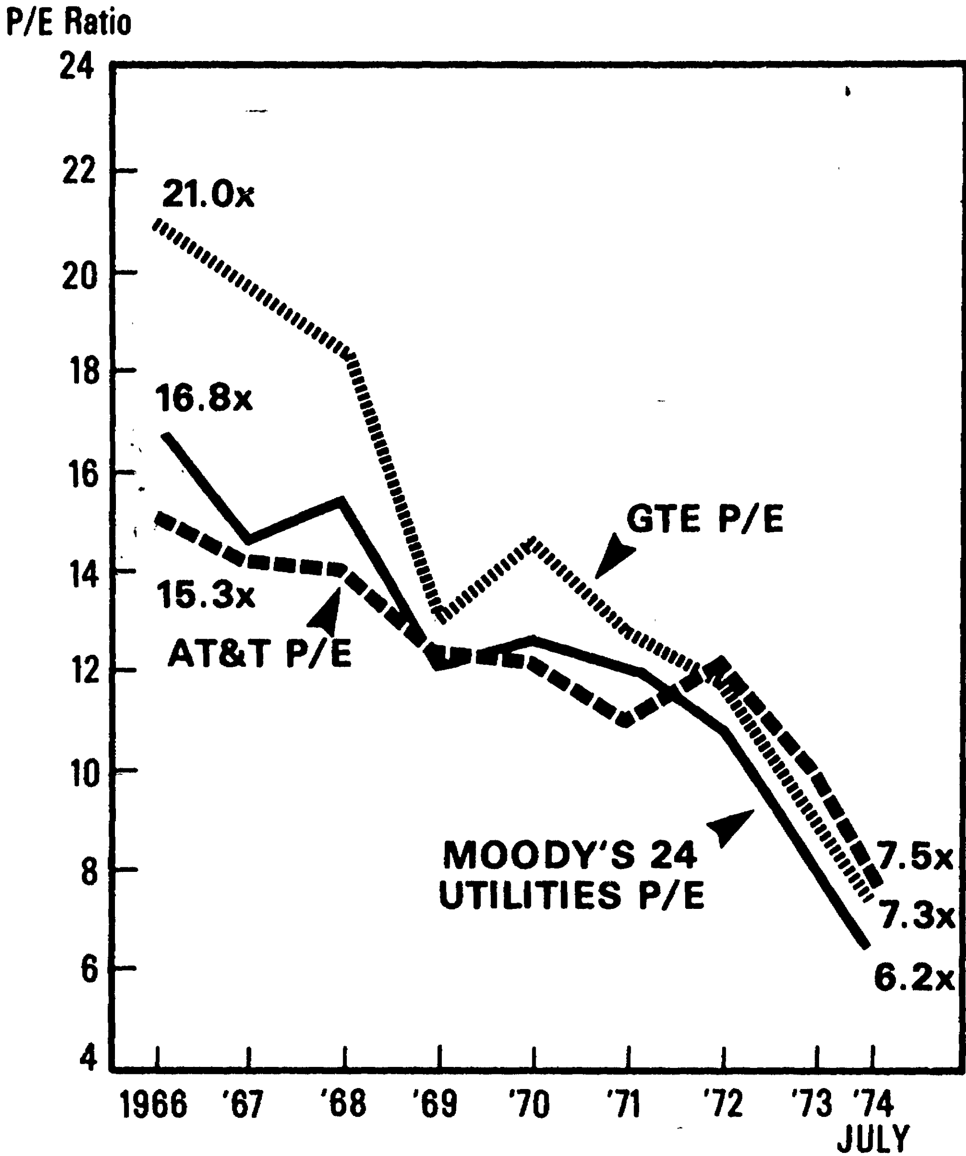
# Comparison of Pre-Tax Interest Coverage Electrics vs. Telephone

Interest Coverage



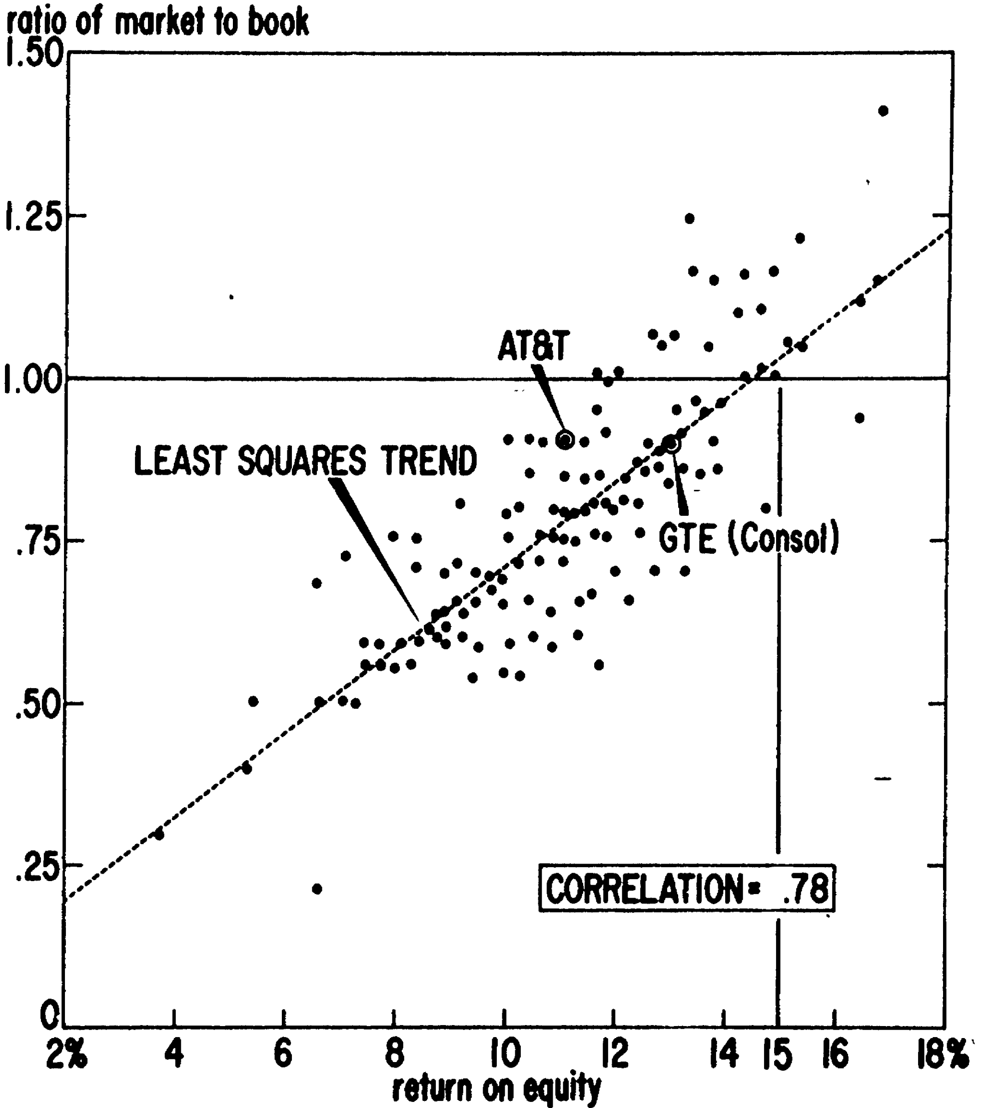

SOURCES: U.S.I.T.A. STATISTICS, AT&T STATISTICAL REPORT
*PACIFIC GAS & ELECTRIC'S 29 LARGEST STRAIGHT ELECTRICS IN COMPARATIVE FINANCIAL DATA: FIFTY LARGEST UTILITY COMPANIES

EXHIBIT 8




SOURCE: MOODY'S INVESTORS SERVICE; AT&T STATISTICAL REPORT

EXHIBIT 9




SOURCES: Media General Financial Weekly; Time Sharing Resources

EXHIBIT 10

# RECOMMENDED CHANGES IN FEDERAL TAX LAWS

- ELIMINATE INVESTMENT TAX CREDIT DISCRIMINATION WHICH FAVORS INDUSTRIAL CORPORATIONS
- INCREASE INVESTMENT TAX CREDIT TO 10%
  - ELIMINATE 50% LIMITATION WITH RESPECT TO PUBLIC UTILITIES
- ALLOW CORPORATE TAX DEDUCTION FOR DIVIDENDS PAID ON NEW ISSUES OF PREFERRED STOCK OF PUBLIC UTILITIES
- PERMIT AUTOMATIC DIVIDEND REINVESTMENT BY SHAREHOLDERS WITHOUT TAX ON DIVIDENDS
- ASSET DEPRECIATION RANGE SYSTEM (ADR)–REVISE TO ALLOW GREATER VARIANCE FROM GUIDELINES (IN EXCESS OF PRESENT 20%)–PROVISIONS SHOULD BE EXTENDED TO CERTAIN ASSETS NOW EXCLUDED
- OTHER CHANGES WHICH WOULD ENCOURAGE PRIVATE INVESTMENT
  - REDUCE CAPITAL GAINS TAXES FOR INDIVIDUALS AND CORPORATIONS
  - RELIEVE CORPORATIONS FROM MINIMUM TAX, AND ELIMINATE CAPITAL GAINS OF INDIVIDUALS FROM INCOME SUBJECT TO MINIMUM TAX
  - SET MAXIMUM TAX ON DIVIDENDS RECEIVED BY INDIVIDUALS (e.g. 50%) TO REDUCE DOUBLE TAXATION OF DIVIDENDS
  - ELIMINATE FROM U.S. INCOME TAX INTEREST AND DIVIDENDS PAID TO FOREIGN INVESTORS

EXHIBIT 11

# RECOMMENDED CHANGES IN RATE MAKING

- Substantially Higher Return on Equity
  - Differential Over Current Long-term Interest Rates
- Elimination of Regulatory Lag
  - Immediate Increases Under Bond
  - Forecasted Test Period
  - Time Limit After Filing
  - Automatic Adjustment Clauses

EXHIBIT 12

# RECOMMENDED CHANGES IN ACCOUNTING PRACTICES FOR RATE MAKING PURPOSES

- Equal Life Group Depreciation

- Include Construction Work in Process in Rate Base and Eliminate Interest During Construction

STATEMENT OF WILLIAM G. BURNS, ASSISTANT TREASURER, AMERICAN TELEPHONE AND TELEGRAPH CO., TO THE SUBCOMMITTEE ON FINANCIAL MARKETS

My name is William G. Burns. This statement is submitted in my capacity as Assistant Treasurer of the American Telephone and Telegraph Company on behalf of the 22 Bell System Companies, the names of which are listed on Attachment A to this statement. In connection with the Subcommittee's hearings and investigation of the growing threat of domestic financial crisis, I would like to address my comments particularly to the problems of capital formation and attraction, specifically as those problems relate to public utilities. References to "Tables" contained in my statement are to the tables of statistical data attached and made a part of it.

THE ROLE OF INFRASTRUCTURE INDUSTRIES

Public and private sector studies indicate that the U.S. economy in general and the utility sector in particular will need substantial increases in production capacity over the next decade to meet the needs of an expanding economy. One study, for example, indicates that a tripling of investment over that of the past decade may be necessary if we are to meet our national economic goals. It is especially vital that the infrastructure industries—those capital intensive suppliers of base components like energy and communications—be able to successfully finance. The growth capacity of all industry will be seriously impaired if energy and communications capabilities are lacking or inadequate.

The telephone utilities of this country share with its electric utilities the role of a capital intensive infrastructure industry. Both exhibit similar characteristics:

The need for a high level of capital investment to meet service needs. (Table 1).

The inability to meet capital requirements solely from internal sources. (Table 2).

The concurrent need for regular ongoing infusions of external capital. (Table 3).

Government regulation of most aspects of their business.

Both communications and electric energy availability is a necessary predicate to sound economic growth. Plant construction must be anticipatory and precede that of other segments of the economy. As a result, our required growth rate necessarily has been greater over the postwar period than that of the economy as a whole. The Bell System, for example, has grown about 8% annually, or twice as fast as the general economy. Electric companies have experienced similar growth patterns. The result of high levels of sustained growth in demand has been reflected in the construction programs outlined above. We have seen no evidence that the rate of growth, and hence the need for very large construction programs, is diminishing. The emergence of energy problems complicates the picture for the electric companies, but the need for national energy self-sufficiency and pollution control seem likely to keep their capital requirements high as well.

We are acutely aware of the growing competition for a limited supply of investment capital under high inflationary conditions. Consequently the Bell System fully supports both the concern and the remedial policy objectives of the government in regard to capital formation.

Inflation affects utilities more adversely than many industries. Table 4, for example, shows the cumulative impact of inflation on Bell System construction expenditures since 1966. Further, investors are increasingly wary of "interest sensitive" utility stocks, recognizing that regulatory lag and attrition accelerate equity earnings erosion, particularly in highly inflationary periods. This combination causes a depression of equity markets for utilities, and results in extreme difficulty, or an actual impossibility, in their raising new equity capital.

The essential nature of utility services precludes their cutting or delaying construction programs in order to "wait out" high capital costs. Recently some electric companies have been forced by dire financial circumstances to make such cuts, but this will undoubtedly pose the serious threat of future capacity shortages. To further aggravate the situation, postwar debt issues are beginning to mature. Refunding these issues will increase external financing needs even further.

### THE BELL SYSTEM'S PRESENT FINANCIAL POSTURE

The Bell System is not currently in extreme financial difficulty. By not pushing its debt ratio as high as the levels reached by the electric companies (Table 5), it has maintained some borrowing margin. Thus far the Bell System companies have been largely successful in holding their Triple A credit ratings. There has been ample evidence in recent weeks of the value of a top quality rating in today's difficult markets. We feel strongly that a target debt ratio of 45% for the Bell System is appropriate for today's circumstances. While we are somewhat above that level currently, the situation is manageable for the moment. It should be borne in mind, however, that our options are fast running out. Should that occur, we would face problems similar to those currently confronting many of the electric utilities. The electric companies would undoubtedly like to reduce their debt ratios, but poor earnings and dismal equity markets preclude any hope of success at the present time.

The quality of Bell System earnings is also better than that of many other utilities. For instance, we have resisted flow-through accounting. Similarly, because of the shorter lead time required in our construction projects, "interest during construction" makes up less than 10% of reported earnings, in contrast to about 25% of reported earnings for the average electric company. In some cases non-cash earnings of electric companies have accounted for much or all of reported earnings. Both investors and rating agencies are quick to recognize the hazards of such non-cash figures.

Continued efforts to use debt capital prudently have enabled us to avoid, by and large, the wholesale downgradings that have occurred in the electric utility industry. Table 6 indicates utility downgradings since 1968. We have not escaped completely unscathed, as Pacific Telephone, New England Tel. & Tel. and the Southern New England Tel. Co. have been downgraded to Double A. Rating agencies have evidenced considerable concern about our declining interest coverage (Table 7). We've arrested the decline, but improvement is essential if we're to maintain our ratings.

Most important, we've been able to generate substantial growth in earnings per share since 1971 through rigorous expense control and vigorous pursuit of rate increases. Our operating ratio, for example, peaked in 1971 and has continued to improve since that time (Table 8). In contrast, the electric companies generally have been unable to stem the adverse trend.

This improvement has permitted us to increase the dividend on AT&T stock in 1972, 1973 and again in 1974, and thus to maintain some modicum of investor support. Our market price remains depressed, however, and we suffer the common inability to sell new equity. This is a clear indication that dramatic improvement in both the extant economic and financial environment and our own earnings level is essential if we are to avoid the financial problems which already confront a substantial portion of the electric utility industry. We need improved earnings to *avoid* financial difficulty, while many other utilities need improved earnings to *overcome* their present financial difficulties.

### BROAD ECONOMIC POLICY

The fundamental needs of the country, like the need for improved housing, new systems of urban transportation, cleaner environment, and expansion of our basic industries will require an immense volume of new investment capital well above historic requirements. To meet these total capital requirements, the nation's economy will need to allocate a larger proportion of its output to capital formation than it has in the past, as reflected by the historic average. From a broad policy viewpoint, concentration should be focused on:

1. Regaining control of inflation,
2. Improving both the level of profits generally and public awareness of the importance of adequate earning power in our economic system, and
3. Shifting economic output from consumption and government deficit spending to private savings and investment.

The primary role in each of these areas must of necessity be taken by the Federal government. Sound and consistent fiscal and monetary policy is a necessary predicate to achieving the capital supply and demand balance required if we are to meet our national economic goals.

Restoration of financial vitality for troubled utilities and perpetuation of the financial soundness of those who have to date avoided such difficulties, are likewise essential.

This must include:

1. Recognition of the essential role of utilities in our economy,
2. Recognition by regulatory bodies that earnings must reflect the higher capital costs in today's economic environment, and the adoption of a rate making philosophy that allows such earnings to be achieved, and
3. Concerted efforts to enhance the internal financing capacity of utilities generally.

UTILITIES AND INFLATION

The problems resulting from rapid inflation and inadequate capital formation are pervasive. They will not be easily resolved, and certainly regulatory commissions, as well as consumers generally, need to recognize that "holding the line" on utility rates will only tend to exacerbate the situation. Utilities are victims of inflation, not its cause. Most importantly, the role of public utilities as infrastructure industries means that any reduction in the general availability of service provided by them would seriously retard other industrial growth. This, in turn, could diminish efforts to increase the supply of goods, and thwart the current efforts to moderate inflation.

Sound financial health for most utilities can be achieved at a reasonable cost to the consumer. The required increase in rates for the Bell System and for the average electric company would be less than 10% of current revenues, assuming a full and timely recovery of other unavoidable increases in expense. This is a small price to pay when the sobering alternatives are considered.

At the same time, utility managers cannot, and should not, expect to solve all their financial problems through rate increases. Effective management of expenses is an absolute necessity. Productivity improvements must be pursued. Increased emphasis must be placed on both basic and applied research and development which can yield enormous dividends. The Bell System's own integrated structure, with Western Electric Company and the Bell Telephone Laboratories working together with AT&T and the telephone operating companies on the basic problems of developing and applying emerging technology to communications, has enabled us to improve productivity at rates well above the national average. Similar efforts on the part of the electric industry have been more fragmented. While the multiplicity of electric companies complicates the problem, a broadly based research and development effort by the electric utility industry seems vital to any attempt at meeting their long run objectives.

CAPITAL FORMATION AND UTILITY REGULATION

There is little that utilities can do to stimulate the formation of external capital for investment. Certainly we should make every effort to insure adequate earnings capacity so that we will be able to compete successfully for the supply of capital that is available. Increasing the size of the total investment supply is beyond the scope of our operations and abilities. Consequently, we can only give full support to the government efforts to stimulate savings generally, and thereby to ultimately increase the supply of investment funds available to all industry.

There are substantial areas, however, where utilities, regulators, and the Federal government can work together to enhance the internal financing capability of the public utility sector. Insofar as specific proposals are concerned, we generally support all well reasoned approaches aimed at stimulating the generation of funds from internal sources, and thus mitigating the need to draw on external financing. It is imperative, however, that the benefits of any such proposals in fact be allowed to enhance capital generation and *not* be "flowed through" to ratepayers in the form of lower rates to current users. While adequate transition procedures must, of course, accompany any changes, the basic thrust of legislation to enhance capital formation should not be deflected.

With this thought in mind, I would now like to touch briefly on a number of proposals and areas of possible legislative and/or regulatory changes which could be important assurances of the long run financial stability of this country's public utilities.

1. We completely support proposals to provide to all utilities full parity with other industry with respect to the availability of the investment tax credit. The current 4% level available to utilities has helped them to finance an increased portion of their needed construction expenditures from internal sources. Any acceleration of that trend would benefit both telephone and energy users as well as other essential users of capital. An increase in internal financing capability would also permit a better assimilation of necessary but non-produc-

tivity improving investments (pollution control, fuel conversion, etc.) and a more rapid implementation of modernization investment resulting from improved technology. To make the credit meaningful to many of the most troubled utilities, the increase in the credit should be accompanied by the removal, or at least a liberalization of the limitations on its availability.

2. The allowance of adequate depreciation rates for tax and regulatory purposes is likewise imperative if utilities are to restore financial vitality. The Bell System is currently proposing to the Federal Communcations Commission the adoption of an Equal Life Group accounting system which would more closely match the allowable depreciation expense to the life of the plant. The adoption of more rapid depreciation *could* offer the potential for substantial increases in our ability to finance internally. The desirability of any such change is inextricably linked to the simultaneous provision of the revenues associated with the change, to assure that further equity earnings erosion will not occur.

3. Recently there have been legislative proposals to eliminate the Asset Depreciation Range (ADR) system. Since its adoption, ADR has been an important source of internally generated funds for utilities in general and the Bell System in particular. Its repeal at this time would not only be unrealistic in terms of actual capital recovery, but unfair in the face of rampant inflation. Rather, current economic conditions require that we should consider revisions in the present system to allow greater variance from guidelines (in excess of the current 20%) and extension of ADR to certain assets now excluded. We support these changes, and strongly oppose those efforts aimed at the elimination or reduction of the current ADR provisions.

4. The present tax law (through amendments added in 1969) contains strict provisions taxing distributions of stock and stock rights where shareowners have options to receive cash or increase their proportionate interest in a corporation. Changes to liberalize these provisions in terms of tax relief for distributions of stock or stock rights, i.e., establishing two classes of common stock, could be beneficial. More specifically, a dividend reinvestment plan wherein the immediate tax liability for dividends reinvested in new common stock is eliminated or deferred would be most helpful in attracting additional equity capital. In our own case, such a provision could substantially augment the $200 million of new capital we are annually raising through the AT&T dividend reinvestment plan.

5. The inclusion of plant under construction in the utility rate base, and the allowance of a full return on that investment, would eliminate the need for deductions for interest charges during construction. This change in regulatory practice would improve the overall quality of utility earnings. The greatest beneficiaries of such a change would be the electric utilities, since larger single construction projects with longer completion periods cause interest during construction to be a much larger portion of their reported earnings than that of other utilities.

6. Regulatory permission to expense certain items currently capitalized, such as station connection charges, would be helpful *if* the revenue requirements associated with such a change were authorized concurrently. "Customer Movement" necessitated a $1.4 Billion investment in the Bell System during 1973. Some sort of gradual phase-in, on a prospective basis, would probably be essential to any shift towards expensing items of this magnitude.

7. There are a number of procedural areas in the regulatory process which should be changed and which would markedly improve the internal financial capacity of utilities.

Capital costs, revenue-expense relationships, and rate base items must all be computed on a timely basis. The most effective way to recognize increasing costs is to adopt a future test period for use in computing revenue requirements in the rate making process.

The lag period between the time necessary rate increases are requested and the time they are granted must be shortened. The most effective solution to regulatory delay is regulatory permission to institute interim rates under bond while the rate case is in progress. Establishing limits on the length of periods during which proposed rates may be suspended is also helpful.

The problem of attrition needs wider recognition. The primary cause of attrition is embedded *past* inflation. The result of attrition, when coupled with regulatory lag and inflation, is that the utility is unable to earn the allowed rate of return.

The financing job that needs to be done over the next decade is massive. Inflation must be brought under control. But while that is being accomplished, implementation of the above recommendations would help assure the continued financial stability of public utilities in this country, and enable the Bell System to continue to provide the top quality communications service this country has come to expect. However, I mentioned earlier, these proposals are only a part of the answer. Substantially higher levels of earnings and a more responsive regulatory attitude are also necessary.

### UTILITIES AND CAPITAL COSTS

As a regulated business the Bell System is continually faced with the problem of explaining to a skeptical public how good earnings are the wherewithal for quality telephone service. That same public's continuing demand for communications service means that the telephone industry mut be able constantly to attract large amounts of new capital. The most important and fundamental element in maintaining or restoring the financial vitality of public utilities is their achievement of earnings levels full in keeping with contemporary economic and financial circumstances.

The current level of inflation means earnings levels well above levels that were adequate in the past and well above the current earnings levels of nearly all utilities. Yesterday's rates cannot cope with today's level of inflation. Moreover, financial "gimmicks" are not a substitute for earnings. Facility leasing and other "off balance sheets" forms of financing, floating rates, Federal guarantee of utility debt, and other so-called novel or innovative approaches are designed to treat the symptoms rather than the root cause of utility financial problems—inadequate earnings. These symptomatic remedies are not constructive long range cures for the ills that beset our utilities, but are merely fiscal palliatives.

A principal source of capital for utilities is the debt market. Inflation has caused a marked escalation of new debt costs and hence a dramatic increase in the embedded cost of debt. Table 9 shows the average new debt cost for the Bell System since 1964. New rates have more than doubled, and the estimated *embedded* cost of debt at the end of this year is greater than the *new* debt cost as recently as 1968. The rapid rise in the embedded cost reflects both higher costs and our heavy reliance on debt.

This heavy reliance on debt financing over the past few years has been required because of the continuing inability of utilities in general, and the Bell System in particular, to raise new common equity capital. Table 10 indicates the changes which have occurred in the capital structure of the Bell System since 1964. The continued inability to raise common equity capital on reasonable terms since 1968-69 necessitated use of preferred and convertible preferred stock. The size of this market is quite limited, however, and it will, at best, only accommodate a small portion of our equity needs. So we must soon be able to return to common equity financing.

The extent of the deterioration in the equity markets for utility stocks is evident in Tables 11, 12, and 13. Although the market in general has been depressed since late 1972, because of severely depressed earnings, the utility sector has fared far worse than most others. The investor in utility common stocks has seen his position substantially weakened. Table 14 shows the erosion of the utility equity owners' claim on total return that has taken place since 1965. Investors are not likely to advance additional funds unless they feel that this pattern is likely to be reversed. The competition for available funds is likely to be fierce as utilities increasingly vie with others for available funds. The external capital needs of the petroleum, paper, aluminum, and steel industries, for example, are likely to be much larger than in the past. Utilities will only be able to attract required equity capital if their earnings are competitive with those afforded by alternative investment opportunities.

The old "rules of thumb" as to what is reasonable for utility earnings must be re-evaluated in the light of today's economic environment. Table 15 indicates the changes which have occurred over the past several years. Both a broad cross-section of the market and, more importantly, the firms which offer prime competition for equity capital, are able to offer substantially higher book returns to investors. There is substantial evidence that the higher book returns do produce higher realized returns in the market place. The conclusion seems inescapable: utility earnings must increase if utilities are to compete successfully for their portion of a limited supply of capital.

Rate relief, adequate and timely, will be required. Our studies indicate that our own return requirements will be in the range of 13½ to 14½ percent on common equity *if* inflation subsides to the 6%–7% range. While this is about in line with what a broad cross-section of American industry has earned in the past, it is well above anything the Bell System has achieved to date. Similar, or even greater, increases in earnings may be required by other telephone and power utilities.

In summary, we are convinced that the hope of preserving the financial integrity of our nation's public utilities lies in the combined efforts of utility managers, regulatory bodies, and the Federal government. Managers exercising responsible judgment and planning can minimize costs, increase productivity and improve services. Regulators can assure full recovery of invested capital and authorize earnings attractive enough to generate continued investment. The Federal government, and the Subcommittee, can act to stimulate an increase in internally generated funds and provide important incentives to capital investment. Together we can guarantee that the United States will continue to have an adequate level of high quality utility services available when needed.

TABLE 1.—CONSTRUCTION EXPENDITURES

[Dollars in million]

| | Bell system | Investor-owned electrics [1] |
|---|---|---|
| 1964 | $3,519 | $3,551 |
| 1965 | 3,918 | 4,027 |
| 1966 | 4,193 | 4,932 |
| 1967 | 4,310 | 6,120 |
| 1968 | 4,742 | 7,140 |
| 1969 | 5,732 | 8,294 |
| 1970 | 7,159 | 10,145 |
| 1971 | 7,564 | 11,894 |
| 1972 | 8,306 | 13,385 |
| 1973 | 9,322 | 14,600 |
| 1974 projection | 10,000 | 14,300 |
| 1975 projection | 10,400 | 14,400 |

[1] Source: Smith, Barney & Company

TABLE 2.—INTERNAL FINANCING AS A PERCENT OF CONSTRUCTION EXPENDITURES

| | A.T. & T. | Investor-owned [1] electric utilities |
|---|---|---|
| 1964 | 66.2 | 57.0 |
| 1965 | 64.8 | 64.1 |
| 1966 | 62.3 | 44.9 |
| 1967 | 63.4 | 47.1 |
| 1968 | 62.7 | 47.1 |
| 1969 | 58.6 | 41.6 |
| 1970 | 48.5 | 22.3 |
| 1971 | 53.6 | 25.2 |
| 1972 | 57.4 | 35.2 |
| 1973 | 63.3 | 32.9 |
| 1974 estimate | 65.0 | 36.0 |

[1] Source: Smith, Barney & Co.

TABLE 3.—A.T. & T. CONSTRUCTION EXPENDITURES AND NEW MONEY REQUIREMENT

[Dollars in millions]

| | Construction expenditures | New money requirement | Internal sources | | |
|---|---|---|---|---|---|
| | | | Retained earnings | Depreciation | Deferred taxes |
| 1964 | $3,519 | $1,314 | $639 | $1,494 | $195 |
| 1965 | 3,918 | 1,482 | 722 | 1,654 | 162 |
| 1966 | 4,193 | 1,666 | 666 | 1,825 | 123 |
| 1967 | 4,310 | 1,669 | 560 | 1,971 | 200 |
| 1968 | 4,742 | 2,040 | 609 | 2,146 | 216 |
| 1969 | 5,731 | 2,413 | 837 | 2,315 | 266 |
| 1970 | 7,159 | 4,173 | 765 | 2,463 | 247 |
| 1971 | 7,564 | 3,931 | 929 | 2,465 | 481 |
| 1972 | 8,306 | 3,670 | 1,014 | 2,936 | 816 |
| 1973 | 9,322 | 3,528 | 1,111 | 3,182 | 1,609 |
| 1974 projection | 10,000 | 4,000 | 1,300 | 3,700 | 1,500 |

TABLE 4.—CUMULATIVE IMPACT OF INFLATION ON BELL SYSTEM CONSTRUCTION EXPENDITURES

[In thousands]

| | Construction expenditures in current dollars | Construction expenditures in 1965 dollars | Construction expenditures due to inflation |
|---|---|---|---|
| 1966 | $4,192,564 | $4,098,303 | $94,261 |
| 1967 | 4,309,620 | 4,065,679 | 243,941 |
| 1968 | 4,742,144 | 4,249,233 | 492,911 |
| 1969 | 5,731,495 | 4,869,579 | 961,916 |
| 1970 | 7,159,180 | 5,704,526 | 1,454,654 |
| 1971 | 7,564,107 | 5,665,998 | 1,898,109 |
| 1972 | 8,305,666 | 5,849,061 | 2,456,605 |
| 1973 | 9,321,829 | 6,298,533 | 3,023,296 |
| 1974 projection | 10,000,000 | 6,134,969 | 3,865,031 |

TABLE 5.—DEBT RATIO

[In percent]

| | Bell System | Aaa electrics | High grade electrics |
|---|---|---|---|
| 1964 | 32.3 | 48.0 | 49.7 |
| 1965 | 31.3 | 47.0 | 49.7 |
| 1966 | 31.9 | 48.4 | 50.8 |
| 1967 | 33.8 | 49.2 | 52.3 |
| 1968 | 35.2 | 51.4 | 54.0 |
| 1969 | 37.6 | 52.1 | 54.7 |
| 1970 | 42.0 | 53.4 | 55.5 |
| 1971 | 45.5 | 53.8 | 55.2 |
| 1972 | 46.6 | 53.5 | 54.3 |
| 1973 | 47.5 | 51.9 | 53.7 |

TABLE 6.—UTILITY DOWNGRADINGS SINCE JAN. 1, 1968

TRIPLE A TO DOUBLE A

| | |
|---|---|
| Connecticut Light & Power. | South New England Telephone. |
| Philadelphia Electric. | Consumers Power. |
| Wisconsin Electric Power. | New England Telephone & Telegraph. |
| Duquesne Light. | Baltimore Gas & Electric. |
| Boston Edison. | Commonwealth Edison. |
| Duke Power. | Pacific Telephone & Telegraph. |
| Kansas City Power & Light. | Cleveland Electric Illumination. |
| Ohio Edison. | |

DOUBLE A TO SINGLE A

| | |
|---|---|
| National Fuel Gas. | Iowa Power & Light. |
| Niagara Mohawk Power. | Central Hudson Gas & Electric. |
| Metropolitan Edison. | Columbus & South Ohio Electric. |
| Potomac Electric Power. | Iowa-Illinois Gas & Electric. |
| Wisconsin Public Service. | Pennsylvania Power. |
| Bell Canada. | Cambridge Electric Light. |
| Brocton Edison. | Duke Power. |
| Indiana & Michigan Electric. | Georgia Power. |
| Madison Gas & Electric. | Canal Electric. |
| Pennsylvania Electric. | Boston Edison. |
| Rochester Gas & Electric. | Atlantic City Electric. |
| Appalachian Power. | National Gas Pipeline of America. |
| Monogahela Power. | San Diego Gas & Electric. |
| Elizabethtown Gas. | Union Electric. |
| Carolina Telephone & Telegraph. | Wisconsin Power & Light. |
| New England Power. | Connecticut Light & Power. |
| Iowa Electric Light & Power. | Hartford Electric Light. |
| New Bedford Gas & Edison Light. | Western Massachusetts Electric. |
| Ohio Power. | Detroit Edison. |
| Florida Power & Light. | Central Illinois Light. |
| Pennsylvania Power & Light. | Delmarva Power & Light. |
| Hawaiian Telephone. | Virginia Electric & Power. |
| Carolina Power & Light. | Consumers Power. |
| Toledo Edison. | Long Island Lighting. |

Moody's as of July 15, 1974, S. & P. as of July 12, 1974.

TABLE 7.—INTEREST COVERAGE POST-TAX
[In percent]

| | Bell System | Aaa electrics | High grad electric |
|---|---|---|---|
| 1964 | 6.18 | 4.8 | 4.2 |
| 1965 | 6.39 | 5.1 | 4.3 |
| 1966 | 6.29 | 4.9 | 4.2 |
| 1967 | 5.52 | 4.7 | 3.9 |
| 1968 | 4.84 | 4.3 | 3.5 |
| 1969 | 4.25 | 3.9 | 3.2 |
| 1970 | 3.27 | 3.4 | 2.9 |
| 1971 | 2.80 | 3.0 | 2.7 |
| 1972 | 2.77 | 2.9 | 2.7 |
| 1973 | 2.76 | 2.9 | 2.6 |

TABLE 8.—OPERATING RATIO
[In percent]

| | Bell System | Electric utilities | Manufacturing industry |
|---|---|---|---|
| 1964 | 59.4 | 53.4 | 92.7 |
| 1965 | 60.3 | 53.6 | 92.0 |
| 1966 | 59.8 | 53.5 | 92.2 |
| 1967 | 60.1 | 54.0 | 93.2 |
| 1968 | 59.9 | 54.2 | 93.1 |
| 1969 | 61.3 | 55.1 | 94.3 |
| 1970 | 64.1 | 57.9 | 95.7 |
| 1971 | 65.2 | 59.2 | 95.2 |
| 1972 | 64.7 | 59.4 | 94.8 |
| 1973 | 63.8 | NA | NA |

TABLE 9.—BELL SYSTEM DEBT COSTS

[In percent]

| | New debt costs | Embedded cost |
|---|---|---|
| 1964 | 4.54 | 3.81 |
| 1965 | 4.62 | 3.86 |
| 1966 | 5.49 | 4.07 |
| 1967 | 5.86 | 4.27 |
| 1968 | 6.61 | 4.54 |
| 1969 | 8.02 | 5.20 |
| 1970 | 8.73 | 5.78 |
| 1971 | 7.57 | 5.94 |
| 1972 | 7.37 | 6.11 |
| 1973 | 7.92 | 6.54 |

TABLE 10.—BELL SYSTEM CAPITAL STRUCTURE RATIOS

[In percent]

| | Debt | Preferred | Common |
|---|---|---|---|
| 1964 | 31.5 | 0.1 | 68.4 |
| 1965 | 31.5 | .1 | 68.4 |
| 1966 | 32.9 | .1 | 67.0 |
| 1967 | 34.5 | .1 | 65.4 |
| 1968 | 36.4 | .1 | 63.5 |
| 1969 | 39.5 | 0 | 60.5 |
| 1970 | 44.9 | 0 | 55.1 |
| 1971 | 45.5 | 2.8 | 51.7 |
| 1972 | 47.4 | 3.7 | 48.9 |
| 1973 | 47.6 | 5.0 | 47.4 |

TABLE 11.—MARKET PRICE

[1964=100]

| | A.T. & T. | Moody's 24 utilities | Moody's 125 industrials |
|---|---|---|---|
| 1964 | 100.00 | 100.00 | 100.00 |
| 1965 | 95.61 | 107.65 | 109.97 |
| 1966 | 80.00 | 94.61 | 103.18 |
| 1967 | 78.50 | 93.67 | 112.18 |
| 1958 | 74.21 | 90.45 | 122.17 |
| 1969 | 75.71 | 86.93 | 121.12 |
| 1970 | 66.88 | 72.69 | 104.75 |
| 1971 | 65.87 | 77.38 | 123.28 |
| 1972 | 64.75 | 73.74 | 140.18 |
| 1973 | 72.33 | 65.47 | 137.79 |

TABLE 12.—P/E RATIO

| | A.T. & T. | Moody's 24 utilities | S. & P. 425 industrials | Top 50 holdings [1] |
|---|---|---|---|---|
| 1964 | 21.55 | 20.12 | 17.63 | 22.6 |
| 1965 | 19.61 | 19.76 | 16.82 | 23.4 |
| 1966 | 15.15 | 16.34 | 15.21 | 21.9 |
| 1967 | 14.47 | 15.27 | 17.04 | 26.8 |
| 1968 | 13.83 | 14.75 | 17.30 | 26.3 |
| 1969 | 13.23 | 13.66 | 17.46 | 26.6 |
| 1970 | 11.72 | 11.48 | 16.49 | 23.4 |
| 1971 | 11.53 | 11.79 | 18.02 | 26.2 |
| 1972 | 10.43 | 10.37 | 18.03 | 29.7 |
| 1973 | 9.99 | 9.43 | [2] 13.52 | 25.8 |

[1] Source: Bell System pension fund holdings ranked by percent of market value of the total portfolio.
[2] Preliminary.

TABLE 13.—M/B RATIO

| | A.T. & T. | Moody's 24 utilities | S. & P. 425 industrials | Top 50 holdings[1] |
|---|---|---|---|---|
| 1964 | 2.05 | 2.28 | 2.20 | 4.40 |
| 1965 | 1.87 | 2.35 | 2.23 | 5.04 |
| 1966 | 1.49 | 2.00 | 2.04 | 5.01 |
| 1967 | 1.41 | 1.90 | 2.13 | 5.46 |
| 1968 | 1.28 | 1.74 | 2.19 | 5.54 |
| 1969 | 1.26 | 1.60 | 2.10 | 5.37 |
| 1970 | 1.07 | 1.27 | 1.75 | 4.34 |
| 1971 | 1.02 | 1.29 | 2.01 | 4.88 |
| 1972 | .98 | 1.17 | 2.14 | 5.55 |
| 1973 | 1.05 | 1.00 | [2] 2.0 | 5.12 |

[1] Source: Bell System pension fund holdings ranked by percent of market value of the total portfolio.
[2] Estimated.

TABLE 14.—EROSION OF EQUITY OWNER'S POSITION

[In percent]

| | 1965 Capital Cost[1] | 1973 Capital Cost[1] |
|---|---|---|
| A.T. & T. return on invested capital: | | |
| Weighted components: | | |
| Debt | 31.3 x 3.8=1.19 | 47.5 x 6.3=2.99 |
| Preferred | 0.1 x 6.5= .01 | 4.2 x 7.8= .33 |
| Common | 68.6 x 9.5=6.52 | 48.3 x 10.5=5.07 |
| After tax earnings on total capital | 7.72 | 8.39 |
| Claim on earnings: | | |
| Fixed charge claim | $\frac{1.19 + .01}{7.72}$ =15.5 | $\frac{2.99 + .33}{8.39}$ =39.6 |
| Equity owner's claim | $\frac{6.52}{7.72}$ =84.5 | $\frac{5.07}{8.39}$ =60.4 |
| High Grade Electrics return on invested capital: | | |
| Weighted components: | | |
| Debt | 49.8 x 3.7=1.84 | 53.7 x 5.7= 3.06 |
| Preferred | 10.1 x 4.6= .46 | 11.6 x 5.9= .68 |
| Common | 40.1 x 13.8=5.53 | 34.7 x 12.4= 4.30 |
| After tax earnings on total capital | 7.83 | 8.04 |
| Claim on earnings: | | |
| Fixed charge claim | $\frac{1.84 + .46}{7.83}$ =29.4 | $\frac{3.06 + .68}{8.04}$ =46.5 |
| Equity owner's claim | $\frac{5.53}{7.83}$ =70.6 | $\frac{4.30}{8.04}$ =53.5 |

[1] Earned Rate for Common Equity.

TABLE 15.—A.T. & T. VERSUS COMPETITIVE RETURNS

[In percent]

| | | A.T. & T. | | | Return on equity | | |
|---|---|---|---|---|---|---|---|
| Year | Inflation | Current debt cost | Embedded debt cost | Return on capital | A.T. & T. | S. & P. 425 | Top 50 holdings[1] |
| 1969 | 4 | 8.02 | 5.20 | 7.73 | 9.51 | 14.6 | 19.1 |
| 1970 | 6 | 8.72 | 5.78 | 7.62 | 9.16 | 12.3 | 18.0 |
| 1971 | 4 | 7.49 | 5.94 | 7.38 | 8.72 | 11.7 | 17.9 |
| 1972 | 3 | 7.11 | 6.11 | 7.73 | 9.37 | 12.7 | 18.1 |
| 1973 | 5 | 7.89 | 6.54 | 8.30 | 10.47 | 14.3 | 19.5 |
| 1974 projection | 10 | 9.5 | 6.8 | [2] 8.6 | [2] 10.7 | NA | NA |

[1] Source: Bell System pension fund holdings ranked by percent of market value of the total portfolio.
[2] Consensus forecast of Market letters.

ATTACHMENT A

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company.
The Bell Telephone Company of Pennsylvania.
Bell Telephone Laboratories, Incorporated.
The Chesapeake and Potomac Telephone Companies.
Cincinnati Bell, Inc.
Illinois Bell Telephone Company.
Indiana Bell Telephone Company, Incorporated.
Michigan Bell Telephone Company.
The Mountain States Telephone and Telegraph Company.
New England Telephone and Telegraph Company.
New Jersey Bell Telephone Company.
New York Telephone Company.
Northwestern Bell Telephone Company.
The Ohio Bell Telephone Company.
Pacific Northwest Bell Telephone Company.
The Pacific Telephone and Telegraph Company.
South Central Bell Telephone Company.
Southern Bell Telephone and Telegraph Company.
The Southern New England Telephone Company.
Southwestern Bell Telephone Company.
Western Electric Company, Incorporated.
Wisconsin Telephone Company.

---

U.S. INDEPENDENT TELEPHONE ASSOCIATION,
*Washington, D.C., August 14, 1974.*

Senator LLOYD BENTSEN,
*Chairman, Subcommittee on Financial Markets, Committee on Finance, Washington, D.C.*

DEAR MR. CHAIRMAN: In reference to the hearings held by your Subcommittee August 7 and 8, 1974 on "The Growing Threat of a Domestic Financial Crisis," the United States Independent Telephone Association was invited to submit a statement for the record.

Accordingly, we are enclosing an original and five copies of our statement and, in behalf of the Independent telephone industry, we thank you for allowing us to submit our view for the record.

Sincerely yours,

THOMAS HOWARTH,
*Director of Government Relations.*

STATEMENT OF THE UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION

The United States Independent Telephone Association (USITA) is the national trade association of the Independent (non-Bell) segment of the telephone industry in the United States. The Independent telephone industry consists of 1,705 operating telephone companies serving over 25 million telephones through 11,100 exchanges in over one-half of the served geographical areas of the nation. These companies, together with the operating companies of the Bell System, provide exchange and inter-exchange telecommunications services through the integrated facilities of the telephone network.

We would like to bring to the attention of the Senate Subcommittee on Financial Markets some badly needed changes which are required in the tax and regulatory rules for utilities. Changes are needed to attract the massive amount of capital for the expansion and modernization required in the telephone industry as well as in other segments of the utility industry. Although our member companies have not experienced the extreme financial trauma of Consolidated Edison, great difficulties exist in attracting capital of a quantity and at a rate which is necessary to the financial health of the industry as well as to give the service our customers require and regulatory agencies demand.

Utility stock prices have suffered a much greater decline than industry in general. Utility equity investments were formerly considered to be a good hedge against inflation and a rather stable investment. The public's confidence in these

long-standing concepts has been greatly damaged. Accordingly, the telephone industry has shared with the utility industry in general a very poor market showing, which makes new debt issues very difficult to market and equity issues nearly impossible.

Attached hereto and made a part of this statement are exhibits covering the following areas:

*Exhibit I.*—Tax changes needed to be considered by the Congress.

*Exhibit II.*—Regulatory changes needed to be implemented by the Federal and State regulatory agencies.

*Exhibit III.*—Information bearing on capital needs, capital sources, the increasing debt-equity ratio and the high cost of raising capital today for the independent telephone industry.

## EXHIBIT I

### TAX CHANGES NEEDED

*1. Investment Credit*

The investment credit rate should be increased from 4% to at least the 7% which is granted to non-regulated companies. A rate of 10% would be more appropriate. The investment credit limitation should be eliminated. Normalization accounting should be required for additional investment credit benefits resulting. Consideration should also be given to requiring normalization on the full amount including the 4%.

Originally the investment credit for regulated companies in general was 3%. A few years ago this was changed to 4%. It has become more evident that the real competitive factors are source of funds rather than business-type competition. Therefore, this discrimination should be eliminated. Furthermore, utilities are suffering from lack of investor interest to an even greater extent than other industries.

As to the elimination of the 50% limitation on the investment credit, there has never been any logical basis for this limitation except protection of the revenue. The 50% limitation discriminates against those companies which do most to carry out the objectives of the Congress in making the investment tax credit available. Carryover provisions cannot permit full use of the investment credit entitlement for many rapidly expanding companies.

A normalization requirement for additional benefits might be granted under the investment credit, either through increasing the rate or as to the elimination of the limitations, should be proposed on a similar basis as provided by Congress in recent years. The logical basis of this action is well understood and will not be developed further here. Furthermore, the benefits that are granted under present law for the investment credit should be required to be normalized for regulated companies. The problems that "flow through" rate making creates are becoming better known to the companies and to the regulators as well as time goes on.

*2. Two Classes of Common Stock—Dividend Reinvestment*

The 1969 law prohibits common stock which permits certain taxpayers to choose dividend income while other taxpayers are allowed in effect to plow back their dividends tax free and realize them, if at all, at a later time through capital gains. Under this post-1969 rule, utilities are forced to choose between appealing to the widows' market that requires high dividends rather than to appeal to more wealthy individual investors who are looking for capital gain opportunities. It is most unfortunate that this latter group is essentially barred from investing through the restrictions that the tax law places on the investment marketing mechanisms.

There may have been some opportunity for abuse under pre-1969 law in closely held corporate situations, but to our knowledge none occurred with respect to utilities. Therefore, while the 1969 law cured no abuses with regard to utilities, it does inhibit a more broad marketing of stock of utilities and practically inhibits corporate level earning retention for internal growth. Therefore, the 1969 prohibition should be repealed for stock in utilities and utility holding companies.

Allowing a tax free reinvestment of dividends by stockholders of utilities or utility holding companies would be an alternative to the two classes of common stock which might serve the same objective.

*3. Tax Deduction for New Preferred Stock Issues*

The dividends paid on new issues of preferred stock should be deductible by public utilities. There is a precedent for this treatment as to pre-1941 issues. The

thought in that prior action is still relevant; preferred stock dividends have many of the characteristics of debt securities on which interest is deductible. Such a change would be beneficial in permitting a more favorable debt-equity ratio to develop and to expand the market for preferred beyond corporate and fund holders.

This in part works toward an integration of the individual and corporate income taxes (to eliminate double taxation) which is taking place in many European countries and which is a desirable movement.

*4. Reduce Capital Gains to Shareholders*

We were gratified to see the recent tentative decision of the Ways and Means Committee to give some modest recognition for the effect of inflation on the tax cost of securities. This concept should be expanded so that a more direct and full recognition of the true cost of an asset could be given by adjusting the basis of the asset sold by an inflation factor. An adjustment of the basis of an asset for price level increase is preferable in concept to the sliding scale not only in principle but also in the manner in which losses are treated. Still any technique which rewards and attracts capital is worth considering.

The effect of the minimum tax to date has been principally to impose an additional tax on investors. If any minimum tax concept is to be continued to apply to shareholders, the concept should be a true minimum tax rather than an *additional* tax as it presently is.

*5. Increased Dividend Exemption*

Individuals have been entitled to a $100 to $200 exclusion of dividend income for many years. Treasury has recently suggested that this minor benefit be eliminated.

If it is to stay at its present level, the amounts are perhaps so insignificant that the benefits of simplification may outweigh the benefits to the contrary. However, this is an appropriate time to take a modest additional step toward corporate and individual tax integration in the manner that is taking place in European countries.

Accordingly, the exclusion should be increased to some more significant amount, such as $1,000, rather than to eliminate it. Incentives which encourage small investors are very much in the national interest. Spending would be reduced and savings increased. This in turn would reduce inflation and increase productivity.

## Exhibit II

### REGULATORY CHANGES NEEDED

*1. Allow Higher Earnings on Equity*

Some companies in the Independent telephone industry are quite highly leveraged in comparison to the Bell System companies and have debt-equity ratios that range from 55%–70%. Due to inadequate earnings and soaring interest rates, interest coverage ratios for many companies have fallen to the point where the companies are all but precluded from issuing additional debt. Similar factors and market conditions have also restricted the use of equity financing. At the same time, customer demand and construction expenditures have continued to rise. Other capital intensive industries are facing similar problems, placing a severe drain on the capital market. Regulators must acknowledge the need to provide higher rates of return on equity to compensate the investor for the additional risk he assumes.

*2. Authorize Automatic Adjustment Clauses*

A problem that faces all telephone companies today is their inability to recover costs of operation on a current basis. Gas and electric companies have been given the opportunity to recover increased costs on a more current basis by means of purchased gas and fuel adjustment clauses. The telephone industry could be helped significantly if automatic adjustment clauses for payroll, interest and other costs were permitted.

*3. Consider Depreciation Changes, Such as Equal Life Group Method*

Current depreciation practices should be thoroughly studied to assure that capital is recovered on a timely basis. One depreciation method currently being considered is the Equal Life Group Method. This method attempts to approximate more closely than vintage group accounting the amount of depreciation that would be recorded if each unit of property were individually depreciated over its life.

40-544 O - 74 - 9

More timely recovery of capital through currently increased depreciation provisions would increase funds provided internally and would help to offset the ravages of inflation.

*4. Reduce Regulatory Lag by Establishing Schedules for Commission Action*

Changes in today's regulatory techniques and methods are necessary to assure telephone companies that they are able to actually earn at least the allowed rates of return. Considering the effects of inflation, it is not acceptable to allow rate increases to become effective six months to a year after the need for increased revenues has occurred.

There are several means at hand that could decrease regulatory lag and provide for a quicker recovery of current costs:

1. Allow use of forward test period.
2. Allow increased rates to become effective, subject to refund, with minimal suspension periods.
3. Attrition factors could be used to offset the effect of embedded inflation in rate base.

*5. Include Construction Work in Progress in Rate Base*

In order to increase cash flow and the quality of public utilities earnings, construction work in progress (CWIP) should be included in rate base and allowed to earn a full rate of return. Most jurisdictions now provide that carrying costs for CWIP be added to the cost of the facilities and credited to income as an allowance for funds used in construction (AFC). This practice does not provide the cash currently that is required to pay the carrying costs and therefore increases the amount of capital the utility is required to raise. Also, the investing community is becoming increasingly concerned with the lack of quality of earnings of utilities which include large credits for AFC.

*6. Price-Level Accounting*

Rate making techniques should give effect to price-level accounting in determining rate base and cost of service. Historical cost rate regulation impairs the real economic return of utilities on a price-level basis. The Financial Accounting Standards Board is presently studying the issues related to reporting the effects of general price level changes in financial statements but price-level changes must be recognized for rate making purposes if the utility investor is to be protected *from* inflation.

EXHIBIT III

LISTING OF SCHEDULE

| *Schedule* | *Description* |
|---|---|
| 1 | Composition of the telephone industry. |
| 2 | Relevant Independent Telephone Co. information. |
| 3 | Independent telephones in service. |
| 4 | Independent Telephone gross additions to plant. |
| 5 | Cumulative impact of inflation on Independent Telephone construction expenditures. |
| 6 | Independent Telephone plant investment per telephone. |
| 7 | Independent Telephone construction expenditures and debt redemption. |
| 8 | Capitalization of the independent telephone industry. |
| 9 | Independent Telephone debt costs. |
| 10 | Independent Telephone revenues. |
| 11 | Independent Telephone comparison of interest and dividends with total revenues. |
| 12 | Independent Telephone return on equity. |
| 13 | Independent Telephone sources of internal and external funds. |

COMPOSITION OF THE TELEPHONE INDUSTRY (DEC. 31, 1973)

| | Independent | Bell | Total | Percent Independent |
|---|---|---|---|---|
| Operating companies | 1,697 | 25 | 1,722 | 98.55 |
| Exchanges | 11,106 | 6,734 | 17,840 | 62.25 |
| Telephones (thousands) | 24,782 | 113,960 | 138,742 | 17.86 |
| Plant investment (thousands) | $17,833,000 | $75,520,000 | $93,353,000 | 19.10 |
| Operating revenues (thousands) | $4,400,000 | $24,072,000 | $28,472,000 | 15.45 |
| Employees (thousands) | 164 | 818 | 982 | 16.70 |

RELEVANT INDEPENDENT TELEPHONE COMPANY INFORMATION

| | 1960 | 1965 | 1970 | 1973 |
|---|---|---|---|---|
| Companies | 3,301 | 2,423 | 1,843 | 1,697 |
| Exchanges | 10,717 | 10,823 | 11,048 | 11,106 |
| Employees (thousands) | 100 | 107 | 151 | 164 |
| Telephones (thousands) | 11,435 | 15,233 | 20,650 | 24,782 |
| Plant investment (thousands) | $4,022,696 | $6,974,040 | $12,633,394 | $17,833,000 |
| Operating revenues (thousands) | $1,020,100 | $1,669,700 | $2,953,300 | $4,400,000 |

INDEPENDENT TELEPHONES IN SERVICE

| | Telephones (thousands) | Net increase over prior year (thousands) | Percent increase over prior year |
|---|---|---|---|
| 1960 | 11,435 | 644 | 5.97 |
| 1965 | 15,233 | 916 | 6.40 |
| 1970 | 20,650 | 1,091 | 5.58 |
| 1971 | 21,807 | 1,157 | 5.60 |
| 1972 | 23,187 | 1,380 | 6.33 |
| 1973 | 24,782 | 1,595 | 6.88 |

*Independent telephone gross additions to plant*

[In thousands]

| | Amount |
|---|---|
| 1945 | $24,000 |
| 1950 | 194,000 |
| 1955 | 336,000 |
| 1960 | 580,000 |
| 1965 | 940,000 |
| 1970 | 1,688,000 |
| 1971 | 1,999,000 |
| 1972 | 2,100,000 |
| 1973 | 2,390,000 |
| 1974 (projected) | 2,550,000 |
| 1975 (projected) | 2,688,000 |

NOTE.—During the next 10 years the Independents are projecting expenditures of $32,000,000,000 for new plant.

CUMULATIVE IMPACT OF INFLATION ON INDEPENDENT TELEPHONE CONSTRUCTION EXPENDITURES

[In thousands]

| | Construction expenditures in historical dollars | Construction expenditures in 1965 dollars | Construction expenditures due to inflation |
|---|---|---|---|
| 1966 | 1,147,000 | 1,121,200 | $25,800 |
| 1967 | 1,276,000 | 1,203,800 | 72,200 |
| 1968 | 1,398,000 | 1,252,700 | 145,300 |
| 1969 | 1,595,000 | 1,355,100 | 239,900 |
| 1970 | 1,688,000 | 1,345,000 | 343,000 |
| 1971 | 1,999,000 | 1,497,500 | 501,500 |
| 1972 | 2,100,000 | 1,479,000 | 621,000 |
| 1973 | 2,390,000 | 1,614,900 | 775,100 |
| 1974 (projected) | 2,550,000 | 1,564,400 | 985,600 |

## INDEPENDENT TELEPHONE PLANT INVESTMENT PER TELEPHONE

| | Average plant per telephone | Plant additions per net gain in telephones |
|---|---|---|
| 1960 | $352 | $901 |
| 1965 | 456 | 1,026 |
| 1970 | 612 | 1,547 |
| 1971 | 655 | 1,728 |
| 1972 | 686 | 1,522 |
| 1973 | 720 | 1,498 |

## INDEPENDENT TELEPHONE CONSTRUCTION EXPENDITURES AND DEBT REDEMPTIONS

[In thousands of dollars]

| | Construction expenditures | Debt redemptions | Total |
|---|---|---|---|
| 1960 | 580,000 | 36,100 | 616,100 |
| 1965 | 940,000 | 61,300 | 1,001,300 |
| 1970 | 1,688,000 | 52,200 | 1,740,200 |
| 1971 | 1,999,000 | 54,200 | 2,053,200 |
| 1972 | 2,100,000 | 62,200 | 2,162,200 |
| 1973 | 2,390,000 | 41,600 | 2,431,600 |

## CAPITALIZATION OF THE INDEPENDENT TELEPHONE INDUSTRY

[Dollar amounts in thousands]

| | Long-term debt | Percent | Preferred stock | Percent | Common stockholders equity | Percent | Total |
|---|---|---|---|---|---|---|---|
| 1960 | $1,614,200 | 50.07 | $348,900 | 10.82 | $1,260,900 | 39.11 | $3,224,000 |
| 1965 | 2,865,600 | 53.66 | 368,200 | 6.89 | 2,106,600 | 39.45 | 5,340,400 |
| 1970 | 5,245,600 | 54.89 | 317,700 | 3.33 | 3,993,300 | 41.78 | 9,556,600 |
| 1971 | 6,106,500 | 55.05 | 355,900 | 3.21 | 4,630,600 | 41.74 | 11,093,000 |
| 1972 | 6,519,800 | 54.51 | 357,700 | 2.99 | 5,083,000 | 42.50 | 11,960,500 |
| 1973 | 7,179,800 | 53.70 | 538,100 | 4.02 | 5,653,500 | 42.28 | 13,371,400 |

## INDEPENDENT TELEPHONE DEBT COSTS

[Dollar amounts in thousands]

| | Long- and short-term debt | Interest expense | Embedded cost (percent) |
|---|---|---|---|
| 1960 | $1,767,200 | $64,400 | 3.64 |
| 1965 | 3,272,100 | 122,300 | 3.74 |
| 1970 | 6,164,500 | 322,600 | 5.23 |
| 1971 | 6,863,600 | 355,400 | 5.18 |
| 1972 | 7,396,100 | 399,400 | 5.40 |
| 1973 | 8,074,100 | 472,600 | 5.85 |

## INDEPENDENT TELEPHONE OPERATING REVENUES

| | Total operating revenues (thousands) | Percent increase over prior year | Total revenues per telephone |
|---|---|---|---|
| 1960 | $1,020,100 | 11.40 | $82 |
| 1965 | 1,668,700 | 9.92 | 113 |
| 1970 | 2,953,300 | 12.98 | 147 |
| 1971 | 3,390,000 | 14.79 | 160 |
| 1972 | 3,859,000 | 13.83 | 172 |
| 1973 | 4,400,000 | 14.02 | 183 |

## INDEPENDENT TELEPHONE COMPARISON OF INTEREST AND DIVIDENDS WITH TOTAL REVENUES

[Dollar amounts in thousands]

| | 1960 | | 1965 | | 1970 | | 1971 | | 1972 | | 1973 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total | Percent of revenues | Total | Percent of revenues | Total | Percent of revenues | Total | Percent of revenues | Total | Percent of revenues | Total | Percent of revenues |
| Total operating revenues | $1,020,100 | 100 | $1,669,700 | 100 | $2,953,300 | 100 | $3,390,000 | 100 | $3,859,000 | 100 | $4,400,000 | 100 |
| Interest on funded debt | 57,200 | 5.61 | 101,580 | 6.08 | 242,600 | 8.21 | 293,900 | 8.67 | 342,600 | 8.97 | 387,500 | 8.81 |
| Interest, other | 7,200 | .71 | 20,800 | 1.24 | 80,000 | 2.71 | 61,500 | 1.81 | 56,800 | 1.49 | 85,100 | 1.93 |
| Preferred dividends | 17,100 | 1.67 | 18,380 | 1.09 | 16,400 | .56 | 17,800 | .52 | 20,000 | .52 | 26,400 | .60 |
| Common dividends | 74,000 | 7.26 | 131,800 | 7.90 | 241,100 | 8.16 | 268,200 | 7.91 | 309,100 | 8.09 | 322,500 | 7.33 |

## INDEPENDENT TELEPHONE RETURN ON EQUITY

[Dollar amounts in thousands]

| | Net income less preferred dividends | Common stock equity | Return on equity |
|---|---|---|---|
| 1960 | $114,600 | $1,260,900 | 9.09 |
| 1965 | 227,100 | 2,106,600 | 10.79 |
| 1970 | 360,400 | 3,993,900 | 9.03 |
| 1971 | 437,500 | 4,630,600 | 9.45 |
| 1972 | 496,900 | 5,083,000 | 9.78 |
| 1973 | 575,800 | 5,653,500 | 10.18 |

## INDEPENDENT TELEPHONE SOURCES OF INTERNAL AND EXTERNAL FUNDS

[Dollar amounts in thousands]

| | 1960 | | 1965 | | 1970 | | 1971 | | 1972 | | 1973 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total | Percent | Total | Percent | Total | Percent | Total | Percent | Total | Percent | Total | Percent |
| Internal funds: | | | | | | | | | | | | |
| Net income | $131,700 | | $245,400 | | $376,800 | | $455,300 | | $516,900 | | $602,200 | |
| Plus— | | | | | | | | | | | | |
| Depreciation | 162,500 | | 299,500 | | 546,300 | | 624,500 | | 705,500 | | 804,200 | |
| Deferred income taxes | | | | | (1) | | (1) | | 130,500 | | 217,600 | |
| Unamortized investment Credit | | | (1) | | 3,800 | | 19,600 | | 52,200 | | 45,900 | |
| Subtotal | 294,200 | | 544,900 | | 926,900 | | 1,099,400 | | 1,405,100 | | 1,669,900 | |
| Less: Interest during construction | 7,900 | | 12,500 | | 49,900 | | 65,000 | | 65,300 | | 77,100 | |
| Total internal funds (cash flow) | 286,300 | 45.79 | 532,400 | 46.18 | 877,000 | 43.71 | 1,034,400 | 45.48 | 1,339,800 | 53.60 | 1,592,800 | 59.06 |
| External funds: | | | | | | | | | | | | |
| Bonds | 104,900 | | 254,300 | | 477,700 | | 541,800 | | 448,900 | | 418,000 | |
| Debentures and notes (long term) | 74,200 | | 109,600 | | 279,800 | | 375,900 | | 272,400 | | 344,000 | |
| Short-term notes | 50,400 | | 131,100 | | 90,800 | | (159,200) | | 134,200 | | 4,800 | |
| Preferred stock | 20,900 | | 15,700 | | 4,100 | | 29,300 | | 13,000 | | 178,600 | |
| Common stock | 88,600 | | 109,700 | | 277,200 | | 452,300 | | 290,800 | | 158,700 | |
| Total, external financing | 339,000 | 54.21 | 620,400 | 53.82 | 1,129,600 | 56.29 | 1,240,100 | 54.52 | 1,159,300 | 46.40 | 1,104,100 | 40.94 |
| Total, internal and external source of funds | 625,300 | 100.00 | 1,152,800 | 100.00 | 2,006,600 | 100.00 | 2,274,500 | 100.00 | 2,499,100 | 100.00 | 2,696,900 | 100.00 |
| Construction requirements | 580,000 | | 940,000 | | 1,688,000 | | 1,999,000 | | 2,100,000 | | 2,390,000 | |
| Cash flow as a percent of construction requirements | | 49.36 | | 56.64 | | 51.95 | | 51.72 | | 63.78 | | 66.64 |
| Dividend requirements: | | | | | | | | | | | | |
| Common | $74,000 | | $131,800 | | $241,100 | | $268,200 | | $309,100 | | $322,500 | |
| Preferred | 17,100 | | 18,300 | | 16,400 | | 17,800 | | 20,000 | | 26,400 | |

[1] Information not available.

CONTINENTAL TELEPHONE CORP.,
*August 21, 1974.*

Hon. LLOYD BENTSEN,
*Chairman, Subcommittee on Financial Markets,*
*Senate Committee on Finance,*
*2227 Dirksen Senate Office Building,*
*Washington, D.C.*

DEAR SENATOR BENTSEN: The Subcommittee hearings on the capital market problems being encountered by the utilities seem to have been focused on the electric power and gas utility groups.

Since the telephone utilities are in deep trouble by reason of the capital market weakness and the extraordinarily high interest rates, I am hopeful that such relief as is contemplated, will apply to the telephone utilities as well.

I need not underline the fact that the telephone network is one of the most important components of our economic health and the general economy is enormously influenced by the communications service provided by the national switched network. Unless this economy is provided with an adequate telephone system, it will certainly affect our ability to emerge from the current recession.

Almost all of the independent telephone companies are selling in the market place below book-value and, hence, do not provide an attractive investment vehicle for people who have historically depended upon utilities as a stable income source for themselves or their estates. Moreover, the demand for plant remains unabated and serves to exacerbate the problem.

Continental Telephone is the third largest of the independent telephone companies; we serve over two million subscribers in 1930 communities. These communities are principally rural and suburban in 41 states.

The loss of our individual investor public coupled with the wholesale flight of institutional investors from utilities has created a condition of extreme peril for the telephone utilities. I believe that legislative and regulatory relief on a timely basis is an urgent requirement if we are to avoid a serious deterioration of service in this country.

I am attaching herewith some suggested forms of relief for your consideration.

Sincerely,

CHARLES WOHLSTETTER.

SUGGESTED LEGISLATIVE RELIEF

1. The investment tax credit should be increased to 10% if possible, but in no circumstance lower than 7%.

2. This must be coupled with either the elimination of the limitation on utilization or, at least, the limitation should be raised to 75%. In order to put this in its proper framework for you, I am summarizing herewith what the effect on my company would be in 1974:

SUMMARY OF INVESTMENT TAX CREDIT GENERATION AND UTILIZATION—1974

[In millions of dollars]

| | Rate of investment tax credit | | |
|---|---|---|---|
| | 4 percent | 7 percent | 10 percent |
| Investment tax credit generated | 7.3 | 12.7 | 18.1 |
| Investment tax credit utilization: | | | |
| (a) With 50 percent limitation | 4.1 | 4.1 | 4.1 |
| (b) With 75 percent limitation | 6.2 | 6.2 | 6.2 |
| (c) Without any limitation | 7.3 | 8.2 | 8.2 |

3. I believe serious consideration should be given to the establishment of some agency similar to the FDIC. In my view, in the ultimate this would cost the government nothing since it would be self-funding and would permit the utilities to do their long-term financing perhaps 200 bases points below their present cost, and I underline, that long-term financing is one of the most difficult problems facing us today. There are very few of us who would have expected to see the bond ratings of so great a utility as Pacific Telephone reduced by the rating agency, but we have indeed seen just that, and the problem is one which I have outlined in my letter.

4. I believe a very useful device for encouraging investment in utilities as opposed to some of these less productive places in the economy, would be to establish a date of September 1, 1974, and declare that all purchases of utilities shares after that date be exempt from capital gains tax. The suggestion made by Ted Brophy on automatic dividend reimbursement, I believe, has a great deal of merit.

Finally, America is almost unique in the world in the area of double taxation, and I believe some attention should be given to the deductability on dividends on preferred stocks. There is a destinction between dividends on preferred instruments and the interest paid on debt securities that does not answer any common sense analysis.

If these changes can be implemented quickly and if the government could take the lead in introducing state regulators to the economic facts of life, I believe our situation will be greatly improved.

CHARLES WOHLSTETTER,
*Chairman of the Board,*
*Continental Telephone Corp.*

---

## STATEMENT BY MARK H. FREEMAN, EXECUTIVE DIRECTOR OF THE LEAGUE OF NEW COMMUNITY DEVELOPERS

### THE DOMESTIC FINANCIAL CRISIS AND NEW COMMUNITIES

#### *Introduction*

These hearings are indeed timely. The full impact of the serious economic situation faced by this country can best be measured at the local level of government.

New community development has been particularly hard hit by the downturn in the economy and the failure of the Nixon Administration to implement many of the provisions of Title VII of the 1970 Housing and Urban Development Act.

Title VII created an expanded Federal program promoting the development of high quality new communities that meet a stringent set of economic, social, environmental and technological goals. In passing Title VII, Congress envisioned new-towns-in-town to help revitalize the central city, suburban satellite new communities to rationalize growth at the periphery of metropolitan areas, rural growth centers involving expansions of small communities with the potential for growth and completely new "free-standing" cities. These various new towns were viewed as part of a national growth policy that would improve the structure and distribution of regional growth and that would improve the quality of community development.

The Title VII new communities were intended to contribute to national goals at both regional and community scales in the following ways:

*Regional Scale*

Regional impact on the form of growth due to their large size.

Locations in accordance with national environmental and economic goals.

*Community Scale*

Economies of scale which decrease the per unit cost of developing land, constructing housing and providing services.

Rigorous planning and high standards which insure that the best of our planning knowledge goes into the creation of the new community.

Coordination of Federal, State and local programs to ensure maximum benefits from governmental programs and to eliminate wasteful duplication and inconsistency.

Balance among various land uses (residential, industrial, commercial, recreational, institutional) to achieve positive fiscal impact, racial and class integration, reduced commuting and transportation costs and minimize adverse environmental impact.

The development of a new public-private partnership devoted to higher quality development.

Pre-servicing of development to ensure that residents enjoy a full range of services.

Sites for innovation at community scale.

There may be other ways to achieve some of these goals, but for new development, new communities offer substantial advantages compared to other methods and they offer a way of achieving all of these goals in a coordinated fashion.

Title VII is an ambitious piece of legislation. However, it recognizes the difficulty of achieving these goals, and it provides a broad array of tools for encouraging public and private developers in the development of new communities. Unfortunately, most of these tools have not been funded or utilized by the Administration. Only the loan guarantee has been used to any substantial extent. These problems have now been compounded by rising labor and materials costs, energy shortages, increased costs for financing, and a slump in the housing market. The result has been difficulties for the program and fears that its original purposes will not be met.

Nevertheless, if properly used, Title VII is flexible enough to provide solutions for even this most luckless succession of events.

ARE TITLE VII'S GOALS STILL VALID?

Of course, it may not be worth the trouble to keep new communities alive. Maybe the goals of Title VII are no longer valid.

At regional scale, some critics claim that free-standing new cities, rural growth centers and new-towns-in-town yield too small a payoff in comparison to the risk and difficulty. The emphasis, say these critics, should be on suburban new towns. Certainly non-suburban efforts are difficult and risky. Yet, the needs of rural and urban America require that some risks be taken. More importantly, numerous cities have proposed new-towns-in-town; many rural communities have the will to grow and the prospects of growth if concerted action is taken; and many areas are being impacted by large energy related installations (e.g., deep water ports, refineries or power plants) or resource extraction industries and will face difficult problems of growth. For all of these situations, new communities offer the possibilities of catalyzing and structuring growth. The experience of foreign countries, especially England and Sweden, indicate some of the possibilities and limitations of these approaches. The evidence seems to suggest that the risks of not acting are much greater than the risks of using Title VII as a tool to shape growth. Certainly, at the very least, we must experiment with solutions to the problems of rural areas and central cities.

At community scale, some critics have questioned the importance of the technological, environmental, economic, governmental and social goals of Title VII. But, if anything, these goals are even more relevant today than they were when Title VII was approved by Congress. The Task Force on Land Use and Urban Growth of the President's Citizens' Advisory Committee on Environmental Quality recently referred to the "new mood in America" based on concerns about the shape and character of urban growth. The Task Force report (*The Use of Land*) stated the problem as:

"How shall we organize, control and coordinate the process of urban development so as to protect what we most value in the environment, cultural and aesthetic characteristics of the land while meeting the essential needs of the changing U.S. population for new housing, roads, power plants, shopping centers, parks, businesses, and industrial facilities?"

Other critics admit the importance of Title VII's goals, but they question whether new communities can help to achieve them and to solve the problems identified by *The Use of Land*. The Task Force's answer to these doubts is an unequivocal emphasis upon larger scale development:

". . . the scale of most development is still far smaller than optimum. And that small scale, we believe, remains a major obstacle to quality development."

The Task Force Report goes on to note that:

"Although an increase in scale does not guarantee higher quality, it does significantly increase the developer's opportunity to achieve quality. New communities, with the fullest range of functions and the most maneuvering room, appear to offer the greatest chances, but any increase in scale is likely to bring increased opportunity."

Other reports and recent events have borne out these contentions about the possibilities for higher quality development in new communities. These possibilities relate to the environmental, economic, social, governmental and technological goals of Title VII new communities.

*Technological Innovation.*—The energy crisis has made it apparent once again that community scale research is neglected and inadequately supported. The current emphasis is on energy conservation through better community development patterns and through demonstrations of new energy sources such as solar heating and cooling. Tomorrow the emphasis may be on solid waste management, and the next day on better security or educational systems. So far, these problems

have always been attacked on an *ad hoc*, crisis basis. It seems much more rational and realistic to start addressing all of these important areas today through a comprehensive Research, Development, Demonstration and Evaluation (RDD&E) program. New communities can be an important part of this program. As numerous people have observed (including Jerome Wiesner, Science Advisor to President Kennedy), new communities provide excellent locations for innovation at community scale. The Title VII program recognizes this and has fostered innovations in the use of cable television, educational systems, sewage treatment systems, industrialized housing and other areas.

*Environmental Protection.*—A recent report prepared by the International City Management Association for the Environmental Protection Agency noted the increasing importance of environmental management in local government. Another study by Real Estate Research Corporation (RERC) for the Council on Environmental Quality calculated significant environmental benefits for new community development over low density sprawl. So new communities can contribute to this important local concern.

*Economics Due to Better Planning and Larger Scale.*—The same RERC study showed that new community development provides significant financial savings over sprawled development.

*Positive Fiscal Impact.*—In many areas local governments have rejected growth due to fears about unfavorable impact on the area's tax base resulting from the high costs of infrastructure for new developments and the lack of offsetting tax revenues. A recent study by Barton-Aschmann Associates, Inc., of the St. Charles new community in Maryland found that it would have a very positive impact on both Charles County and the State of Maryland. Another study by Booz, Allen, Hamilton of Reston, Virginia (a non-Title VII new community), revealed similar results. Consequently, new communities seem to be a realistic way to deal with the legitimate fears of local governments concerning environmental degradation and unfavorable fiscal impact.

*Social Goals.*—Suburban development often suffers from a woeful lack of basic commercial, retail and social services, and it often excludes many income groups due to the high price of its housing and "snob" zoning which requires large lots and large homes. There is certainly a need for "pre-servicing" new development to insure an adequate level of services. Furthermore, with the increasing concern with the problems of low and moderate income housing, and with the possible advent of a housing allowance, there is a real need for efforts which provide this housing in a high quality environment. Title VII was designed to deal with both pre-servicing and with providing a wider range of housing choice. Achieving these goals has proved to be difficult because the most important aspects of Title VII (public service grants and supplemental grants and housing assistance) have either never been funded or poorly supported. But, even without this necessary support, new communities have provided a better living environment. A recent study by the University of North Carolina found that new communities have provided significantly better recreational and open space facilities.

*Governmental Goals.*—One of the goals of the New Federalism has been to coordinate the efforts of Federal, State and local governments and to ensure more consistency among various efforts. Title VII provides a variety of methods (e.g., the creation of the Community Development Corporation, the post of General Manager for New Communities, the supplementary grant program, provisions for joint funding, special planning assistance, the judicious use of "701" planning funds) for facilitating this coordination and consistency at all levels of government.

At the local level, *The Use of Land* notes that:

"Yet another advantage of large scale is that it allows local governments to apply more sophisticated regulatory techniques to achieve public objectives without the constriction that is almost unavoidable when projects are small."

Thus new communities can facilitate the development of a new regulatory framework (which implies a new kind of public-private relationship) and they can help to rationalize the existing melange of regulatory requirements. This latter possibility is especially important in light of a recent study completed for the Environmental Protection Agency which stresses that "a need exists to coordinate various environmental plans and regulations affecting land use."

All this evidence suggests that the goals of Title VII are still valid—especially in light of the critical national need to develop a far more disciplined approach to community building. It appears that an era of acute shortages and uncertain economic trends is upon us. New community devleopment provides a powerful tool to build more efficiently and effectively.

## PROBLEMS FACED BY THE PROGRAM

The basic issue now facing the Title VII program is whether it can be successful considering the constraints it must overcome. It is almost becoming a cliche to say that domestic programs have not been implemented along the lines set out by the Congress. The new communities program has been a major casualty of this general problem. For example:

Most of the grant provisions of the Act were never funded.

Suplemental grant support was terminated.

Subsidized housing allocations have not been provided in a timely manner or in the quantity called for in the Project Agreements entered into between the Department of Housing and Urban Development and the developer.

The program has not been effectively coordinated within HUD.

No formal interagency arrangements have been entered into with other Federal Departments or agencies. These arrangements are critical to the success of the program if the range of new town types called for in the legislation is to be achieved and the contemplated level of community services provided.

Federal Regional Councils have been of little assistance in helping work out the many problems encountered by public and private developers.

Formal standards and procedures have yet to be published by the Department in clear contravention of The Administrative Procedure Act.

Direct technical assistance to developers as called for under Section 719 has not been made available. This is particularly crucial since this new field is a most complex one.

## THE DOMESTIC FINANCIAL CRISIS AS THE COUP DE GRACE

All of these difficulties would be enough to stymie almost any Federal program. But in addition to these problems, Title VII new communities have just started out at a time when economic conditions have gotten progressively worse. The new community developer requires enormous amounts of capital to undertake a project. For example, one recent estimate determined that a community of 70,000 people requires a minimum of $700 million in mortgage loans for 20,000 dwelling units; another $400 million is required for capital outlay, public services and buildings; and about $400 million is needed for industrial and commercial development. Thus the total is about $1.5 billion.

This whole process is sensitive to economic conditions from a variety of directions. First of all, increased materials, energy and labor costs have hit the construction industry especially hard. New community developments use great amounts of diesel oil (averaging about 50,000 gallons per month). They use large amounts of asphalt, plastic products and other basic construction materials. Costs for these fuels and materials have increased greatly in just the last year, and in some cases there are delays in delivery due to rationing. As for labor costs, the removal of Construction Industry Stabilization Committee Controls, on April 30 of this year, has led to great pressure for large increases in wages and to an unstable "leapfrogging" as each group tries to stay ahead of inflation and each other. The result of all this is spiraling inflation that could cause developers to run out of money (borrowed through the loan guarantee process) before they have a sufficient cash flow to allow them to start paying back principal as well as interest on their bonds. Initial projections simply did not consider such runaway inflation as a likely possibility, and developers now find that their projects are undercapitalized even though their ultimate financial prospects may be very bright. This problem is exacerbated by infrequent reappraisals of the land used as security for their debentures. Consequently, increased land prices due to inflation are not taken into account and excessive amounts of money are tied up in escrow accounts.

Secondly, increased mortgage costs and building costs have made it difficult for builders to build housing and for homebuyers to buy homes. There is a slackening demand for homesites and a resultant reduction in the developer's cash flow. Some of the most recent estimates of housing activity for 1974 predict that housing starts will be off more than 30% from 1973. Construction and home mortgages have increased by many percentage points in the last few years, and the amount of credit for home mortgages may be dwindling as disintermediation occurs and as other investment opportunities such as Treasury Bonds and floating rate debt offerings attract savings. As a result of all this, the cost of housing is rising from 15% to 20% (or even more) this year. Last year, exclusive of lot, the median sales price of a square foot of new home rose 11.4%.

Thirdly, the financing not covered by Title VII must be found in an extremely tight market. New equity financing is almost unobtainable. Debt capital for the industrial and commercial development which is a fundamental (and profitable) part of new community development can only be obtained at very high interest rates (if at all). One promising source of this type of money, the Real Estate Investment Trust, has been experiencing real trouble as money has tightened.

Finally, local governments which provide vital public services in many new communities are facing extremely high rates on their tax exempt municipal securities.

To a large extent, these difficulties are a result of Federal credit policies which have hit the housing and construction industry especially hard. The Chairman of the Federal Reserve Board, Arthur Burns, has ruled out a general easing of credit, but he has indicated that there may be justification "for assistance to particular industries—such as housing—that are especially hard hit by a policy of monetary restraint."

WHAT CAN BE DONE?

In the long-run the solution to the current problems of new communities is a healthy economy and full implementation of Title VII. Neither possibility seems to be at hand. In the interim, Title VII does provide for some relief, and it should now be possible to review programs like new communities and provide the help they need. Congress recognized that cash flow problems might occur at the early stages of even the best new communities, and it authorized interest payment loans under Title VII. The House Committee Report asserted that "this form of aid is essential in order to help solve the problem of delayed cash returns which has prevented significant new community developments." In addition, Title VII provides that the loan guarantee (in the case of a private developer) may cover the sum of 80% of land costs before development plus 90% of land development costs. As a result of inflation and other factors, many approved Title VII new communities could qualify for an additional guarantee which could help them to deal with their cash flow problems.

These two approaches, interest payment loans and additional loan guarantees, would have no impact on the budget totals in this year of budgetary stringency. The interest payment loans can be funded out of the revolving fund set up by Title VII. This fund contained almost $10 million as of December 31, 1973 and it has increased by several million dollars since then. The loan guarantees are excluded from the budgetary totals so that they will not affect the budget. And, of course, under Title VII, both approaches can only be used for a new community project when its long-term prospects are good. As a result, lenders will be repaid in full with interest.

SPECIFIC STEPS

HUD should proceed immediately to utilize these provisions of Title VII to help the fourteen approved new communities which have received initial loan guarantees. HUD should base its actions on some very simple facts:

1. The Federal government has decided upon a policy of monetary and fiscal restraint which hits hardest at housing (and especially hard at new communities where development pace is vital).

2. The Administration itself has failed to provide leadership; it has not fully implemented Title VII; and it has allowed the program to become mired in red tape.

Some efforts to clear up the red tape now seem to be underway at HUD. But this is a little late for those new communities which have seen time and money eaten up by protracted negotiations. And solving the red tape problem still leaves the more important issue of leadership and full implementation unresolved. Something more must be done. Of course, HUD should not overstep the Congressional mandate for new communities in an effort to save projects at any cost. But going beyond Congressional intent is not necessary. Interest payment loans and additional guarantees are both authorized by Title VII, and they are a natural approach to the current financial crisis which has been especially difficult for new communities.

Since HUD has already approved these fourteen new communities, it should be able to expedite applications for interest payment loans and additional guarantee authority. Even in cases where changes must be made in the Project Agreements, HUD's knowledge of the new community and its increasing expertise should speed things along. Mr. Trevino, General Manager of the new communities program, has emphasized a reduction in red tape so that this exercise should be a vast improvement over the past performance of the New Communities Administration.

Specifically, HUD should not have to go through a pre-application stage. It should be able to move immediately to a "full application". In most instances, this should involve no more than a slight expansion of the voluminous financial and economic data which HUD already requires. The major criteria should be the protection of the security interests of the United States through proof of ability to meet payments on both interest and principal and conformance with the limitations in Title VII. Where developers wish to make changes in development plans, HUD should create teams to quickly review and negotiate the changes.

CONCLUSION

New community development in this country can play a vital role as this country grapples with an uncertain economic future and the crushing problems of growth and development. The Congress has been unflagging in its support of the new communities program. We only hope that the Administration will provide the vigorous leadership necessary to implement this program. New town development has been successfully undertaken in numerous countries around the world. There is no reason why this program can't work equally well here.

---

NEW YORK, N.Y., *August 15, 1974.*

Senator LLOYD BENTSEN,
*Chairman of the Subcommittee on Financial Markets,*
*U.S. Senate.*

DEAR MR. CHAIRMAN: First of all, I want to thank you for the unusual honor and timely opportunity afforded me to express my views in these turbulent times on such pertinent topics. A series of financial problems of great magnitude now faces the world. Monetary crisis and a persistent balance of payments problem exist all through the developed, as well as in most developing countries. A sharply deteriorating international monetary system is being caused by a flow of capital from Western Europe and America, into a handful of countries. There is no doubt in my mind that the current unique financial development has started with the quadrupling of oil prices. An extraordinary situation has been created with far-reaching implications. It is the most important issue facing financial as well as political leaders all over the world today!

When we speak of inflation or impending recession we are only talking about the symptoms of the current malaise. When we talk about the banking crisis, we are speaking in terms of sensational headlines. When we speak of shortages and commodity price increases, we are still not getting at the root of the problem. In order to present a proper perspective, may I start by summarizing some salient financial figures in order to illustrate the current state of affairs in the international monetary system.

Since the beginning of the Middle East war in October 1973, due to the quadrupling of oil prices, a balance of payments deficit has been created in virtually all industrialized countries which is absolutely unsustainable at its current rate. As the table below illustrates, as of June 30, 1974, the 10 wealthiest nations of the world, which now include Saudi Arabia and Iran, have combined currency reserves of $71.7 billion, excluding the currency reserves of the United States, and approximately $83 billion if we include the United States into the total system. (The dollar holdings of the United States government are, of course, excluded.) The combined gold holdings of the above nations, excluding Saudi Arabia and Iran, amount to approximately $30.6 billion, calculated at the price of $42.22 per ounce. See Table I.

40-544 O - 74 - 10

TABLE I.—THE BIG LEAGUE IN OFFICIAL RESERVES

[In billions of dollars]

| | Gold reserves [1] | Foreign exchange, SDR's, IMF reserve positions [2] |
|---|---|---|
| United States | 11.5 | (3) |
| Germany | 5.0 | 26.0 |
| Japan | 1.0 | 12.0 |
| Saudi Arabia | .3 | 5.5 |
| Britain | 1.5 | 5.25 |
| Australia | 1.0 | 5.0 |
| Canada | 1.3 | 5.0 |
| France | 4.8 | 4.5 |
| Switzerland | 4.5 | 4.5 |
| Iran | .3 | 4.0 |

[1] Gold is being calculated at the official $42.22 per ounce.
[2] Calculated in dollars.
[3] Not comparable.

Source: "The Economist" (London, United Kingdom).

For the purpose of completing the overall evaluation, the total gold reserves of the 20 leading industrialized nations amounted to approximately $38.8 billion in December 1973. See Table II.

TABLE II.—OFFICIAL GOLD HOLDINGS OF OECD COUNTRIES

| | 1973 [1] | | |
|---|---|---|---|
| | | Volume | |
| | Value (millions) | Ounces (millions) | Metric tons |
| United States | $11,652 | 275.98 | 7,822 |
| United Kingdom [2] | 886 | 20.99 | 595 |
| Austria | 881 | 20.87 | 592 |
| Belgium/Luxembourg | 1,789 | 42.37 | 1,201 |
| Denmark | 77 | 1.82 | 52 |
| France | 4,261 | 100.92 | 2,860 |
| Germany | 4,966 | 117.62 | 3,334 |
| Italy | 3,483 | 82.50 | 2,338 |
| Netherlands | 2,294 | 54.33 | 1,540 |
| Norway | 41 | .97 | 27 |
| Sweden | 244 | 5.81 | 165 |
| Switzerland | 3,513 | 83.21 | 2,358 |
| Canada | 927 | 21.96 | 622 |
| Japan | 891 | 21.10 | 598 |
| Finland | 35 | .83 | 24 |
| Greece | 148 | 3.51 | 99 |
| Iceland | 1 | .02 | 1 |
| Ireland | 18 | .43 | 12 |
| Portugal | 1,160 | 27.48 | 779 |
| Spain | 602 | 14.26 | 404 |
| Turkey | 151 | 3.58 | 101 |
| Australia | 311 | 7.37 | 209 |
| Total OECD | [3] 38,331 | [3] 907.89 | [3] 25,733 |

[1] December 1973.
[2] September 1973.
[3] Includes United Kingdom to September.

Note: Converted at $42.22 per ounce of gold. Converted at 35,281 ounces equals 1 metric ton.

Source: International Financial Statistics.

Since gold has not been used in the past to settle international obligations, the entire flow of international trade, including the oil trade, was financed by the above mentioned $83 billion, supplemented by loan capital created by individual central banks or by the Euro-dollar market, which by current estimates amounts to approximately $170 billion in various currency denominations. In view of the enormous rise in the price of oil, which has quadrupled since last October, most of the nations in the world face simultaneous trade deficit problems. According to an estimate by Morgan Guaranty Trust, the Common Market countries will face a $25 billion trade deficit in 1974, and the developed countries combined approximately $40 billion in the current year. See Table III.

TABLE III.—*Estimated Balance of Payments for 1974*

[Based on current accounts: net trade in goods and services plus the net flow of remittances and foreign aid]

| | *Billions* |
|---|---|
| Great Britain | $8.5 def. |
| Italy | 8.0 def. |
| Japan | 6.0 def. |
| France | 5.0 def. |
| U.S | 2.5 def. |
| Canada | 0.5 def. |
| WestGermany | 6.0 surplus. |
| Estimated trade deficits for Western countries | 25.0. |
| For all developed countries | 40.0. |

Source: Morgan-Guaranty Bank.

The most obvious and plausible result of this huge oil bill and subsequent trade deficit by all major countries is a transfer of the currency reserves of the western world to the so-called OPEC countries, which since October 1973 have accumulated enormous dollar and other currency reserves. As reported in *The New York Times* on August 8, 1974:

"The reserves of 10 oil producing countries rose 16.12% in June to $29.96 billion following a gain of 15.7% in May as calculated by the International Monetary Fund. Since October 1973, the reserves of the OPEC countries have jumped from $12.88 billion to $29.96 billion. The members of OPEC include Algeria, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Saudi Arabia and Venezuela. According to the estimates of the IMF, in June the 10 oil producers had reserves amounting to 29.9% of the reserves of the group of 10 leading nations. In May, the percentage was 25.4%."

*This statement means that the 10 oil producing countries acquired 4.5% of the currency reserves of the 10 leading industrialized nations in one month.* At this rate, over a period of twelve months the OPEC countries could acquire an additional $50 billion in currency reserves from the West. With their already substantial $30 billion currency holdings, the OPEC nations would then possess approximately four times as great total currency holdings as the entire industrialized world, excluding the gold holdings of the various central banks. Naturally, this state of affairs cannot persist, unless we are willing to live in a world that is entirely different from the one we know today.

As time goes by, the disappearing liquidity of the western system is creating dislocations and deterioration in the economic structure of the western world. According to the latest estimate of the *London Economist* on August 10, 1974, the collective deficit of the 9 Common Market countries could amount to $40 billion in 1974. The same source estimates that had all prices remained static in 1974, the Common Market countries would have showed a surplus of $5–$10 billion. In other words, the collective oil bill for the Common Market may amount to roughly $45–50 billion for one year alone.

The immediate economic implications are obvious. Apart from the much-publicized double-digit inflation, which the press seems to have picked up as the single indicator of the current monetary woes, the results have been a market decline in the growth of industrial production, a pickup in unemployment, and more than double-digit increases in the money supply of virtually all of the 9 Common Market countries plus the U.S. and Japan. See Table IV.

TABLE IV.—KEY INDICATORS—THE NINE—OUTPUT, JOBS AND MONEY

| | Industrial production | | | Unemployment | | | Money supply | | |
|---|---|---|---|---|---|---|---|---|---|
| | Index[1] 1970 =100 | Percent change | | Index[1] 1970 =100 | Percent change | | Index[1] 1970 =100 | Percent change | |
| | | Previous 3 mo | 1 yr | | Previous 3 mo | 1 yr | | Previous 3 mo | 1 yr |
| Germany | 115 | Nil | +1.0 | 363 | +45.0 | +110.0 | 159 | +2.5 | +11.0 |
| France | 124 | +1.5 | +2.0 | 162 | −1.0 | +14.0 | [3] 170 | +4.0 | +16.5 |
| Britain | 107 | +4.0 | −3.0 | [2] 99 | +3.0 | −4.0 | [3] 193 | +1.0 | +24.0 |
| Italy | [4] 121 | +3.5 | +17.5 | [2] 86 | −10.5 | −19.5 | [3] 168 | +5.5 | +22.5 |
| Holland | 131 | +2.5 | +7.5 | 267 | +19.5 | +5.0 | [3] 155 | +5.0 | +16.0 |
| Belgium | [4] 125 | +5.0 | +8.5 | 132 | +1.5 | +4.0 | [3] 145 | +2.0 | +10.5 |
| Denmark | NA | NA | NA | 65 | −25.5 | −3.0 | [3] 145 | −2.5 | +12.5 |
| Ireland | NA | NA | NA | 105 | +3.0 | −2.0 | [3] 166 | +3.5 | +24.5 |
| United States | [3] 117 | Nil | +2.5 | [3] 114 | −1.0 | +7.0 | [3] 158 | +4.5 | +12.0 |
| Japan | 131 | −3.0 | +5.0 | 105 | +3.5 | −3.0 | [4] 185 | +3.0 | +16.0 |

[1] Index numbers (seasonally adjusted) refer to the 3 months to April or May, 1974. Industrial production excludes construction. Unemployment indices based on actual numbers. Money supply includes time deposits.
[2] Early 1974, late 1973.
[3] June and July.
[4] March.

Note: Industrial production figures for the EEC now look pretty sick. Even Germany can only show a small increase on a year ago and its jobless figure is already rising at a fast rate, having doubled over the past year.

Source: The Economist (London, United Kingdom).

Furthermore, if we re-examine the previous tables, it is obvious that the industrialized nations have sufficient reserves to last through 1974 and, perhaps, into the first part of 1975. However, they clearly do not have sufficient amounts of money in the central banks to complete even a three-year plan under the current price structure of the world's commodity markets. The only asset which has not as yet come into force in settling international obligations is the gold reserves of the western nations. At the current market price of $156 per ounce, the developed world has sufficient amounts of gold to support its trade deficit for 3 or 4 years. This period, on the surface, would give us sufficient time to re-arrange our entire style of living and, perhaps, develop some alternative source of energy rather than foreign oil. Regretfully, however, it should be noted that in the period since the inauguration of Project Independence, very few constructive steps have been taken to solve our energy problems. Simultaneously, on the financial front, governments have not been eager to utilize gold as a reserve asset to postpone the growing problems of the international banking world.

About two months ago, when the first two countries, Italy and Great Britain, started to accrue substantial foreign debt obligations, the Group of 20 industrialized nations met in Washington to authorize the government of Italy to obtain a multi-billion dollar international loan, using gold as collateral. This step came as a necessity since it was obvious that the government of Italy, with debts of over $10.5 billion in the Euro-currency market and a persistent payments deficit of an additional $500–700 million a month, simply could not sustain itself as a viable, financial entity or borrow without gold-collateral. Table V will illustrate the huge liabilities that are currently being sustained by individual countries in the Euro-currency market. See Table V.

TABLE V.—LONDON EURO-CURRENCY MARKET (LONDON BANK'S POSITION IN FOREIGN CURRENCIES)

[Dollar amounts in billions]

| | Outstanding liabilities (i.e. deposits) | Outstanding claims (i.e. deposits) |
|---|---|---|
| Japan | $3.62 | $10.87 |
| Italy | 8.62 | 9.84 |
| United States | 6.38 | 8.38 |
| France | 7.58 | 6.22 |
| Germany | 3.96 | 6.00 |
| Belgium | 5.83 | 5.30 |
| Switzerland | 15.14 | 3.00 |
| Canada | 4.78 | 2.98 |
| Netherlands | 4.30 | 2.45 |
| Brazil | 1.94 | 2.42 |
| U.S.S.R | .32 | 1.37 |
| Mexico | .96 | 1.27 |
| Norway | 1.13 | 1.25 |
| Denmark | .60 | 1.18 |
| Greece | 1.20 | 1.13 |
| Australia | .14 | .91 |
| Middle East oil producers | 4.15 | .84 |
| Spain | 4.32 | 9.84 |

Note: Figures for main industrial countries are end-March 1974; others end 1973

Source: The Wall Street Transcript.

This step will have many implications. My colleague, Mr. James Sinclair, a partner in the brokerage firm of Vilas & Hickey, aptly stated in an interview the following salient features of this historic decision:

1. The utilization of gold in the above format is a milestone because this is the first time since 1934 that the government of the United States clearly admitted that gold is a reserve currency of last resort.

2. In utilizing gold as collateral, no problem has been solved. In fact, it may be construed as a license to inflate currencies even further, but it is, at least, a temporary solution to save a major industrialized nation such as Italy from default on previous debt obligations.

3. The utilization of gold in international banking circles may lead to a new monetary system which will use gold in a more complex fashion. However, by reintroducing gold into the international monetary systems, the actual money growth of individual countries has to be monitored as well as restricted, and thereby greater responsibility in the international banking world would be attained.

This decision, in my opinion, has another psychological meaning. If we assume that, in the future, deficit countries will refrain from selling gold in the open market, which was not completely avoided by Italy and Great Britain in the last few months, and retain their gold holdings for the purpose of collateralizing international debt obligations, a question arises as to the treatment of loans that are gold collateralized versus those which are not. Should there be a great difference in terms of interest rates between the two different kinds of international obligations? These are major questions to which no answer has, as yet, emerged.

There is a possibility that by using gold both in settling international trade obligations and in strengthening various international debts, a new monetary sys-

tem could emerge—almost by default. Certainly, the integrity of the banking world has been seriously questioned since a few major banking failures have occurred during the last few months. In the United States, the Federal Reserve decided to save the Franklin National Bank and pumped approximately $1.2 billion into this $5 billion, major New York City bank. In Germany, the Bundesbank allowed the private bank Herstadt to go under, and thereby opened itself up to speculation as to whether the Bundesbank is or is not guaranteeing the integrity of the German banking system. The leading question, of course, which applies to every country, is whether the international banking fraternity as such can be considered totally secure and backed by each central bank. As an even more profound question, can the integrity of the Euro-dollar market be underwritten at all?

Let us look at a few figures here in the United States. See Table VI.

TABLE VI

[In percent]

| | 50 major banking organizations | | | Top 10 U.S. banks | |
|---|---|---|---|---|---|
| | Increase of deposits | Increase of loans | Increase of net worth | | |
| 1964/73 | 186 | 241 | 116 | | |
| | | 1964 | 1973 | 1964 | 1973 |
| Ratio of loans to deposits | | 61 | 72 | | |
| Capital to deposits | | 8.9 | 7.3 | 9.2 | 5.5 |
| Operating profit margins | | 17.3 | 8.9 | 20.0 | 8.0 |

Note: The aggregate amount of short-term borrowing by the 12 largest banking organizations climbed between 1968 and 1973 from $5,300,000,000 to $30,800,000,000.

Source: First Albany Corp.

The deteriorating structure of the banking giants is obvious. Even among the 10 leading banks, profit margins have dropped from 20% in 1964 to 8% in 1973. The increase in loans (241%) compared to the growth of net worth (116%) among the 50 major banking organizations has caused alarm. However, nothing is more questionable than the fact that the 12 largest banking organizations in the U.S. have increased their short-term borrowing from $5.3 billion in 1968 to $30.8 billion in 1973. Since, in the international banking world, most debts are medium to long-term, matching these loans against short-term borrowing is a clear departure from what has been generally regarded as sound banking practices.

The problem, of course, is even worse in Europe where the central banks do not have the financial muscle that the Federal Reserve has in the U.S. According to Mr. Sinclair, the Arab nations with approximately $80 billion in reserves, are differentiating, not by choice but by necessity, in lending mainly short-term and only to the largest financial institutions in Europe. Until the western world presents a more comprehensive plan to cope with the current monetary difficulties, we cannot expect anything different.

The fact that there is a banking crisis in Europe today should be neither forgotten nor overlooked. This crisis emerged when the Bundesbank decided to let Herstadt collapse, although the Bank of England and several other European central banks made statements that they would spare no effort to save the largest banks in their respective countries. Correspondingly, most depositors are pulling their money out of smaller banks and placing it with the larger banks. Frankly, this is a state of affairs that responsible central bankers should like to avoid. According to my readings, only 40 or 50 of the largest banks in Western Europe can obtain loans in the already overstrained Euro-dollar markets. The distortion of this state of affairs is almost too obvious as medium-sized banks find it difficult to obtain loans from other banks at almost any interest cost.

The crisis is further accentuated by the desire of the Arab countries to have the so-called buy-back oil payments to be made universally in dollars and not in any other currency. Since this statement was made unofficially, the dollar has risen very sharply in all major European currency markets. With the

impending illiquidity of the international banking world and the jittery effect of banking failures, defaults have brought forward currency trading down 50–60% during the last few months. Banks are unwilling to accept future contracts, except from their largest competitors. In addition, the effect of caution and slowdown in currency trading is, of course, a negative factor in international trade. This occurs at a time when the smooth financial transactions that accompany the exchange of goods between various nations are needed more than ever to increase exports of individual countries and thereby enable them to pay the oil bills. In other words, a vicious cycle is getting even more vicious.

Needless to say, the state of affairs in the financial world has nothing but negative effects on the stock markets of various countries. Almost exclusively, the world's market averages are hitting new ten-year lows as illustrated in Table VII.

TABLE VII.—KEY INDICATORS, WORLD BOURSES

| | Stock price indices Aug. 7 | 1974 | | Percentage change on— | | | |
|---|---|---|---|---|---|---|---|
| | | High | Low | 1 week | 1 month | 1 year | Record high |
| London | 237.8 | 339.3 | 232.1 | +0.6 | −6.3 | −44.1 | −56.3 |
| New York | 797.6 | 391.7 | 751.1 | +5.3 | +4.7 | −11.6 | −24.2 |
| Canada | 185.8 | 228.8 | 179.0 | +.5 | +3.1 | −15.5 | −21.9 |
| Australia | 318.2 | 536.1 | 318.2 | −3.7 | −16.3 | −43.3 | −52.0 |
| Japan | 306.6 | 342.5 | 299.2 | −4.4 | −7.0 | −18.5 | −27.4 |
| Hongkong | 331.8 | 481.9 | 290.1 | −1.9 | −4.5 | −51.2 | −81.3 |
| Belgium | 105.2 | 131.5 | 99.1 | −.8 | +5.0 | −22.0 | −26.1 |
| France | 63.2 | 85.1 | 59.1 | −1.7 | +4.6 | −27.9 | −36.8 |
| Germany | 566.7 | 609.2 | 537.0 | +3.6 | +3.9 | −9.5 | −45.1 |
| Holland | 124.4 | 140.8 | 115.0 | −.6 | +5.9 | −19.6 | −27.6 |
| Italy | 114.7 | 154.2 | 108.8 | −1.0 | +5.4 | −7.6 | −53.1 |
| Sweden | 374.7 | 410.6 | 323.8 | −1.1 | +.9 | −.9 | −8.7 |

Source: The Economist (London, United Kingdom).

In this environment, of course, it was not a total surprise when, in July, it was announced that the government of Iran had acquired a 25.4% equity interest in the Krupp Steel combine in West Germany. What does this mean?

The acquisition of this major interest in one of the oldest European corporations could be considered a milestone for petro-dollars acquiring direct ownership in the economies of the Western countries. Apart from potential financial benefits, the nét intangible dividend is the technological expertise to modernize Iran's own steel industry.

It has also been rumored that the government of Italy has obtained a yet unspecified type of $1.8 billion loan from the governments of the common markets and permission to draw an additional $3 billion loan from the Government of the United States and a $1 billion loan from the IMF. This loan will temporarily solve the problems of Italy and, consequently, it can be assumed that its central bank would cease to be a net seller of gold as it had been in the past two months.

We presume that the common market countries will continue to search for a $7–8 billion euro-dollar loan either from a syndicate of international banks or, more likely, from the Arab oil producing countries direct. In view of the shaky conditions of the euro-dollar market we presume that any such loan will be collateralized by gold in whatever denomination the loan would take shape.

These events, as well as the possible success of Secretary Simon's mission to the Middle East to obtain a direct $5–10 billion investment from Saudi Arabia in U.S. government securities, indicate to us that the power of the Arab money is now showing itself. There is every indication that we have not as yet seen the final shape in which the petro-dollars will assert their influence over the Western world but it is highly unlikely that charity, as opposed to businesslike associations, will remain prominent in their considerations.

Today, there are rumors in Switzerland and Lebanon that the Shah of Iran is also considering the purchasing of 28% of Bayer A.G., the largest chemical company in Europe. The transaction, based on current market prices, would amount to somewhere between $450–500 million.

Every politician would like to see some of the Arab money returning in one form or another to the West. However, we cannot help but question the implications of the OPEC oil money, which is being acquired at the rate of $6–7 billion a month, returning to severely depressed stock markets.

Needless to say, those of us who know a little about corporate takeovers understand fully the economic and political implications if such transactions do, in fact, take place.

Another of my colleagues, Mr. Meyer Berman, one of Wall Street's leading security analysts, spoke on July 22, 1974 to the New York Society of Security Analysts. In his speech, he quoted an imaginary headline from *The New York Times* for August 15, 1983:

> "Oil Producing Countries Unite and Tender United States New York Stock Exchange"

Let there be no mistake—this is a theoretical possibility! Accordingly, we have to question the political strengths, the military strengths and the financial integrity of the western world to avoid such a development.

This brings us to the issue of *recycling*. Let me explain what recycling means, how it helps our payment problems, and how it helps the current predicament of both the United States and other industrialized nations.

During the last six months since the increased oil bill has changed the financial structure of the industralized world, much attention has been paid in trying to attract the OPEC billions back into the international banking system. Miracles have been attached to the words "recycling of OPEC money". A new economic boom ending the major 5½-year bear market is expected once the surplus capital of the OPEC countries, particularly that of Iran, Kuwait and Saudi Arabia, is gainfully utilized in the western world. Undoubtedly, economic partnerships have usually been profitable, particularly if they serve the purposes of both parties concerned.

During the last few years, the word *Detente* has been construed to mean the ending of the Vietnam war and the creation of a better working relationship between the U.S. on one side, and the Soviet Union and the Peoples Republic of China on the other. The state of affairs known as *Detente* may become more popular because the word is pronounced usually with a charming foreign accent. As I see it, recycling is not *Detente*. Recycling is not even equity financing, it is the equivalent of a "*bridge-loan*", a financial term which has never gained the respect of the banking world. What such transaction amounts to is that Saudi Arabia, Kuwait or other wealthy OPEC countries place billions of dollars of loan capital into U.S. government securities or long-term bank notes of the largest international banks who, in turn, reloan them to other banking institutions. Then, as the cycle goes further and the liquidity of the banking system increases. this money would be allocated to large, creditworthy international corporations. In turn, these corporations would create business opportunities not only for their own employees but also for their suppliers. Finally, the increased liquidity of the industrial and banking worlds would recreate the conditions that existed in 1973, or before.

While all this is true, it is not the entire story. *Detente* is possible and can be negotiated due to the mutual permanent capital. It depends on the terms upon which the U.S. or other countries can obtain 5–10 year loan capital. It is the very loan capital that is currently in shorter money market instruments of the Euro-dollar market or in the U.S., made somewhat more permanent by the terms upon which it is given and accepted. However, on the ultimate level, these loans replace our own reserves, our own equity. To put it another way, our reserves are now being removed from our free use and being passed over to the OPEC countries. They, in turn, will set the terms upon which these newly acquired assets, as medium-term mortgage, long-term mortgage, or secondary mortgage money are redeposited in our banking system. However desirable this may be, it must be pointed out that this equity does not belong to the industrialized nations but to the OPEC countries. We will not have jurisdiction as to the ultimate movement of this capital beyond its temporary return for a few years to our own banking world.

*Moreover, in the current state of affairs, if we examine not only the trade deficit figures for 1974 but also for 1975 and 1976, we will see more and more of our equity disappearing and being replaced, if it is replaced at all, by several layers of mortgage capital under the label of recycled currencies. It is better than nothing, but it is certainly not a base upon which to build a future.*

Obviously, the U.S. and West Germany are probably the two countries whose respective treasuries are most likely to obtain the recycled-OPEC money because of the powerful economies that their monetary system represents. Apart from lending it back to the U.S. banks, the U.S. Treasury has in lending some of these recycled OPEC dollars to the Euro-dollar markets or to other countries as well. A few days ago in a press conference in London, Secretary Simon, on his way back

from his commendable mission to the Middle East, heroically announced that the U.S. would supply liquidity to prevent a chain reaction of failures in the Euro-dollar market.

Needless to say, the U.S. today does not have the reserves to underwrite the $160 billion Euro-dollar market, without a huge influx of capital during the next few years from the oil producing countries. It is questionable whether our banking system is sound enough or whether our government is liquid enough with long-term recycled OPEC loans to stand by every economic dislocation in the industrialized world. Secretary Simon's statement is obviously a commendable boost to the international banking world, but we do not escape the problem by making this obligation. Accepting the responsibility for patching up the imminent problems in the international banking fraternity is commendable but it is more our duty to get to the root of the matter itself. With the experience of Vietnam behind us—are we going to become the financial policeman of the world?

Under the new administration a number of practical steps have to be taken immediately to face up to the pending crisis that is facing the entire civilized world. If we recognize that the roots of inflation lie in the current energy crisis and, if we recognize that the present problems of the financial world are due to the trade deficits of today, and tomorrow, then, obviously, this is the problem that we must solve, putting aside all other considerations.

I would like to make a few recommendations which, in my opinion, are absolutely essential if we want to avoid what could potentially occur on August 15, 1983. On this date, the OPEC countries could tender, if not for 1,600 companies presently listed on the New York Stock Exchange, then for the remaining 800 or 900 companies that will still be listed at that time. My suggestions are as follows:

1. Ask Congress to examine all laws of the Environmental Protection Agency, declare a national emergency and modify those that hinder the production of energy.

2. Urge Congress to remove every restriction on coal mining, including strip mining, unless serious and immediate hazards to health can be justified. The objections of various environmental groups should be brushed aside until this country, as well as our major trading partners, are energy independent or, at least, on their way to independence in a meaningful fashion.

3. Urge members of Congress to stop at all levels of Government, the senseless witch-hunting of oil companies. Almost all oil companies invest over 100% of their cash flow in oil exploration every year. Now there is no question that if we want to explore for oil and natural gas, a lot of companies will make big profits and a lot of people become rich. At the same time, I would rather see big and small oil companies double or triple their profits—by finding and producing more oil and gas to sell at free market prices—than to see lower domestic energy exploration programs and to have our financial destiny in the hands of the OPEC countries. Most Americans can buy a share in any of the oil companies or oil service companies that search for American or Western energy. This is a subject which, I believe, should be explained properly to the American people.

4. In discussing energy, I think it is a good illustration to recall the Alaska Pipeline situation. There is oil in Alaska, there is natural gas in Alaska, there is no excuse for not having 3 or 4 oil and gas pipelines to tap the natural resources of Alaska. What hindered the economic development of Alaska was shortsightedness for which we are now paying a very heavy price. In April 1971, I first went to Alaska to study the economic and environmental issues that, at that time, were blocking the final permit to build the Trans-Alaska Pipeline System. I was given the honor of writing an article for the Anchorage Daily News. In this article, I said the following:

"There is no doubt that some of our liberal politicians have done a great deal for our country. At the same time, it would not hurt them to read some elementary books on economics and to understand that which can be clearly understood, that the ecological problems of Manhattan, where my 2½ year old boy has to grow up, are far worse than the ecological problems of the uninhabited Northern part of Alaska."

I received approximately 1,000 letters from citizens of Anchorage, thanking me for that article. The only thing that has changed since that article was written is that my son is now 5½ years old. The people of the U.S. are still no closer to receiving oil from Alaska.

I do not wish to dwell on the subject, but the Middle Eastern oil crisis was clearly predicted in 1956. I quote below, a letter from Sir Winston Churchill

to the late President Eisenhower, written during the Suez crisis. Its words are well fitting to the hearings of this Committee than, perhaps, at any time since the letter was written.

"There is not much left for me to do in this world and I have neither the wish nor the strength to involve myself in the present political stress and turmoil . . . there seems to be a growing misunderstanding and frustration on both sides of the Atlantic. If they be allowed to develop, the skies will darken and it is the Soviet Union that will ride the storm. We should leave it to the historians to argue the rights and wrongs of all that has happened during the past years. What we must face is that at present these events have left a situation in the Middle East in which spite, envy and malice prevail on every hand and our friends are beset by bewilderment and uncertainty over the future. The Soviet Union is attempting to move into this dangerous vacuum, for you must have no doubt that the time for Nasser could be an even greater time for them."

"The very survival of all we believe in may depend on our setting our minds to forestalling them. If we do not take immediate action in harmony, it is no exaggeration to say that we must expect to see the Middle East and North Africa coast line under Soviet control and Western Europe placed at the mercy of the Russians. If at this juncture we fail in our responsibility to act positively and fearlessly, we shall no longer be worthy of the leadership with which we are entrusted. . . ."

"WINSTON S. CHURCHILL"
HAROLD McMILLAN:
*Riding the Storm 1956–1959.*

Since this hearing deals with the problems of the financial markets, let us face the facts. The current state of the stock exchanges, the current state of the capital markets, the current state of the brokerage industry is so shaky that they are incapable of channeling the savings of the American people into fruitful vehicles to solve our energy problems. There are three major issues that I would like to discuss.

1. With the atmosphere in Wall Street gloomier that at any time since the Depression, and with the losses sustained by the brokerage industry higher than at any other time in the history of the U.S., I do not think it is time for experimentation with a new system whose implications cannot be correctly foreseen during the next 12–24 months. This is the time to strengthen our financial institutions, strengthen the brokerage industry and bring back the confidence of the investors in the integrity of our financial systems. Many experts have said, and I would like to reaffirm, that fully negotiated commission rates may lead to a better financial system. But for the short-term, when our problems are so serious, any untried experimentation can be very dangerous indeed.

2. Congress must recognise that the private investors over the last 6 years have consistently lost money on its investments. The investor lost money, his company or union pension fund lost money, he has no faith in returning to the stock market, and he cannot be blamed for feeling this way. The average investor is not upset because of the high brokerage commission rate he has to pay, he is upset because he lost money. It has been calculated that, if you take inflation into account, during the last six years the average stock has declined approximately 80% on most listed exchanges. I believe it was first proposed by Mr. Ross Perot and then by some other leading economists that a new set of laws should be enacted enabling every American to accumulate $50–100,000 in tax-free capital gains during his or her lifetime. This would be a true incentive to investors. As a security analyst, let me reiterate, we need the savings and the daring of every potential investor in this country to receate a prosperous stock market, a prosperous and functioning money-raising mechanism in the U.S.

3. Lastly, let me discuss a technical issue. This sub-committee has spent a year investigating the prospects and problems of the two-tier market. There were many abuses but there were many good reasons for that system. Let me quote one virtually unspoken issue that is more responsible than any other in eliminating the majorty of publicly-owned companies from large scale private or institutional ownership. I am referring to Rule 144 that became effective in April, 1971 when the Dow-Jones Industrial hit 970. This S.E.C. Rule permits non-registered securities to be sold after 2 years of holding, subject to certain volume considerations. In effect, it has been disastrous for the majority of securities. Every 6 months a torrent of selling can hit a particular security when the various option holders, letter stockholders, or original founders of

the company, can unload previously unlisted securities on the open market. Everybody knows that because of that net selling it is very difficult for most securities to gather strength. As my colleague, Mr. Meyer Berman, emphasized in a speech to the New York Society of Security Analysts, the abuse of Rule 144 has created a great many new residents on the North Shore of Long Island, in Westchester County, and in Palm Beach. It has also rendered virtually impossible for over 60% of the publicly-owned companies to achieve a decent price/earnings multiple. I hereby call on Congress to re-examine Rule 144 and, if possible, modify it and, if practical, to revoke it.

President Ford is probably facing a more complex set of economic and political issues than any other president since Franklin Roosevelt. For the first time in our history, the U.S. is not economically strong enough to cope with the financial might of countries which, up to the last 4 years, it did not even take seriously. Yet, we live in a civilized world and our problems can only be solved through negotiation. Former President Nixon embarked on this course calling his Administration an Era of Negotiation, and I trust President Ford will continue along this road.

The U.S. needs all forms of fossil fuel created in this country—so does the Western world. This is not the time for Norway to hold back its production of oil. This is not the time to have disagreement among the industrialized nations whose banking systems are inter-dependent. The liquidity crisis, the banking crisis, and the inflationary crisis will end or will see a road to improvement once the OPEC countries see that:

a. The Western world produces more and, therefore, requires less oil from them.

b. Our capital raising mechanism functions properly so that we can raise the necessary amount of capital to accelate the exploration of our oil reserves, our natural gas reserves, develop our oil shale deposits and obtain energy from nuclear sources.

If they see this happen, they will join us in order not to miss the boat. If they see that, year by year, we are able to cut back our oil imports, then they will cooperate with us today. If they see that our stock markets are not sinking but rising, they will be looking for ways to participate in our newly born prosperity.

In summary, let us clearly state that the quadrupling of oil prices has taken place because certain countries believed that the U.S. was weakened by internal strife; the "oil bill" upset the entire financial mechanism of the Western world. However, we do have the staying power, we do have the energy to improve our own internal situation. When this happens, slowly but inevitably every country in the world will join us and the U.S. will re-emerge with stronger financial markets and greater energy forces than ever before.

Respectfully submitted.

ANDREW G. RACE.

---

A STATEMENT ON FINANCIAL MARKETS BY ARMCO STEEL CORP., MIDDLETOWN, OHIO

We fully *concur with Senator Bentsen's statement:* "Our economy is currently not generating sufficient money to meet the capital needs of American business, as well as the capital needs of our states, counties and municipalities. As a result, new job opportunities that require capital investment are not being created."

Fiscal and monetary policies which prevailed in the early 1970's have contributed to a great extent toward the so-called *"double-dig" inflation in* our economy. During the inflationary period, the cost of money, like the costs of other commodities, has gone up to an unprecedented level in the United States. Besides the *high borrowing costs* which a borrower is faced with in money markets (short-term funds), as well as in capital markets (long-term funds), there are occasions when a borrower has no access to these financial markets. Business firms with bond ratings of less than single A confront serious problems in raising funds in today's financial markets.

Fortunately, *at Armco*, we do not have to raise long-term or short-term funds at the present time. However, our *debt ratio* has been the highest among major steel producers in the United States since the late 1960's due to major capital investments in our steel facilities. As a result, our bond rating has deteriorated and our borrowing cost has increased over the past several years. Debt financing, therefore, is not a major source that a corporation of Armco's size and financial background could depend upon for vitally needed capital expenditures.

An alternative to debt financing is *equity financing*. As the cost of debt climbs up, so does the cost of equity. A simplified expression of the cost of equity is the reciprocal of the widely publicized price/earnings ratio (P/E ratio). The lower the P/E ratio, the higher the cost of equity. In the recent past, the *P/E ratio has declined* substantially for most of the corporations. For example, the ratio for Armco used to be around 10 in the 1960's and the early 1970's, but it is now only 5. This means that an investor is now willing to pay only $5 for a common stock earning $1 per year, while he would have paid $10 per share only a few years back. Low price/earnings ratios have driven away many corporations in need of capital from using equity financing in the present day business environment.

Textbooks on investments generally emphasize that an *investment in common stocks is a hedge against inflation*. However, this has not been true for the last several years for common stocks of many companies. As a result, funds in the equity market have dried up.

For a given business firm, its *earnings* in terms of quantity and quality determine its capability to raise funds externally. Higher earnings in relation to investment enable the firm to attract equity capital at reasonable cost. Higher earnings also permit the firm to reinvest more dollars in the business which expands the firm's equity base, and the expanded equity base enables the firm to raise additional debt. The *Steel Industry* in general and *Armco* in particular has not been able to earn a reasonable return on investments because of government regulations and competition from foreign steel producers aided by their governments. As can be seen in the enclosed chart, Armco's return on total assets has been substantially below the average for FORTUNE 500 industrial firms during 1968–1978 period. It should be kept in view that Armco is one of the three best performers in the U.S. Steel Industry. With such financial plight, firms like Armco do not have enough funds from internal sources (i.e., net profit and depreciation) and are not very competitive in financial markets. As a result, these firms must limit their expansion and modernization programs resulting in shortages of basic commodities in the economy over the long run.

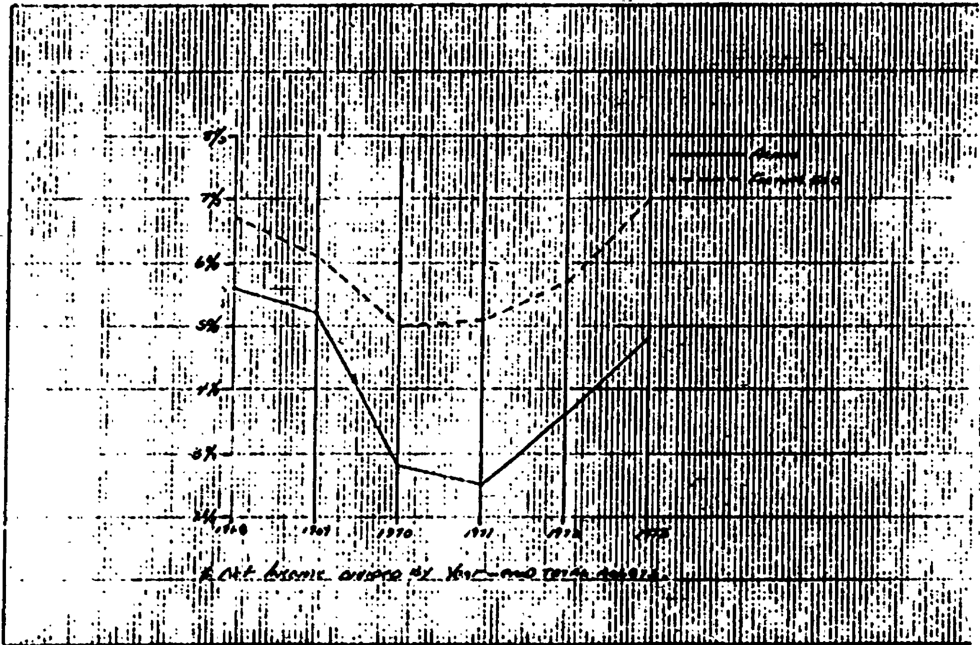
The problem of raising funds was eased to some extent with the usage of *tax-exempt financing* for pollution abatement facilities. With inflation, the cost of such financing has also increased in the recent past. This source of financing could be more helpful to the business community if speedy procedures used by various governmental agencies approving such financing could be developed, and if the interpretations of pollution abatement facilities were not so narrowly defined.

## WHAT THE GOVERNMENT CAN DO

The government, through its policies, must bring the rate of inflation and interest rates down to a reasonable level on a relatively permanent basis. Additionally, the government must enact those legislations which will enable businesses to earn a reasonable rate of return on the investors' capital and generate adequate cash flow to finance needed capital investments. This could be accomplished possibly by tax reduction and faster depreciation write-off regulations without repealing the present Investment Tax Credit. If business firms could generate more cash flow from internal sources, their demand for capital from financial markets would ease off.

A reduction in government spending would take some of the pressure for capital demand from financial markets and probably bring down the borrowing cost. Finally, some type of the government guarantee of loans needed by the corporations which do not have any access to financial markets would help avoid any threat of a domestic financial crisis.

We appreciate the opportunity to share our views with the Subcommittee on Financial Markets. We will be happy to provide additional information to the Subcommittee on the subject if necessary.



MUNICIPAL FINANCE OFFICERS ASSOCIATION,
UNITED STATES AND CANADA,
*Washington, D.C., August 20, 1974.*

HON. LLOYD BENTSEN,
*Chairman, Subcommittee on Financial Markets,*
*240 Old Senate Office Building,*
*Washington, D.C.*

DEAR SENATOR BENTSEN: The Municipal Finance Officers Association, representing over 5,000 fiscal officers and experts in State and local government, has great interest and operational responsibility in the behavior of the financial markets. The nation's capital and money markets are constantly called upon to supply approximately $50 billion in new long-term and short-term loans to States and localities each year in the process of helping to finance their $185 billion of annual direct expenditures. Thus unstable or deteriorating conditions in the financial markets can have a profound effect on the cost and availability of governmental credit and, consequently, the provision of public goods and services.

Recent history has shown that the municipal bond market, along with the mortgage market and perhaps small business finance, shows the greatest sensitivity to changing monetary conditions. This volatility in the cost and volume of borrowing is due to several factors, foremost of which are the unique role played by commercial banks as demanders of municipal bonds, the existence of certain institutional limitations such as interest rate ceilings, and the demonstrated need or willingness of States and localities to postpone borrowing plans in the face of high interest rate situations. While actual expenditures on projects to be debt-financed often can be insulated from temporary interruptions in bond sales, the degree of such insulation varies greatly among individual units and inversely with the duration of the credit tightness.

A series of surveys conducted by the Federal Reserve Board throughout the late 60's and early 70's were designed to measure the impact of changing credit conditions on State and local governments.[1] These provide the most detailed

[1] A detailed analysis of the survey results is contained in the articles by Paul M. McGouldrick and John E. Petersen, "Monetary Restraint and Borrowing and Spending by Large State and Local Governments in 1966," *Federal Reserve Bulletin*, (July 1968) and "Monetary Restraint, Borrowing, and Capital Spending by Small Local Governments, and State Colleges in 1966." *Federal Reserve Bulletin* (December 1968).

John E. Petersen, "Response of State and Local Governments to Varying Credit Conditions" *Federal Reserve Bulletin* (March 1971) and Paul Schneiderman "Planned and Actual Long-term Borrowing by State and Local Governments," *Federal Reserve Bulletin* (December 1971).

BEST COPY AVAILABLE

evidence of the sector's reaction to credit market conditions. The studies found that high and rising interest rates in the credit crunch periods of 1966 and 1969–70 lead to massive reductions in State and local borrowings (about 10 to 25 per cent below the intended levels) and, in turn, that the borrowing postponements led to capital spending reductions equal to about 25 to 30 per cent of the dollar volume that was planned, but was not borrowed. Of course, these reductions in spending took quite some time to materialize and were transitory if the borrowing delay were temporary. Most projects were kept on track in the face of long-term borrowing delays by use of short-term borrowing, or to a lesser extent, by the use of liquid assets.

Several important findings stand out:

First, small units were the most likely not to alter their borrowing plans voluntarily mainly because if they did not borrow long-term, they had limited alternative means of financing. Thus, when smaller governments are forced to postpone, it signals real problems for spending plans.

Second, large units frequently would voluntarily postpone long-term borrowings, especially if they had alternative means of temporarily financing projects. Thus, the liquid asset position of governments and their access to short-term loans are of critical spending problems in credit restraint periods.

Third, State-imposed interest rate ceilings were of great importance in the 1969 and 1970 shortfalls in borrowing, but revisions and suspensions have lessened their impact today. Long-term borrowing postponements are most likely to be made on a voluntary basis either because the project became infeasible at very high rates or because it is felt worthwhile to anticipate a decline in rates. The much greater amplitude in municipal bond rates over the past five years probably encourages an attitude of voluntarily holding up definitive financings until rates turn down, as well as greater use of call provisions on bonds and partial borrowings.

Fourth, ultimate impacts on spending and other financial dislocations depend on both the size of the rise in interest rates and the duration of the squeeze. Governments evidently are able to cope with sharp—but temporary—increases and gradual upward moves in borrowing costs, but rapid moves to prolonged higher levels of interest costs will spell the greatest problems, especially for those who have stalled definitive funding in hopes of a future relaxation of rates.

Since the credit crunch of 1969–70, the municipal bond market has maintained a farily even keel, albeit at higher levels. Interest cost on twenty-year municipal bonds have generally fluctuated between 5.0 and 5.5 per cent. However, in March of this year interest rates began a sharp upward climb. Rates by mid-August were about 150 basis points (or 30 per cent) higher than four months earlier. Upsurging rates have lead to several large, well-publicized postponements. From April 1 to June 28 (the latest data for which postponements are available from *The Bond Buyer*), a total of 51 State and local issues were held back from the market, totalling about $660 million. Subsequently, the months of July and August have experienced large displacements. Whether these will materialize into permanent reductions remains to be seen.

It should be pointed out that postponements as tabulated by *The Bond Buyer* represented the last decision point on borrowing postponements. Studies have shown that in prolonged periods of high interest costs, borrowers simply will not bother to advertise sales that they know will be too costly, thus published postponements represent only a portion of delayed or abandoned financings. The longer that rates stay around historic highs—or advance to new ones—the larger will be the volume of unpublicized shortfalls in bond sales.

It is our opinion it is perhaps too early to attempt a measurement of the impact of recent tightenings on State and local finances. But it is undeniable that careful watching and a cautionary attitude are definitely in order.

Certain key areas suggest themselves as particularly worthy of surveillance:

Short-term borrowing, the preferred alternative source of capital funds, has become increasingly expensive and its rapid growth must be watched carefully. The piling up of large short-term liabilities, often borrowing under ceilings on interest notes that are only temporarily suspended, can transmit borrowing pressures to later dates and thus auger a prolongation of tightness in the municipal bond market.

The advent of general revenue sharing has provided an influx of funds that has reduced somewhat State and local government borrowing demands. This has relieved some credit market pressures over the past two years. However, as revenue sharing funds become built into operating budgets to help meet spiraling

operating costs, they will become less available for capital items. Obviously, a sudden withdrawal of revenue sharing money would not only intensify capital market needs, but will also mean that more tax dollars will be needed to keep up service levels. In both cases, loss of revenue sharing would intensify the borrowing demands of State and local governments.

Bank demand remains of primary importance to the demand for municipal bonds. In periods of tight money the loan demands of business have first claim on bank credit and this heightens municipal market problems. Efforts, therefore, to attract more of the banking system's lendable funds to other sectors—such as the housing market which, unlike the municipal bond market, already received extensive Federal assistance—will weaken bank support of the public bond market. Therefore, such proposals as full insurance of public deposits, which seek to divert more of the supply of savings to other sectors, can have a disastrous effect on the State and local bond market. Further erosion of bank demand for municipals must be avoided.

Tax-exemption of the interest income of municipal bonds is the primary determinant of borrowing costs and continued public confidence in this exemption for municipal bonds is of key importance in maintaining reasonable rates. This is especially so when the retardation of commercial bank investments in municipals necessitates greater purchases by individual investors. Therefore, any expansion of credit sources beyond the use of conventional tax-exemption would only be of benefit to the extent it provides an additional, rather than exclusive, source of funds and leaves the tax-exempt market as a feasible and unfettered alternative. Mixing notions of market expansion with those of erosion of the present exemption of State and local securities is both distracting and very expensive for borrowers when it undermines investor confidence in existing tax-exempt bonds.

Over a longer perspective, there is no doubt that the most critical factor in averting financial chaos in the municipal bond market (and everywhere else) is a stemming of inflation. Today's high interest costs will be absorbed permanently into the governmental cost structure to be financed by higher future taxes. At the same time, spiraling construction costs can force issuers to raise money and let contracts before prices ratchet up, thus forcing panic borrowing and buying decisions. Other destructive consequences of rampant inflation on the State and local sector are too numerous to review here, but those evidenced now in the capital markets are merely straws in the wind for a sector that employs one out of every seven wage earners and which collects taxes from us all.

We respectively request that this letter be made a part of the permanent record of the hearings on this subject.

Sincerely,

JOHN PETERSEN,
*Washington Director.*

---

## STATEMENT OF JOHN WINTHROP WRIGHT

### SUMMARY OF PROPOSALS FOR LEGISLATIVE AND REGULATORY REFORM OF AMERICAN ECONOMIC AND MONETARY MANAGEMENT

I. Require by Resolution, U.S. International Negotiation to Create an Inflation-proof Standard of Value in the International Monetary System.

II. Require by Resolution, U.S. International Negotiation of An Agreement to Regulate the Creation of "Eurodollar" and Other Foreign Currency Deposits in Non-domiciled Banks.

III. Enact Legislation to Insulate Domestic U.S. Monetary and Credit Policies from the Influence of Excessive Foreign Capital Requirements and Interest Rates.

IV. Expand by Legislation, the Federal Reserve Board's Regulatory Powers to Include Variable Reserve Requirements Depending on the Proportion of Each Bank's Loan Portfolio Allocated to National Economic Purposes and Priorities.

V. Establish by Legislation, More Precise Requirements and Procedures for National Economic and Financial Policies.

VI. Expand and Revise by Legislation, the Requirements for and Terms of Office of Membership of the Federal Reserve Board so as to Provide for Broader Representation of Public and National Interests.

VII. Limit by Legislation, Interest Rates on all Deposits including Negotiable Certificates of Deposit to a Maximum of 1% Less than the Prime Bank Lending Rate or 5%. whichever is Higher.

VIII. Repeal the One-Bank Holding Company Legislation and Limit Banks and Banking Corporations Strictly to Banking Functions with No Involvement in Investments, Insurance or Other Non-banking Activities.

IX. Establish by Legislation, a "Citizen's Capital Investment Tax Credit" to Encourage Savings and Capital Formation by Individual Citizens and thus Reduce Inflationary Spending Demand while Increasing the Supply of Productive Capital.

## Outline of Testimony

(By John Winthrop Wright)

### A. Background and Qualifications of John Winthrop Wright

(1) Born Bridgeport, Connecticut, June 27, 1912.

(2) Education: Phillips Exeter Academy 1929, Amherst College 1933, Teacher of Economics St. John's College 1939–40.

(3) Experience: Accountant, Home Owners' Loan Corporation, Washington, D.C. 1933–36; Special Representative, Mortgage and Trust Departments, First National Bank, Bridgeport, Connecticut 1937–38; Fraternity Business Manager, Amherst College 1938–39; Treasurer, St. John's College, Annapolis, Maryland 1939–40; Commander, active duty, U.S. Naval Reserve 1940–47; Executive Vice President, Standard Air Service 1947–48; Founder and President, Wright Power Saw and Tool Corporation 1947–54; Sr. Partner, Andres Trubee and Company, Financial Consultants 1955–59; Chairman, Rototiller, Incorporated 1958–59; President, Wright Investors' Service, Bridgeport, Connecticut, 1960 to date. Wright Investors' Service is an investment management and advisory organization, registered with the United States Securities and Exchange Commission since 1961, presently consisting of 120 officers and employees, managing directly about one quarter of a billion dollars of investments of corporate and union pension and profit sharing funds, eleemosynary institutions and other organizations and individuals, and serving as investment adviser to 17 NYSE member brokerage firms and about 500 banks and institutional investors.

(4) Author: "Q.V.T., Three Keys To Stock Market Success," published by Prentice-Hall, Inc., 1970. Also numerous articles on investment and economic subjects in most leading financial journals.

(5) Address: John Winthrop Wright, Wright Building, 500 State Street, Bridgeport, Connecticut 06603. Telephone: 203–377–9444.

### B. The Purpose of this Testimony

(1) As a citizen, to protest the ill-conceived legislation and the misguided governmental policies and management which in six years have drastically damaged and are now destroying the American free enterprise system as we have known it.

(2) As an investment counselor and manager, to ask for relief from the unrelenting pressure by which the Federal Reserve Board has caused the greatest shrinkage of American security values since the great depression of the nineteen thirties, virtually destroyed our equity markets, forced the liquidation of individual ownership of publicly held corporate equity securities and of most of the securities industry, caused the transfer of ownership of American industry from individual to institutional investors, and transformed us from a nation of investors into a nation of lenders and borrowers.

(3) As both a lifelong student of finance and economics and a practical businessman of thirty years experience, to point out the dogmatic, pedagogical misconceptions and the obvious lack of objective, constructive thought which have caused these ill-conceived governmental policies and brought us to this sorry state, and to present to this committee some remedial and constructive proposals which, I believe, have at least the merit of objective logic and common sense.

C. THE CURRENT MISCONCEPTIONS OF OUR ECONOMISTS AND NATIONAL ECONOMIC AND MONETARY MANAGERS VS THE TRUE CAUSES OF AND REMEDIES FOR INFLATION

Misconception Number One . . . that the cause of today's inflation is excessive growth of the nation's domestic money supply, and that this has been an unavoidable result of excessive government spending.

I submit that this is a gross over-simplification and distortion of the facts. The inflation of 1968–70 which reached a 5.3% annual rate (GNP deflator) was a result of financing the escalated costs of the Viet Nam War without either raising taxes or imposing controls, but the double digit inflation of 1973–74 is a result of a confluence of factors, none of which may be laid at the door to excessive government spending *per se*. Here is a list of the true causes.

(1) The accumulated Federal deficits of 1970–73 were a contributing factor to, but by no means the principal cause of today's inflation. These deficits, in fact, resulted primarily from a decline of more than −10% in federal tax receipts per capita (in constant dollars) from 1969 through 1971, and an expansion of nearly +20% in expenditures (in constant dollars) from 1970 through 1972, both of which were a direct result of the until then unprecedented contraction in 1969–70 of our money supply by the Federal Reserve Board and the consequent decline in national product, corporate and personal incomes, and the government's tax revenues thereon. *Neither the decline in tax revenues nor the "economically stimulative" expansion of federal expenditures would have occurred if the Federal Reserve Board had not taken it upon itself to plunge the nation into a recession in 1969–70.*

(2) The Administration's decision in 1971 to suspend the convertibility of the U.S. dollar into gold although necessary to correct a long term accumulated imbalance of international payments, cast practically all of the world's currencies, as well as the dollar to which they had been tied, afloat upon a confused and angry international sea. The result was a worldwide loss of confidence in the stability of practically all governmental currencies and an unprecedented, excessively stimulative demand for every kind of tangible store of value which caused world commodity prices to more than *double* within one year, and created material shortages which substantially impaired production in the United States and caused severe imbalances between supply and demand for practically all products.

(3) The devaluation of the U.S. dollar, although necessary to restore the international competitiveness of U.S. dollar priced exports, was also a direct result of the long term mismanagement of our international trade and finance, our subsidy of foreign nations, and the export of American capital to increase production overseas instead of in the United States. The resulting cumulative decline of −17.4% in the U.S. dollar's international purchasing power was in effect a de facto recognition of the U.S. dollar inflation which had already occurred internationally, and which has subsequently been reflected in the increase of domestic prices. Please note that a −17.4% dollar devaluation is equivalent to a +21% price rise, and that this alone is equivalent to two years of double digit inflation at annual rates.

(4) The foreign-controlled increase in the cost of energy, has, of course, been an inescapable and major factor in our current inflation. Certainly, this was not and is not subject to correction by reducing the domestic money supply, or by any other domestic measures, except for the long term development of alternate sources of energy which, incidentally cannot possibly be successfully financed if today's usurious level of interest rates is permitted to continue. The energy price rise, although more than double for foreign oil, averages out, according to our calculations, to close to a +50% overall average price rise in all U.S. energy costs, foreign and domestic. Although this is still in the process of permeating the price structure of practically all U.S. goods and services, the process is now nearing completion and this major cause of domestic inflation will soon become an historical fact as distinguished from a continuing factor.

(5) The unregulated increase in the supply of "Eurodollars" has been equivalent to a +115% increase in the total supply of current U.S. dollars (M1) since 1968, +95% of the total current money supply of $241 billion at the beginning of the period ($200 billion in domestic funds [M1] plus $41 billion in Eurodollars

already on deposit in foreign banks). The Eurodollar increase was also equivalent to +57% of all dollar deposits inside the U.S.A. including all time deposits. The FRB regulated domestic U.S. money supply (M1) increased by only +40% during the same period (or 38% of all current dollars including Eurodollars at the beginning of the period). The unregulated massive increase of Eurodollars has been and still is unquestionably a major domestic as well as a worldwide cause of inflation. Believe it or not, the supply of "Eurodollars", which are essentially deposits in foreign banks abroad payable in U.S. dollars, is now almost as great as the entire U.S. domestic money supply of about $279 billion in currency and demand deposits in U.S. banks (M1). These dollars, have in part been simply created by foreign bank dollar loans and are not backed, directly or indirectly, by reserves in U.S. Federal Reserve banks. Here is the major villain of the inflationary piece, for these dollars, "fictitious" or not, do represent actual dollar buying power demand and are therefore a very powerful factor in the demand/supply imbalance which has created today's inflation. This unregulated creation of U.S. dollars by foreign banks is a continuing inflationary factor which can and should be brought under strict U.S. control. Is it not incredible that our government's monetary authorities are now drastically restricting the U.S. domestic money supply and our domestic economic growth, while completely neglecting to take any measures to reduce or even to bring under control this enormous, unregulated foreign-made expansion of U.S. dollars?

(6) The suspension of ceilings on negotiable bank certificates of deposits in June 1970, while essential at the time to avoid a nationwide financial panic of the first magnitude which then threatened to result from the FRB's excessive and prolonged "credit crunch" of 1969–70, has since turned out to be a financial Frankenstein of previously unimaginable power. Herein is the cause of the apparent paradox of unprecedentedly usurious interest rates and an "adequate" supply of bank lendable funds—that is by big banks to big borrowers. For while the conventional "current money supply" of currency and demand deposits (M1) has been growing at an average +6.8% annual rate during the last 5½ years (+6.8% during the last eighteen months), large certificates of deposit have averaged a +25% compound annual rate since 1968, have skyrocketed to a +54% annual growth rate since 1972, and have caused the total money supply including all demand and time deposits to rise at a +12.7% annual rate during the same period.

The adverse effects upon the American free enterprise capitalistic system of this suspension of regulation of large negotiable bank certificates of deposit can scarcely be exaggerated. This one terrible mistake, which benefits no one except the large banks, has caused:

(a) The escalation of interest rates to levels which are unprecedented in our history, were inconceivable a few years ago, are nearly double the rate which centuries of civilization have considered "usurious", and are unsustainable by a productive society. It is interesting, if somewhat disconcerting to note that in the early vigorous days of the Roman Republic 8⅓% was the maximum legal rate of interest; this was raised to 12% in 87 AD as the empire began to decline.

(b) The demoralization, disintegration and forced liquidation of our securities markets for common stocks, bonds and commercial paper alike.

(c) The concentration of financial and economic power in the major banks, interposing big bankers between the owners and the users of capital and causing the transformation of equity capital into debt, investors into lenders and businessmen into borrowers instead of partners.

(d) A dangerous shift from long term capital investment into short term lending, which seriously reduces the true liquidity of our banks and the availability of long term investment capital for the expansion of competitive, productive enterprise.

(e) A serious impediment to the liquidity, viability and growth of our savings institutions and a very real threat to the American tradition of individual home ownership.

(7) Finally, high interest rates are themselves a primary cause of inflation for two reasons:

First, because the very reason by which they are justified—"to slow down the economy"—actually slows down production before consumption, reduces supply before curtailing demand, and thus accelerates inflation while causing recession.

Second, because interest costs are themselves a major component in the cost of goods and services. Gross debt of the United States Government now amounts to close to $500 billion. Each additional 1% added to the cost of servicing that

debt amounts to $5 billion. Thus the increase of $11.2 billion in the annual interest cost of the federal debt, which has already resulted from the increase in interest rates, can be computed to have inflated by about 2% per year that portion of the cost of our Gross National Product which represents interest on the Federal debt alone. When we compute an estimated average 5% increase in current vs 10 year 1959–68 average annual interest costs on private consumer debt of $178 billion, plus the progressive escalation of interest rates from 6% to 9½% on mortgages of $620 billion, we add billions more to inflation. Altogether, U.S. public and private debt now totals more than two and a half trillion dollars ($2,526 billion at 1973 year end), about double the U.S. Gross National Product, which is now estimated at $1,383 billion. Thus each 1% addition to interest costs adds close to 2% to inflation. A very significant portion of the inflation of 9.3% during the last 12 months can be attributed to the concurrent escalation of interest rates.

Misconception Number Two . . . that the current rate of inflation is unprecedented in our history and threatens the destruction of the American capitalistic system.

This is simply not true. Since World War II, inflation in the United States has twice before reached "double digit" proportions, first in 1947 with the post-war relaxation of wage/price controls and second during 1951 as a result of the Korean War. Both cases, represented essentially one time price adjustments and were followed by a return to "normal" rates of less than 3% within one or two years.

I submit that it is thoroughly irresponsible for any of our economic leaders to threaten our nation with the permanent destruction of our economic way of life unless we accept their program for an extended period of economic regression. The recent excessive rate of inflation is essentially a "one time" adjustment which has already run most of its course, and which was the inevitable result of the domestic governmental mismanagement and the international developments which have already been outlined. These inflationary measures have already taken place, and there is no reason to believe that the excessive inflation which they caused will continue beyond 1974 unless excessively restrictive FRB monetary policies and a prolongation of prohibitively usurious interest rates are allowed to cause another recession to be followed again by stimulative spending and a renewal of federal deficits.

Misconception Number Three . . . that the principal remedy for inflation is unrelenting restriction of the domestic supply of money and credit and a continuation of unprecedentedly high interest rates.

The rationale for this belief assumes that all inflation is caused by an increase in the domestic money supply, and is therefore curable by reducing the supply, or is at least stoppable by ceasing to increase it. This would be demonstrably valid if the United States were an island, entirely insulated from the rest of the world; but it is demonstrably false in the present circumstances because the regulated U.S. domestic money supply has not increased excessively. On the contrary, it is the unregulated foreign supply of dollars, known as "Eurodollars" which have proliferated and are the fundamental cause of a worldwide inflation in which the United States has been caught up because it did not take effective measures either to control this proliferation or to insulate itself against its effects. To hold that this is curable by starving the American domestic supply of money and credit, and denying American business the working capital which is vital to its existence seems to me to represent a new high in irrationality.

Misconception Number Four . . . that these policies, currently described as "that old time religion" have been successful in the past and must now be employed regardless of their consequences in reduced national productivity, increased unemployment, and a reduced standard of living for our citizens.

Although a balanced federal budget may perhaps be properly described as an "old time religious credo", the history of the application of policies of excessively restrictive monetary growth can be described as "successful" only if one is willing to consider the creation of a series of domestic recessions as a successful accomplishment. The disinflation of 1930 which followed the speculative boom of 1926–29 was unnecessarily turned into the "great depression" of the nineteen thirties as a result of the unrelenting contraction of money and credit by the Federal Reserve Board. and was finally corrected after three years of unnecessary damage to our economy, by the then unprecedented, easy money and low interest rate policies of the New Deal. During the last two decades, the United States has experienced a series of interruptions of the growth of its gross national product and the standard of living of its citizens (1957–58, 1960–61, 1967, 1969–70, and now in 1974), none of which had to happen and all of which were caused by excessive con-

traction of money and credit by the Federal Reserve Board. Two wrongs do not make a right, and there is simply no logic in a belief that because poor monetary management has caused excessive expansion from time-to-time in the past, it necessarily follows that stable monetary growth is not attainable and that excessive monetary restriction and recession are unavoidably required periodically to offset a prior cyclical period of excessive monetary growth.

When I hear over and over again the statement that high interest rates and a stagnant, no-growth economy are "necessary to fight inflation", I cannot help but be reminded of the post-medieval era when the medical profession believed, practically to a man, and had persuaded the public of the "scientific" doctrine of "phlebotomy", which held that bloodletting was practically the universal cure for diseases of all kinds, ranging from high blood pressure to insanity. This, it seems to me, is now the sorry state of our economic science whose leaders today are so busily engaged in draining the very life blood from our competitive free enterprise economic system.

Misconception Number Five . . . that the management of the nation's credit, interest rates, and money supply had best be left in the hands of the Federal Reserve Board, "because they know best" and "such matters ought to be kept out of the hands of politicians", specifically the President and the Congress.

During World War I, the French Premier Clemenceau once remarked that "War is much too important a matter to be left to the generals". I believe that with different words the essential truth of this statement is applicable today to our economy and its matters, the seven members of the Federal Reserve Board and the five Federal Reserve Bank presidents who serve with them on the all-powerful "Open Market Committee" which absolutely (not partially) controls (not influences) the supply of money and credit and the level of interest rates in the U.S.A.

I am, therefore, including in the proposals for economic reform which I am about to submit respectively to this committee one which is intended to place the responsibility for economic and monetary policy with the elected representatives of the people, specifically the President and the Congres, a second proposal which broadens and more precisely defines the qualifications for F.R.B. membership and a third proposal which increases the regulatory means and authority of the Board in carrying out these policies.

D. THE IMMINENT DANGER OF DESTRUCTION OF THE TRADITIONAL AMERICAN FREE ENTERPRISE SYSTEM AS A RESULT OF CURRENT FEDERAL BANKING AND MONETARY POLICIES

When we think of the special genius of America, we think of liberty, opportunity and free enterprise. Today, the constitutional safeguards of our liberty remain intact, but the economic opportunity to develop and expand free, competitive economic enterprise has been drastically curtailed by three major developments:

(1) The great expansion of the power of the major banks as a result of the One Bank Holding Company Act has given them a grossly unfair and decisive competitive advantage over independent competitive enterprises which have neither the franchised right to use the public's deposited funds for private profit, nor the influence on prospective clients for non-banking services which is inherent in lender-borrower relationships. Consequently, we are today witnessing a progressive "takeover" by the major banks of the investment industry and a parallel penetration of leasing, insurance and related activities. This is obviously damaging to thousands of independent competing organizations, serves absolutely no discernible public purpose, and should be stopped forthwith before it is too late.

(2) The unrestricted use of large negotiable certificates of deposit, together with the incredible escalation of interest rates to unprecedentedly usurious levels has already largely destroyed the American capital markets and is rapidly killing independent competitive business.

The word "usury" has an ancient history, and it is no accident that throughout the evolution of civilization seven percent has been considered as the threshold rate beyond which society suffers and only the rich and the greedy can benefit. Today's "prime rate" plus compensating balances is more than twice that level, is causing our cherished competitive free-enterprise system to expire before our eyes and is replacing it with an oligarchy of bigness—big banks and the big corporate customers who have first call on what it takes to get ahead in a creditor-debtor society.

I have been unable to find any reason why it is in the public interest to permit banks to pay unlimited rates of interest on large deposits to those who presum-

ably have more and need less than the run-of-the-mill saver; and I have therefore included the prohibition of such discriminatory regulation, or lack of it, in these proposals for economic reform.

E. PROPOSALS FOR LEGISLATIVE AND REGULATORY REFORM OF AMERICAN ECONOMIC AND MONETARY MANAGEMENT

(1) Require by Resolution, U.S. International Negotiation to Create an Inflation-proof Standard of Value in the International Monetary System.

The recent international agreement on the "basket of currencies" principle for the valuation of each nation's currency in relation to an international "numeraire" known as "SDRs" was a useful first step in the right direction, but left unsolved the establishment of a constant inflation-proof standard of value to fill the role which, in the past, was acted by gold. For this purpose, I propose an extension of the "basket" principle to arrive at an overall rate of international inflation by applying the same "weights" as in the currency basket to each nation's respective "GNP Deflator" rate, thus adjusting and devaluing (or revaluing) all currencies in relation to the "SDRs", which would thereby always maintain constant purchasing power. By doing this, we would create for the first time a constant standard of monetary value, suitable for inflation-proof international financing and the settlement of international obligations. The result would immensely advance the restoration of confidence in the international monetary system and diminish international inflationary expectations.

(2) Require by Resolution, U.S. International Negotiation of An Agreement to Regulate the Creation of "Eurodollar" and Other Foreign Currency Deposits in Nondomiciled Banks.

The unregulated creation of "Euro-dollars" by means of loans made by and deposits in banks domiciled outside of the United States and not subject to U.S. Federal Reserve Board regulation, has been *the major cause of worldwide inflation*. It is obviously not in the interest of the United States or, for that matter, of any nation to permit a foreign bank to "create" additions to its money supply without restriction, regulation or the requirement of liquid reserve deposits with the central bank of the nation whose money supply has thus been expanded. For this reason, I propose that the United States take the lead in negotiating an international banking agreement under which any bank which accepts or creates deposits in the currency of another nation would be required to keep reserve deposits in the central bank of that nation and to comply with the regulations of that central bank with respect to such deposits. I believe that all central banks would find this to be in their respective self interests.

(3) Enact Legislation to Insulate Domestic U.S. Monetary and Credit Policies from the Influence of Excessive Foreign Capital Requirements and Interest Rates.

The fear of increasing the outflow to foreign borrowers of U.S. capital has frequently been given as a compelling reason for maintaining interest rates in the United States which are excessively high by traditional American standards. I propose that this influence can and should be effectively neutralized by requiring American taxpayers with capital deposits, loans or investments abroad to pay a tax on any net annual increase of such capital. the rate of such tax to be determined from time-to-time by the U.S. Federal Reserve Board as sufficient to offset substantially any competitive attraction to U.S. capital of higher interest rates abroad.

(4) Expand by Legislation, the Federal Reserve Board's Regulatory Powers to Include Variable Reserve Requirements Depending on the Proportion of Each Bank's Loan Portfolio Allocated to National Economic Purposes and Priorities.

The current reserve requirements of the Federal Reserve Banks are directed to the safety of deposits and the overall liquidity of lendable funds. As a weapon in "the fight against inflation", this is more like a single bludgeon than the assortment of precision instruments which our modern economy and diverse national interests require. Accordingly, I propose that the powers of the Federal Reserve Board be expanded to permit the reserve deposit requirements of individual banks to be varied in accordance with formulae promulgated from time-to-time by the Board for the purpose of increasing or decreasing reserves in proportion to each bank's distribution of its loan portfolio between loans for

(a) Specific National Priorities
(b) Productive Purposes
(c) Consumer Purposes
(d) Purchasing or Carrying Publicly-Owned Equity Securities

(e) Purchasing or Carrying Publicly-Owned Debt Securities
(f) All Other Purposes

Obviously, the present objective of containing inflation would be much better served by selectively favoring loans for productive purposes which would add to the supply of goods and services, and limiting loans which would add to consumer demand, than by the present policy of indiscriminately beating the economy to death.

The FRB's utilization of these powers would be required to implement national economic policies established as provided in proposal number 5 below.

(5) Establish by Legislation, More Precise Requirements and Procedures for National Economic and Financial Policies.

Because it is self-evident that our national economic and financial welfare is of vital concern to all of the people and should by no means be the special province of a group of bankers, regardless of their qualifications, I propose that the President, aided by his Cabinet and Council of Economic Advisers be required to supplement his annual national economic message to Congress with specific policies and priorities, and to supplement such policies and programs by quarterly reviews and modifications, that, subject to a 30-day veto by either house of the Congress, the Federal Reserve Board be required to exercise its powers to implement this program, and that the policies and operations of the Federal Reserve System be subject to audit and review comparable to that required for other federal government organizations.

(6) Expand and Revise by Legislation, the Requirements and Terms of Office of Membership of The Federal Reserve Board so as to Provide for Broader Representation of Public and National Interests.

The Federal Reserve Board is presently made up of seven members appointed by the President with the advice and consent of the Senate, for terms of 14 years so arranged that one term expires every two years. The President is supposed to give due regard to fair representation and balance between financial, agricultural, industrial, and commercial interests in making his selections. Of the present Board, three may be classed as academic economists, two as economists with banking backgrounds, one as a lawyer-banker and one as a businessman.

I submit that neither the present statutory representation nor its implementation is adequate for the Board's immense responsibilities and suggest reform to enlarge the board to fifteen members with 5 year overlapping terms (3 to expire each year), 10 members representing both big and small banking, investment, industrial, commercial, and agriculture interests, plus five members (two consumers and three professional economists) representing the general public interest. Membership on an Open Market Committee of 9 members would be by selection of the Chairman, approved by the Board and would include 3 Presidents of Federal Reserve Banks.

(7) Limit by Legislation, Interest Rates on All Deposits including Negotiable Certificates of Deposit to a Maximum of 1% Less than the Prime Bank Lending Rate or 5% whichever Is Higher.

I believe that the compelling need to control this centralization of big bank control and escalation of interest rates is self-evident for the reasons previously outlined in this testimony.

(8) Repeal the One-Bank Holding Company Legislation and Limit Banking Corporations Strictly to Banking Functions With No Involvement in Investment, Insurance or Other Non-banking Activities.

The need to repeal this legislation is self-evident in the light of the damage which it has already done to our competitive free-enterprise system as previously outlined in this testimony.

(9) Establish a Citizens' Capital Investment Tax Credit to Encourage Savings and Capital Formation by Individual Citizens and thus Reduce Inflationary Spending Demand while Increasing the Supply of Productive Capital.

Although I recognize that tax proposals are not the special province of this Committee, I venture to bring to your attention a proposal which I recently made supplementing my testimony as Chairman of the Committee on Capital Gains Taxation before the Committee on Ways and Means last year. I do so because I believe that the preservation of our free enterprise capitalistic system requires not only the remedial measures which I have submitted here, but also every practicable encouragement to the formation of new capital by individual American citizens, as distinguished from banks and major corporations many of which, although domiciled here, are trans-national in character, interests, and loyalties.

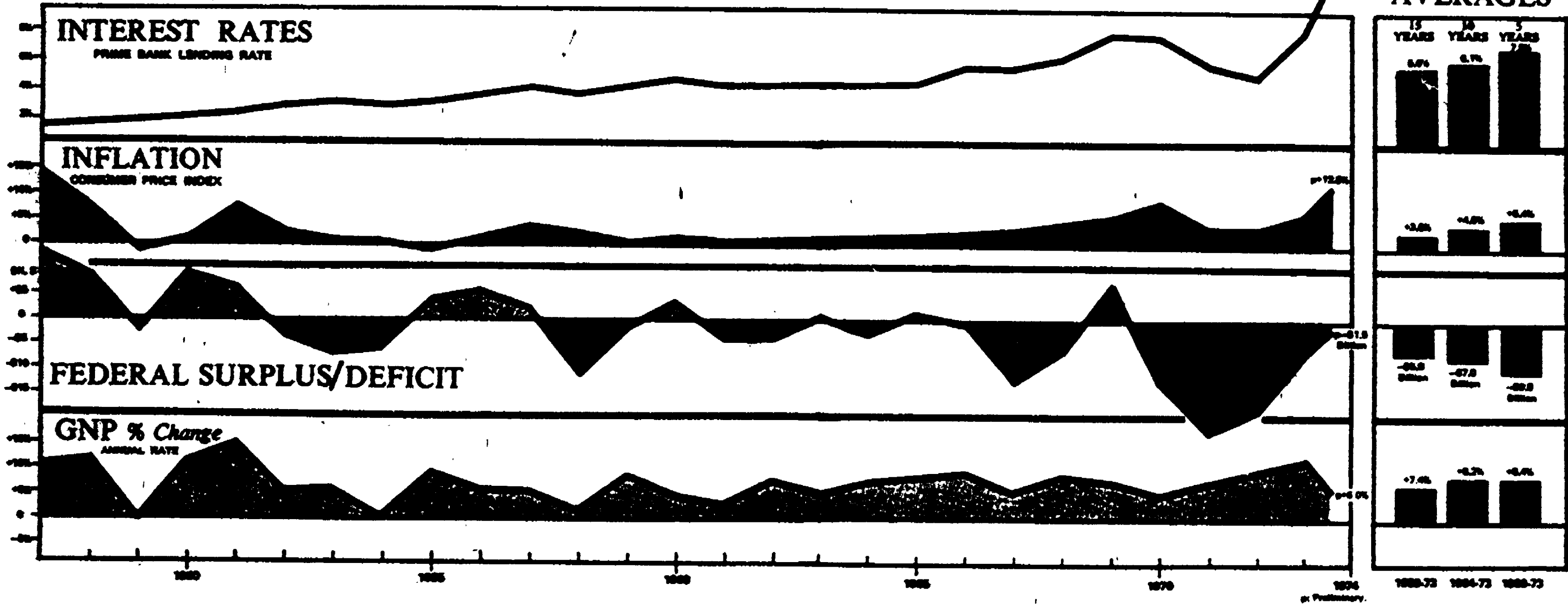
For these reasons, I propose that Congress give individual American citizens a break by extending to them a "Citizen's Capital Investment Tax Credit" of 5% on the first $100,000 accumulated, beginning in 1974 and continuing for life. Mechanically, this would take the form of a supplemental optional tax schedule on which any citizen could list the net annual increase (up to a cumulative total of $100,000) of his savings, cash, investments and real estate at cost less indebtedness. 5% of the net annual increase could be deducted each year from his federal income tax due. Thus each citizen who saved $1,000 in a year would get a $50 tax break, and dedicated savers could look forward to saving $5,000 in taxes on the first $100,000 accumulated over the years.

Here at one stroke, the Congress would: (1) offer every citizen a non-inflationary tax break and incentive to become a constructive capitalist; (2) provide individual citizens with a savings tax credit comparable to the investment tax credit which is now available to commerce and industry; (3) reduce inflationary demand by substituting savings for consumption, and capital formation for its dissipation.

SCHEDULE OF EXHIBITS

I. The Budget & the Economy
   (a) Chart of Interest Rates, Inflation, Federal Surplus/Deficit & Gross National Product.
   (b) Table of Federal Government Receipts, Expenditures & Surplus/Deficit.
   (c) Table of Inflation Rates.
   (d) Table of Consumer Price Index.
II. Growth of Unregulated U.S. Money Supply
   (a) Chart of U.S. Money Supply vs Gross National Product & Inflation.
III. Comparative International Economic Indices
   (a) Charts of Money Supply, Inflation & Real Gross National Product for Europe, Japan & U.S.
IV. Causes of Inflation in the U.S.
   (a) Chart of Components of Inflation in U.S.
V. Comparative Growth of U.S. Money Supply
   (a) Chart of Gross National Product vs The Components of Money Supply—Current & Constant Dollars.
VI. Comparative Interest Rates.
   (a) Chart of 10 Year (1958–68) Average vs Current Rates.
   (b) Table of Historic Interest Rates.
VII. Collapse of the U.S. Stock & Bond Markets
   (a) Chart of Dow-Jones Industrial Average, Dow-Jones Corporate Bond Average & Unweighted Average of 1,550 Publicly-Owned Common Stocks.
VIII. Federal Interest Expense
   (a) Chart of Interest Expense & Potential Increase at Current Interest Rates.
IX. The Money Supply vs the Economy
   (a) Chart of Dow-Jones Industrial Average vs Stock Price/Earnings Ratios, Prime Bank Lending Rates, Gross National Product, Current Money Supply & Broadly Based Money Supply.

# THE BUDGET & THE ECONOMY



# FEDERAL GOVERNMENT
# RECEIPTS, EXPENDITURES & SURPLUS / DEFICIT

| | FEDERAL GOVERNMENT RECEIPTS | | | | FEDERAL GOVERNMENT EXPENDITURES | | | | SURPLUS/DEFICIT | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | In Billions $ | % Change | Per Capita Nominal $ | Per Capita Real $ | In Billions $ | % Change | Per Capita Nominal $ | Per Capita Real $ | In Billions $ | % of Expenditures | % of GNP | Per Capita Nominal | Per Capita Real |
| 1947 | $43.2 | N.C. | $299 | $618 | $29.8 | N.C. | $206 | $426 | $+13.4 | +45.0 | +5.6 | $+93 | $+192 |
| 1948 | $43.3 | +0.2 | $294 | $670 | $34.9 | +17.1 | $237 | $489 | $+8.4 | +24.1 | +3.3 | $+57 | $+111 |
| 1949 | $38.9 | -10.2 | $260 | $607 | $41.3 | +18.3 | $276 | $636 | $-2.4 | -5.8 | -0.9 | $-16 | $-31 |
| 1950 | $49.9 | +28.3 | $329 | $631 | $40.8 | -1.2 | $269 | $516 | $+9.1 | +22.3 | +3.2 | $+60 | $+116 |
| 1951 | $64.0 | +28.3 | $413 | $744 | $57.8 | +41.7 | $373 | $672 | $+6.2 | +10.7 | +1.9 | $+40 | $+72 |
| 1952 | $67.2 | +5.0 | $428 | $751 | $71.0 | +22.8 | $451 | $795 | $-3.8 | -5.4 | -1.1 | $-24 | $-44 |
| 1953 | $70.0 | +4.2 | $437 | $764 | $77.0 | +8.5 | $480 | $838 | $-7.0 | -9.1 | -1.9 | $-44 | $-76 |
| 1954 | $63.6 | -9.9 | $391 | $673 | $69.7 | -9.5 | $428 | $737 | $-6.9 | -9.5 | -1.6 | $-36 | $-64 |
| 1955 | $72.1 | +13.0 | $436 | $730 | $68.1 | -2.3 | $410 | $686 | $+4.0 | +5.9 | +1.0 | $+24 | $+42 |
| 1956 | $77.6 | +7.6 | $460 | $763 | $71.9 | +5.6 | $426 | $696 | $+5.7 | +7.9 | +1.4 | $+34 | $+54 |
| 1957 | $81.6 | +5.2 | $474 | $759 | $79.6 | +10.7 | $462 | $721 | $+2.1 | +2.6 | +0.5 | $+12 | $+19 |
| 1958 | $78.7 | -3.6 | [illegible] | [illegible] | $88.9 | +11.7 | $508 | $784 | $-10.2 | -11.5 | -2.3 | $-58 | $-90 |
| 1959 | $89.7 | +14.0 | $504 | $765 | $91.0 | +2.4 | $512 | $770 | $-1.2 | -1.3 | -0.2 | $-7 | $-13 |
| 1960 | $96.5 | +7.6 | $534 | $796 | $93.0 | +2.2 | $515 | $790 | $+3.5 | +3.8 | +0.7 | $+19 | $+29 |
| 1961 | $98.3 | +1.9 | $535 | $789 | $102.1 | +9.8 | $556 | $820 | $-3.8 | -3.7 | -0.7 | $-21 | $-31 |
| 1962 | $106.4 | +8.2 | $571 | $833 | $110.3 | +8.0 | $591 | $862 | $-3.8 | -3.4 | -0.7 | [illegible] | $-28 |
| 1963 | $114.5 | +7.6 | [illegible] | $871 | $113.8 | +3.3 | $602 | $866 | $+0.7 | +0.6 | +0.1 | [illegible] | $+5 |
| 1964 | $115.0 | +0.4 | $599 | $861 | $118.1 | +3.7 | $616 | $874 | $-3.0 | -2.5 | -0.5 | $-16 | $-23 |
| 1965 | $124.7 | +8.4 | $642 | $903 | $123.5 | +4.6 | $636 | $895 | $+1.2 | +1.0 | +0.2 | $+6 | $+8 |
| 1966 | $142.5 | +14.3 | $725 | $992 | $142.8 | +15.6 | $727 | $995 | $-0.2 | -0.1 | -0.02 | $-1 | $-3 |
| 1967 | $151.2 | +6.1 | $761 | [illegible] | $163.6 | +14.6 | $824 | $1081 | $-12.4 | -7.6 | -1.6 | $-62 | $-82 |
| 1968 | $175.0 | +15.7 | $872 | $1109 | $181.5 | +10.9 | $905 | $1142 | $-6.5 | -3.6 | -0.8 | $-32 | $-42 |
| 1969 | $197.3 | +12.7 | $973 | $1171 | $189.2 | +4.2 | $933 | $1123 | $+8.1 | +4.3 | +0.9 | $+40 | $+48 |
| 1970 | $192.0 | -2.7 | $937 | $1066 | $203.9 | +7.8 | $995 | $1135 | $-11.9 | -5.8 | -1.2 | $-58 | $-67 |
| 1971 | $198.6 | +3.4 | $959 | $1047 | $220.3 | +8.0 | $1064 | $1162 | $-21.9 | -9.9 | -2.1 | $-106 | $-115 |
| 1972 | $227.2 | +14.5 | $1088 | $1140 | $244.7 | +11.1 | $1171 | $1227 | $-17.5 | -7.2 | -1.5 | $-84 | $-88 |
| 1973 | $258.5 | +13.8 | $1227 | $1227 | $265.2 | +8.4 | $1259 | $1259 | $-6.6 | -2.1 | -0.4 | $-32 | $-32 |
| AVERAGES | | | | | | | | | | | | | |
| 5 Year 1969-73 | $214.7 | +8.3 | $1037 | $1133 | $224.7 | +7.9 | $1084 | $1183 | $-9.8 | -4.1 | -0.9 | $-48 | $-50 |
| 10 Year 1964-73 | $170.2 | +8.7 | $876 | $1040 | $186.3 | +8.9 | $913 | $1066 | $-7.0 | -3.4 | -0.7 | $-36 | $-39 |
| 15 Year 1959-73 | $152.6 | +8.4 | $766 | $979 | $157.6 | +7.6 | $794 | [illegible] | $-5.0 | -2.5 | -0.5 | $-26 | $-29 |
| 15 Year 1953-67 | $96.8 | +6.7 | $542 | $810 | $106.9 | +5.9 | $583 | $865 | $-2.0 | -1.7 | -0.4 | $-11 | $-40 |
| 15 Year 1947-61 | $66.0 | *+6.6 | $416 | $703 | $67.8 | *+9.8 | $407 | $664 | $+1.2 | +5.1 | +0.6 | $+8 | $+19 |

Notes: Per Capita (Real) are in 1973 Dollars; *: 14 year Average.

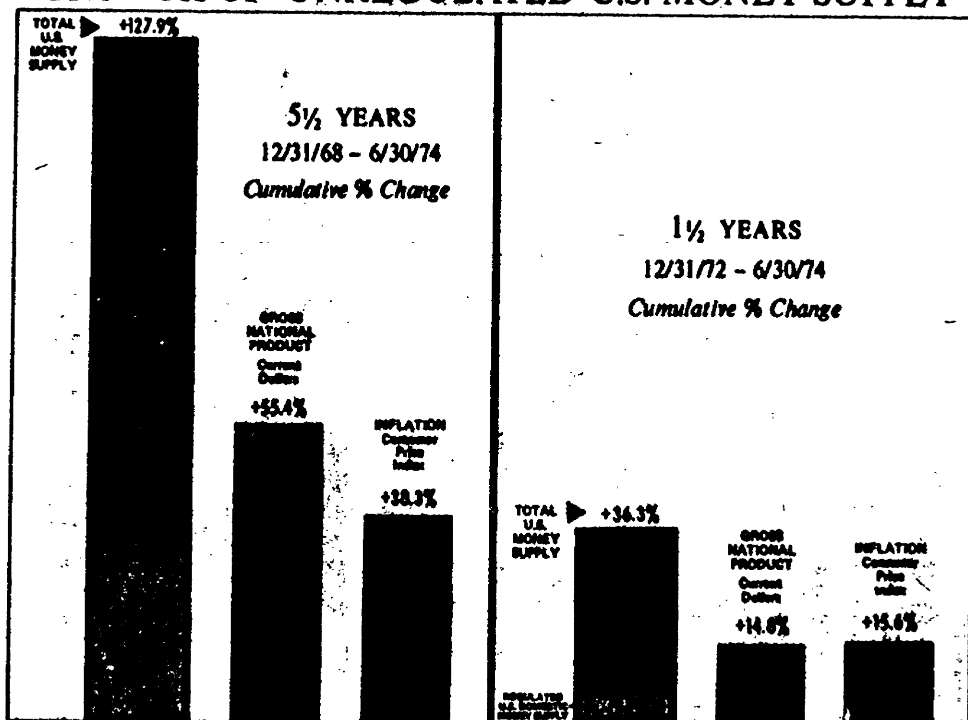
# INFLATION

| | CONSUMER PRICE INDEX | | | WHOLESALE PRICE INDEX | | | |
|---|---|---|---|---|---|---|---|
| | All Items % Change | Food % Change | All Items Excluding Food % Change | All Commodities % Change | Farm Products % Change | Industrial Commodities % Change | GNP Implicit Price Deflator % Change |
| 1947 | +14.4 | +21.5 | – | +22.8 | – | +22.1 | – |
| 1948 | +7.8 | +8.5 | +7.2 | +8.2 | +7.4 | +8.6 | +4.3 |
| 1949 | -1.0 | -4.0 | +1.0 | -5.0 | -13.5 | -2.1 | +1.7 |
| 1950 | +1.0 | +1.4 | +1.1 | +3.9 | +5.0 | +3.6 | +4.3 |
| 1951 | +7.9 | +11.1 | +6.5 | +11.4 | +16.4 | +10.4 | +6.3 |
| 1952 | +2.2 | +1.8 | +2.4 | -2.7 | -5.6 | -2.3 | +1.8 |
| 1953 | +0.8 | -1.5 | +1.9 | -1.4 | -9.4 | +0.8 | +1.1 |
| 1954 | +0.5 | -0.2 | +0.6 | +0.2 | -1.4 | +0.2 | +1.6 |
| 1955 | -0.4 | -1.4 | +0.3 | +0.2 | -6.2 | +2.2 | +2.0 |
| 1956 | +1.5 | +0.7 | +1.8 | +3.3 | -1.3 | +4.5 | +4.1 |
| 1957 | +3.6 | +3.3 | +3.3 | +2.9 | +2.7 | +2.8 | +3.2 |
| 1958 | +2.7 | +4.2 | +2.3 | +1.4 | +4.4 | +0.3 | +2.1 |
| 1959 | +0.8 | -1.6 | +1.9 | +0.2 | -6.2 | +1.8 | +1.5 |
| 1960 | +1.6 | +1.0 | +1.7 | +0.1 | -0.3 | 0 | +1.9 |
| 1961 | +1.0 | -1.3 | +1.0 | -0.4 | -0.9 | -0.5 | +1.1 |
| 1962 | +1.1 | +0.9 | +1.2 | +0.3 | +1.7 | 0 | +1.1 |
| 1963 | +1.2 | +1.4 | +1.8 | -0.3 | -2.0 | -0.1 | +1.4 |
| 1964 | +1.3 | +1.3 | +1.3 | +0.2 | -1.5 | +0.5 | +1.7 |
| 1965 | +1.7 | +2.2 | +1.4 | +2.0 | +4.3 | +1.3 | +1.7 |
| 1966 | +2.9 | +5.0 | +2.3 | +3.3 | +7.3 | +2.2 | +3.5 |
| 1967 | +2.9 | +0.9 | +3.4 | +0.2 | -5.6 | +1.5 | +3.5 |
| 1968 | +4.2 | +3.6 | +4.4 | +2.5 | +2.5 | +2.5 | +4.1 |
| 1969 | +5.4 | +5.1 | +5.5 | +3.9 | +6.4 | +3.4 | +5.3 |
| 1970 | +5.5 | +5.6 | +6.0 | +3.7 | +1.7 | +3.8 | +5.3 |
| 1971 | +3.4 | +3.0 | +4.6 | +3.2 | +1.7 | +3.5 | +4.5 |
| 1972 | +3.4 | +4.3 | +3.0 | +4.6 | +10.8 | +4.6 | +3.4 |
| 1973 | +6.2 | +14.5 | +3.9 | +13.8 | +41.0 | +7.7 | +5.6 |
| 1974 (6 Mos Annual Rate) | +12.8 | +12.3 | +13.0 | +14.8 | -18.9 | +25.5 | +10.5 |
| AVERAGES | | | | | | | |
| 5 Year 1969-73 | +5.4 | +6.5 | +4.6 | +5.8 | +12.3 | +4.6 | +4.8 |
| 10 Year 1964-73 | +4.0 | +4.6 | +3.6 | +3.7 | +5.9 | +3.1 | +3.9 |
| 15 Year 1959-73 | +3.0 | +3.1 | +2.9 | +2.5 | +4.1 | +2.1 | +3.0 |
| 15 Year 1953-67 | +1.5 | +1.0 | +1.7 | +0.8 | -1.0 | +1.2 | +2.1 |
| 15 Year 1947-61 | +3.0 | +2.9 | +2.4 | +3.0 | -0.6 | +3.5 | +2.6 |

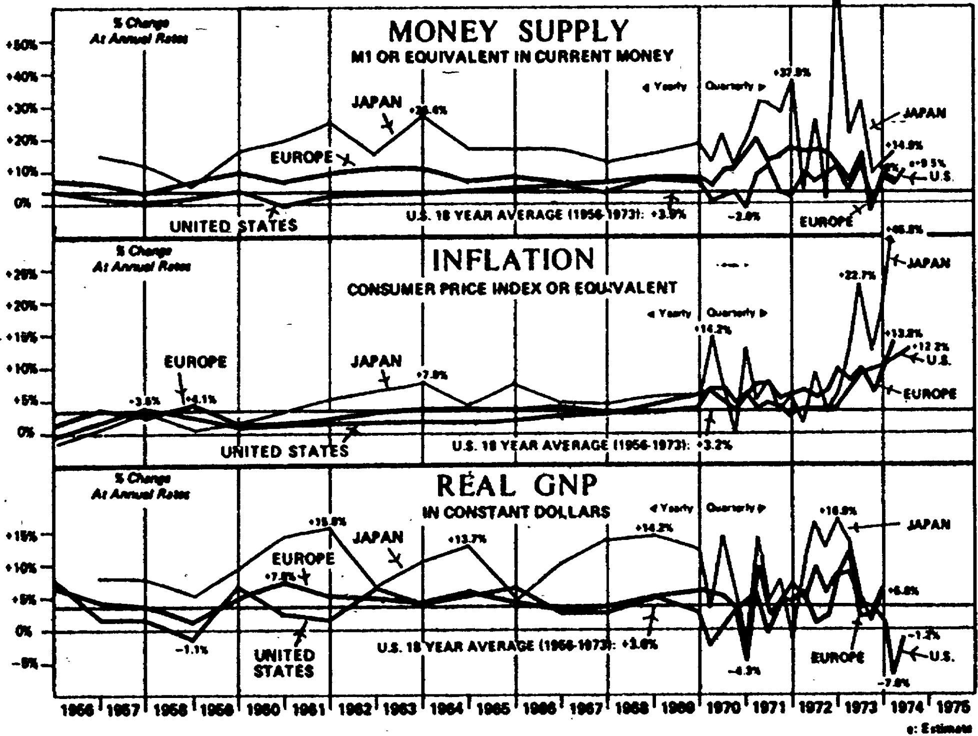
# CONSUMER PRICE INDEX

| | INDEX END OF PERIOD | % INCREASE ANNUAL AVERAGE DURING PERIOD | % INCREASE CUMULATIVE FROM DECEMBER 1950 | PURCHASING POWER OF $1.00 END OF PERIOD |
|---|---|---|---|---|
| **5 YEAR AVERAGES** | | | | 1950 = $1.00 |
| 1951-1955 | 80.4 | +1.4% | | |
| 1956-1960 | 89.3 | +2.1% | | |
| 1961-1965 | 95.4 | +1.3% | | |
| 1966-1970 | 119.1 | +4.5% | | |
| 1969-1973 | 138.5 | +5.4% | | |
| **ANNUALLY** | | | | |
| 1966 | 98.6 | +3.4% | +31.6% | .760 |
| 1967 | 101.6 | +3.0% | +35.6% | .737 |
| 1968 | 106.4 | +4.7% | +42.1% | .704 |
| 1969 | 112.9 | +6.1% | +50.7% | .664 |
| 1970 | 119.1 | +5.5% | +59.0% | .629 |
| 1971 | 123.1 | +3.4% | +64.4% | .608 |
| 1972 | 127.3 | +3.4% | +70.0% | .588 |
| 1973 | 138.5 | +8.8% | +84.9% | .541 |
| 1974 (June 30) | 147.1 | +12.8% | +96.4% | .509 |

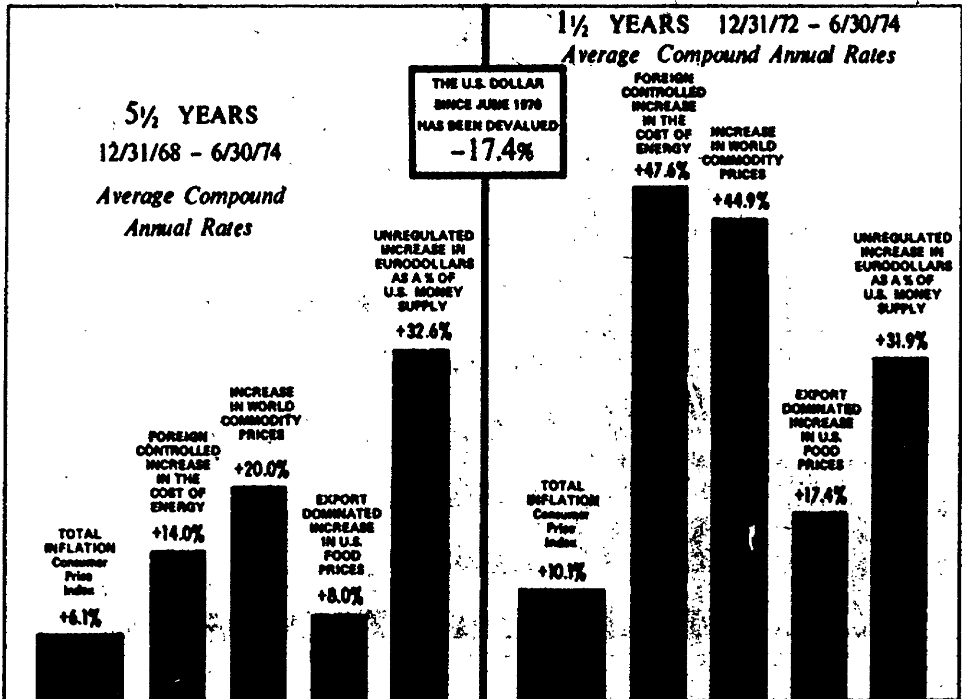
## GROWTH OF UNREGULATED U.S. MONEY SUPPLY



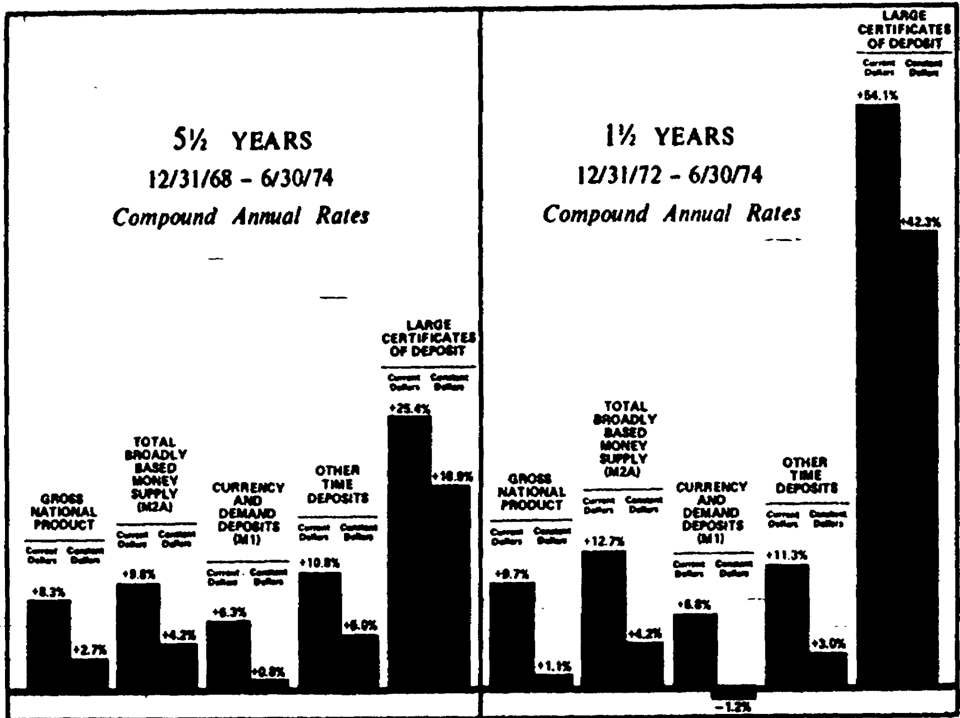
# COMPARATIVE INTERNATIONAL ECONOMIC INDICES



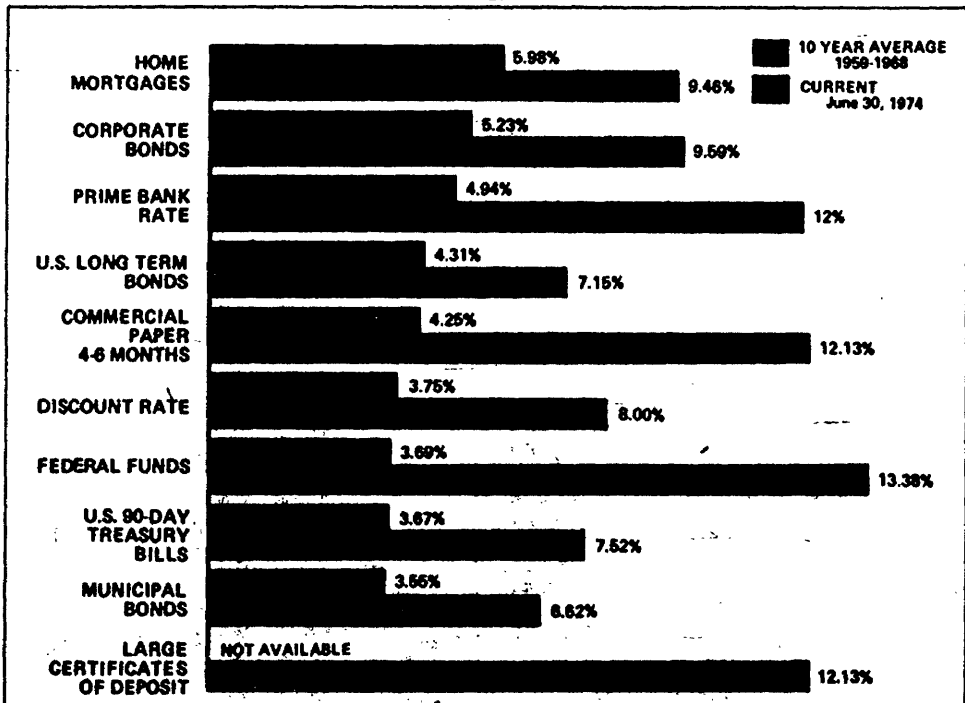

# CAUSES OF INFLATION IN THE U.S.



## COMPARATIVE GROWTH OF U.S. MONEY SUPPLY




## COMPARATIVE INTEREST RATES

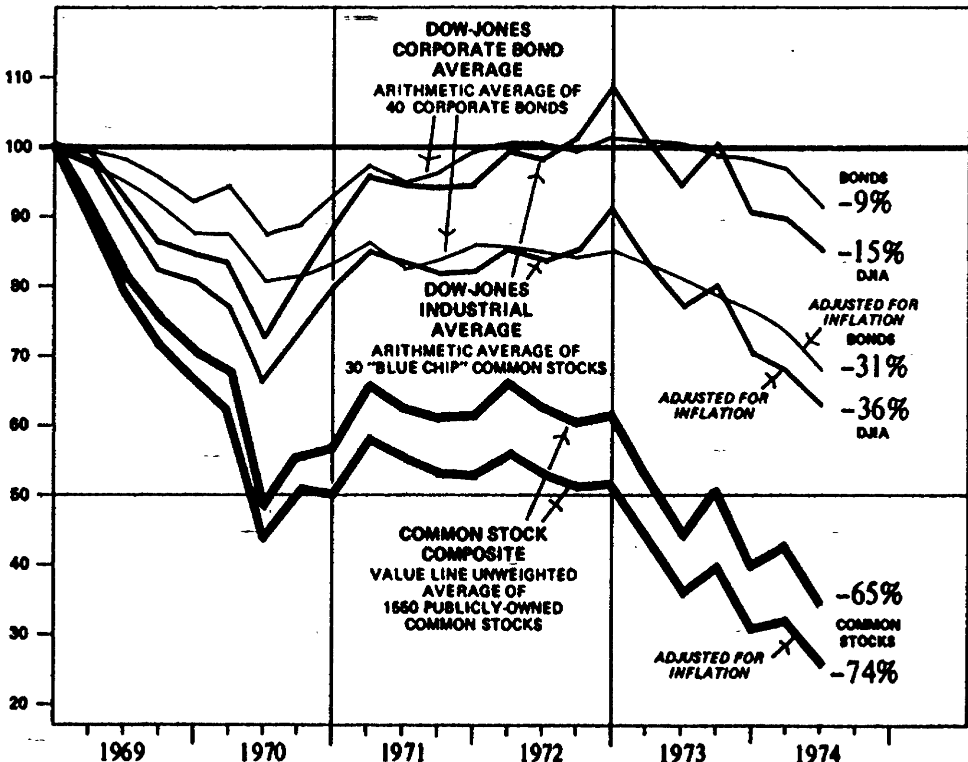


# INTEREST RATES

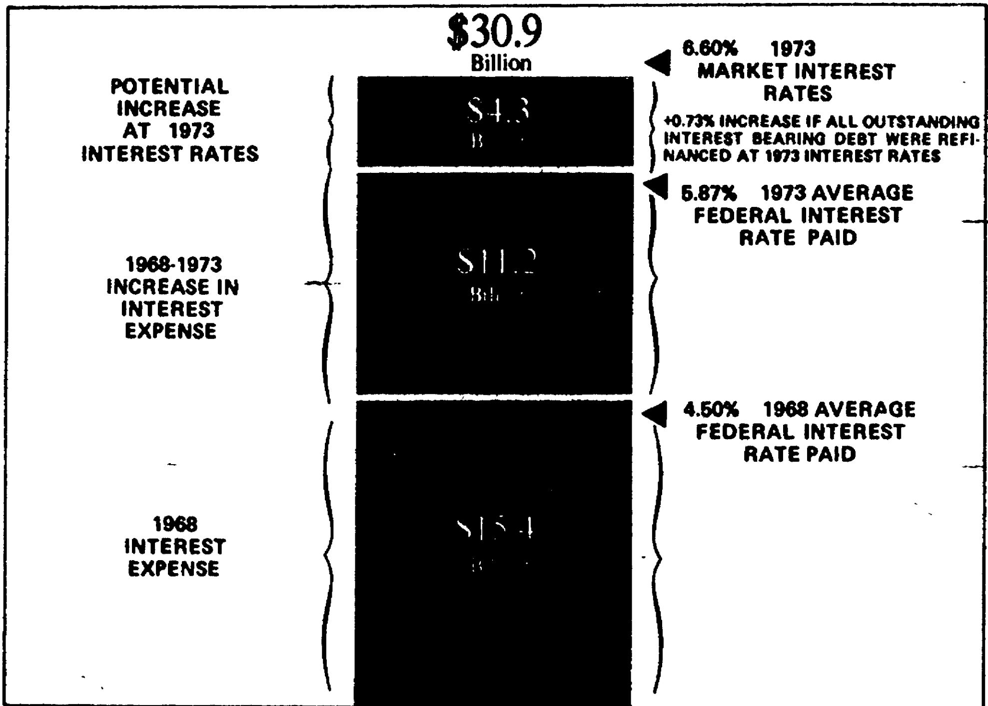
| | U.S. Treasury Bills (3 mo.) | U.S. Long Term Bonds | Prime Bank Lending Rate | Municipal Bonds | Corporate Bonds | Mortgage Residential | Composite* |
|---|---|---|---|---|---|---|---|
| 1947 | 0.60 | 2.25 | 1.50 | N.A. | 2.62 | N.A. | 1.74 |
| 1948 | 1.04 | 2.44 | 1.85 | 2.36 | 2.92 | N.A. | 2.12 |
| 1949 | 1.10 | 2.31 | 2.00 | 2.15 | 2.64 | 4.21 | 2.42 |
| 1950 | 1.22 | 2.32 | 2.08 | 1.92 | 2.60 | 4.14 | 2.38 |
| 1951 | 1.55 | 2.58 | 2.57 | 1.95 | 3.04 | 4.23 | 2.65 |
| 1952 | 1.77 | 2.68 | 3.00 | 2.19 | 3.10 | 4.30 | 2.84 |
| 1953 | 1.94 | 2.94 | 3.19 | 2.73 | 3.42 | 4.66 | 3.15 |
| 1954 | 0.95 | 2.55 | 3.04 | 2.39 | 2.80 | 4.10 | 2.78 |
| 1955 | 1.75 | 2.84 | 3.15 | 2.48 | 3.17 | 4.65 | 3.01 |
| 1956 | 2.66 | 3.08 | 3.77 | 2.76 | 3.68 | 4.82 | 3.46 |
| 1957 | 3.26 | 3.47 | 4.20 | 3.28 | 4.45 | 5.43 | 4.02 |
| 1958 | 1.84 | 3.43 | 3.84 | 3.16 | 4.02 | 5.49 | 3.63 |
| 1959 | 3.41 | 4.08 | 4.47 | 3.56 | 4.93 | 5.81 | 4.37 |
| 1960 | 2.95 | 4.02 | 4.82 | 3.52 | 4.92 | 6.16 | 4.40 |
| 1961 | 2.38 | 3.90 | 4.50 | 3.46 | 4.63 | 5.76 | 4.10 |
| 1962 | 2.78 | 3.95 | 4.50 | 3.18 | 4.36 | 5.60 | 4.06 |
| 1963 | 3.16 | 4.00 | 4.50 | 3.17 | 4.34 | 5.46 | 4.11 |
| 1964 | 3.55 | 4.15 | 4.50 | 3.21 | 4.47 | 5.45 | 4.22 |
| 1965 | 3.95 | 4.21 | 4.53 | 3.26 | 4.61 | 5.47 | 4.34 |
| 1966 | 4.88 | 4.65 | 5.62 | 3.81 | 5.67 | 6.40 | 5.16 |
| 1967 | 4.33 | 4.85 | 5.62 | 3.94 | 6.08 | 6.56 | 5.23 |
| 1968 | 5.34 | 5.26 | 6.30 | 4.45 | 6.84 | 7.19 | 5.90 |
| 1969 | 6.69 | 6.12 | 7.95 | 5.72 | 8.06 | 8.26 | 7.13 |
| 1970 | 6.44 | 6.58 | 7.91 | 6.35 | 9.05 | 9.03 | 7.56 |
| 1971 | 4.34 | 5.74 | 5.72 | 5.48 | 7.85 | 7.70 | 6.14 |
| 1972 | 4.07 | 5.64 | 5.25 | 5.26 | 7.59 | 7.53 | 5.89 |
| 1973 | 7.03 | 6.31 | 8.00 | 5.19 | 7.89 | 8.19 | 7.11 |
| Current (6/30/74) | 7.51 | 7.09 | 12.00 | 6.35 | 9.32 | p9.46 | 8.62 |
| **AVERAGES** | | | | | | | |
| 5 Year 1969-73 | 5.71 | 6.08 | 6.97 | 5.60 | 8.09 | 8.14 | 6.77 |
| 10 Year 1964-73 | 5.06 | 5.35 | 6.14 | 4.67 | 6.82 | 7.18 | 5.87 |
| 15 Year 1959-73 | 4.35 | 4.90 | 5.61 | 4.24 | 6.09 | 6.70 | 5.31 |
| 15 Year 1953-67 | 2.92 | 3.74 | 4.28 | 3.19 | 4.37 | 5.45 | 4.00 |
| 15 Year 1947-61 | 1.89 | 2.99 | 3.20 | 2.71 | 3.53 | 4.90 | 3.14 |

p: Preliminary; *: Arithmetic Average.

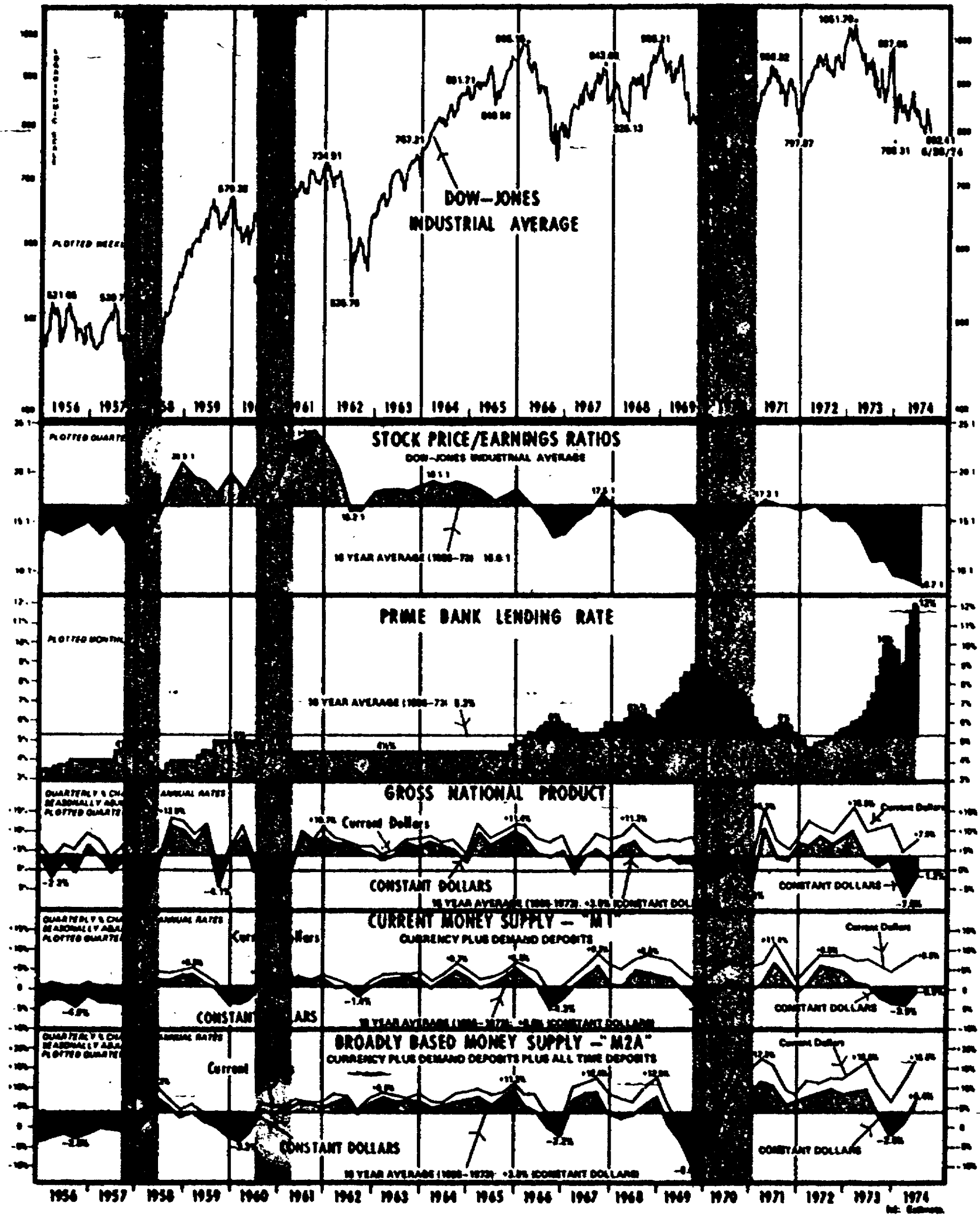
# COLLAPSE OF THE U.S. STOCK & BOND MARKETS



# FEDERAL INTEREST EXPENSE



# THE MONEY SUPPLY vs THE ECONOMY



# COMPARATIVE STATISTICS

| Quarter Ending | | Dow-Jones Industrial Average: Stock Prices Qtrly % Chg | Dow-Jones Industrial Average: Price/Earnings Ratio | Dow-Jones Bond Average: Bond Prices Qtrly % Chg | Dow-Jones Bond Average: Bond Yields | Prime Bank Lending Rate | Gross National Product Constant Dollars Qtrly % Chg* | MONEY SUPPLY "M1" Current Money Supply: Current Dollars Qtrly % Chg* | MONEY SUPPLY "M1" Current Money Supply: Constant Dollars Qtrly % Chg* | MONEY SUPPLY "M2A" Broadly-Based Money Supply: Current Dollars Qtrly % Chg* | MONEY SUPPLY "M2A" Broadly-Based Money Supply: Constant Dollars Qtrly % Chg* | Inflation GNP Deflator Qtrly % Chg* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1956 | Mar | +4.78 | 14.2 | +0.33 | 3.54 | 3.50 | -2.4 | +1.49 | -2.41 | +1.09 | -2.84 | +4.3 |
| | Jun | -3.71 | 13.9 | -2.46 | 3.73 | 3.72 | +1.8 | +0.89 | -2.43 | +1.96 | -1.87 | +3.7 |
| | Sep | -3.56 | 14.1 | -4.27 | 4.07 | 3.86 | -1.0 | +0.29 | -4.58 | +1.73 | -2.77 | +5.4 |
| | Dec | +5.10 | 15.0 | -2.58 | 4.29 | 4.00 | +5.4 | +1.79 | -1.93 | +2.50 | -1.40 | +3.2 |
| 1957 | Mar | -4.94 | 13.8 | +1.19 | 4.19 | 4.00 | +2.7 | +0.88 | -3.03 | +3.44 | -0.40 | +4.2 |
| | Jun | +6.00 | 14.4 | -4.40 | 4.79 | 4.00 | -0.1 | 0 | -3.05 | +2.98 | -0.40 | +2.9 |
| | Sep | -9.34 | 12.4 | -2.13 | 4.87 | 4.31 | +1.8 | +0.29 | -3.36 | +2.74 | -0.81 | +4.2 |
| | Dec | -4.52 | 12.1 | +3.30 | 4.77 | 4.50 | -6.0 | -2.32 | -4.76 | +1.04 | -1.41 | +1.9 |
| 1958 | Mar | +2.54 | 13.7 | +0.96 | 4.82 | 4.11 | -9.2 | -0.29 | -3.14 | +4.21 | +1.23 | +3.4 |
| | Jun | +7.03 | 16.3 | +2.58 | 4.24 | 3.61 | +1.8 | +4.48 | +2.36 | +10.20 | +7.72 | +1.6 |
| | Sep | +11.27 | 19.0 | -4.47 | 4.88 | 3.81 | +10.6 | +4.13 | +2.34 | +7.19 | +5.49 | +1.7 |
| | Dec | +9.88 | 20.9 | -0.46 | 4.76 | 4.00 | +10.0 | +4.98 | +3.20 | +4.80 | +2.98 | +1.9 |
| 1959 | Mar | +3.09 | 19.4 | -0.44 | 4.77 | 4.00 | +6.2 | +5.51 | +3.47 | +5.75 | +3.56 | +2.1 |
| | Jun | +6.96 | 18.0 | -3.35 | 5.12 | 4.24 | +10.0 | +3.41 | +1.71 | +3.30 | +1.75 | +1.2 |
| | Sep | -1.86 | 17.7 | -1.84 | 5.31 | 4.67 | -4.0 | +1.96 | +0.28 | +2.11 | +0.58 | +1.8 |
| | Dec | +7.56 | 19.8 | -1.00 | 5.57 | 5.00 | +4.6 | -2.47 | -3.34 | -1.13 | -2.29 | +0.8 |
| 1960 | Mar | -10.12 | 18.2 | +2.65 | 5.32 | 5.00 | +8.4 | -1.86 | -3.37 | -1.70 | -3.26 | +2.0 |
| | Jun | +4.82 | 20.5 | -0.14 | 5.40 | 5.00 | -0.4 | -0.56 | -2.55 | +0.38 | -1.56 | +1.7 |
| | Sep | -9.44 | 18.3 | +1.86 | 5.13 | 4.78 | -1.9 | +3.12 | +1.45 | +6.03 | +4.38 | +1.5 |
| | Dec | +6.16 | 19.1 | +0.46 | 5.04 | 4.50 | -2.9 | +0.84 | -0.86 | +5.74 | +3.73 | +2.3 |
| 1961 | Mar | +9.86 | 22.9 | +1.72 | 4.86 | 4.50 | -0.9 | +1.67 | +0.29 | +5.66 | +4.29 | +1.1 |
| | Jun | +1.08 | 23.4 | -2.23 | 5.14 | 4.50 | +8.7 | +3.38 | +2.32 | +7.11 | +6.02 | +0.8 |
| | Sep | +2.52 | 24.2 | -0.86 | 5.26 | 4.50 | +7.3 | +2.49 | +2.02 | +6.42 | +6.32 | +0.1 |
| | Dec | +4.27 | 22.9 | +0.42 | 5.25 | 4.50 | +8.4 | +3.87 | +2.59 | +6.89 | +5.07 | +2.1 |
| 1962 | Mar | -3.31 | 20.7 | +1.86 | 5.07 | 4.50 | +6.2 | +2.46 | +0.57 | +8.23 | +6.14 | +1.4 |
| | Jun | -20.61 | 16.2 | -0.06 | 4.91 | 4.50 | +6.5 | +1.62 | +0.85 | +8.06 | +7.18 | +0.5 |
| | Sep | +3.15 | 16.3 | +1.15 | 4.80 | 4.50 | +4.3 | -0.80 | -1.40 | +4.41 | +3.94 | +0.9 |
| | Dec | +12.63 | 17.9 | +1.64 | 4.67 | 4.50 | +3.7 | +2.43 | +0.85 | +7.82 | +6.07 | +1.8 |
| 1963 | Mar | +4.66 | 18.3 | +1.28 | 4.54 | 4.50 | +2.2 | +3.78 | +2.28 | +8.87 | +7.24 | +1.5 |
| | Jun | +3.64 | 18.3 | +0.09 | 4.49 | 4.50 | +3.6 | +4.01 | +2.55 | +8.17 | +6.76 | +1.2 |
| | Sep | +3.09 | 18.2 | -0.63 | 4.56 | 4.50 | +6.6 | +3.91 | +3.10 | +7.68 | +6.82 | +0.8 |
| | Dec | +4.12 | 18.5 | -0.45 | 4.62 | 4.50 | +5.4 | +4.20 | +2.51 | +8.67 | +6.71 | +2.1 |
| 1964 | Mar | +6.80 | 19.1 | +0.01 | 4.64 | 4.50 | +6.6 | +2.32 | +0.85 | +6.90 | +5.08 | +1.5 |
| | Jun | +2.24 | 18.7 | +0.96 | 4.61 | 4.50 | +5.3 | +3.87 | +2.50 | +6.63 | +5.36 | +1.4 |
| | Sep | +5.28 | 19.1 | +0.17 | 4.61 | 4.50 | +5.1 | +6.71 | +4.72 | +8.82 | +6.76 | +2.0 |
| | Dec | -0.14 | 18.8 | +0.27 | 4.60 | 4.50 | +1.9 | +5.06 | +3.00 | +9.08 | +6.97 | +2.0 |
| 1965 | Mar | +1.71 | 18.3 | +0.29 | 4.58 | 4.50 | +9.2 | +2.72 | +0.84 | +9.62 | +7.49 | +2.0 |
| | Jun | -2.38 | 17.1 | -0.60 | 4.64 | 4.50 | +5.9 | +3.20 | +1.34 | +7.81 | +5.63 | +2.0 |
| | Sep | +7.21 | 17.6 | -0.82 | 4.73 | 4.50 | +8.2 | +4.86 | +3.24 | +9.07 | +7.71 | +1.1 |
| | Dec | +4.16 | 18.1 | -1.80 | 4.82 | 4.64 | +9.4 | +6.86 | +5.12 | +11.26 | +9.56 | +1.8 |
| 1966 | Mar | -4.50 | 16.8 | -2.96 | 5.20 | 5.12 | +8.1 | +6.49 | +3.71 | +8.36 | +5.47 | +3.1 |
| | Jun | -5.91 | 15.5 | -1.48 | 5.42 | 5.51 | +3.7 | +4.94 | +1.30 | +8.45 | +4.39 | +4.0 |
| | Sep | -11.02 | 13.5 | -3.45 | 5.79 | 5.88 | +3.2 | -0.68 | -4.32 | +3.83 | +0.14 | +3.8 |
| | Dec | +1.48 | 13.6 | +0.63 | 5.76 | 6.00 | +4.9 | +0.46 | -2.84 | +0.97 | -2.18 | +3.0 |
| 1967 | Mar | +10.22 | 15.3 | +2.93 | 5.47 | 5.81 | -0.9 | +3.94 | +1.06 | +10.49 | +7.40 | +2.8 |
| | Jun | -0.06 | 15.8 | -3.57 | 5.81 | 5.50 | +3.0 | +6.01 | +3.45 | +11.37 | +8.70 | +2.3 |
| | Sep | +7.72 | 17.6 | -2.01 | 6.06 | 5.90 | +4.4 | +9.22 | +5.84 | +12.42 | +8.80 | +4.0 |
| | Dec | -2.33 | 16.8 | -6.13 | 6.61 | 5.73 | +2.8 | +6.02 | +1.29 | +8.58 | +3.70 | +4.7 |
| 1968 | Mar | -7.12 | 15.6 | +0.58 | 6.60 | 6.00 | +5.4 | +5.26 | +1.03 | +7.14 | +2.87 | +3.6 |
| | Jun | +6.80 | 16.1 | +0.48 | 6.61 | 6.40 | +7.5 | +7.86 | +4.14 | +6.68 | +3.12 | +3.9 |
| | Sep | +4.23 | 16.4 | +1.67 | 6.50 | 6.47 | +4.0 | +8.59 | +4.10 | +10.48 | +5.86 | +4.3 |
| | Dec | +0.85 | 16.3 | -3.53 | 6.93 | 6.27 | +2.4 | +8.19 | +3.54 | +12.84 | +7.62 | +4.6 |
| 1969 | Mar | -0.88 | 15.8 | -1.32 | 7.12 | 7.06 | +3.4 | +7.60 | +3.00 | +4.86 | +0.49 | +4.2 |
| | Jun | -6.66 | 14.7 | -0.56 | 7.24 | 7.74 | +1.9 | +4.79 | 0 | +1.38 | -3.28 | +5.5 |
| | Sep | +4.57 | 13.6 | -2.40 | 7.58 | 8.50 | +1.9 | +2.36 | -3.40 | -4.34 | -8.57 | +6.1 |
| | Dec | -12.36 | 14.0 | -3.88 | 8.25 | 8.50 | -2.3 | +2.14 | -3.42 | -0.79 | -6.22 | +5.5 |
| 1970 | Mar | -1.86 | 14.6 | +2.16 | 7.98 | 8.46 | -2.1 | +4.29 | -1.74 | +1.80 | -4.33 | +6.4 |
| | Jun | -12.98 | 12.8 | -6.50 | 8.75 | 8.00 | +0.5 | +6.81 | +1.77 | +10.37 | +5.06 | +4.6 |
| | Sep | +11.29 | 14.7 | +1.06 | 8.90 | 7.94 | +2.9 | +6.11 | +1.76 | +16.47 | +11.44 | +4.1 |
| | Dec | +10.29 | 16.4 | +4.50 | 8.51 | 7.23 | -4.3 | +5.83 | 0 | +14.78 | +8.89 | +6.4 |
| 1971 | Mar | +7.80 | 17.3 | +4.35 | 7.73 | 5.88 | +10.2 | +6.50 | +1.26 | +17.26 | +11.56 | +4.8 |
| | Jun | -1.46 | 16.7 | -2.54 | 8.11 | 5.30 | +2.9 | +11.35 | +6.35 | +15.97 | +10.58 | +4.8 |
| | Sep | -0.44 | 16.6 | +1.66 | 8.01 | 5.97 | +2.8 | +6.50 | +3.21 | +9.10 | +5.73 | +2.6 |
| | Dec | +0.34 | 16.2 | +3.08 | 7.76 | 5.54 | +6.5 | +2.07 | -0.24 | +8.56 | +6.25 | +1.9 |
| 1972 | Mar | +5.87 | 16.6 | +1.09 | 7.59 | 4.89 | +8.4 | +5.38 | +0.87 | +11.80 | +7.23 | +5.5 |
| | Jun | -1.34 | 15.8 | +0.13 | 7.60 | 5.01 | +8.4 | +8.50 | +5.43 | +11.63 | +8.28 | +1.9 |
| | Sep | +2.61 | 15.3 | -0.43 | 7.83 | 5.34 | +6.0 | +8.49 | +5.36 | +12.53 | +9.39 | +3.3 |
| | Dec | +7.00 | 16.2 | +1.84 | 7.74 | 5.76 | +8.3 | +8.86 | +4.80 | +12.23 | +8.15 | +4.0 |
| 1973 | Mar | -8.77 | 13.2 | -0.77 | 7.87 | 6.11 | +8.5 | +7.13 | +1.88 | +14.29 | +8.77 | +5.5 |
| | Jun | -6.24 | 11.5 | -0.35 | 7.98 | 7.03 | +2.2 | +7.66 | +1.16 | +16.56 | +9.36 | +7.3 |
| | Sep | +6.21 | 11.6 | -1.70 | 8.38 | 9.13 | +1.6 | +5.76 | -2.06 | +10.96 | +2.74 | +8.3 |
| | Dec | -10.16 | 9.9 | -0.25 | 8.36 | 9.81 | +2.4 | +4.59 | -3.87 | +6.40 | -1.98 | +8.6 |
| 1974 | Mar | -0.48 | 9.5 | -1.51 | 8.50 | 9.25 | -7.0 | +6.98 | -3.93 | +11.79 | +0.80 | +12.3 |
| | Jun | -6.23 | e8.7 | -6.57 | 9.32 | 11.88 | -1.2 | +8.75 | -0.94 | +16.84 | +6.36 | +8.8 |
| AVERAGES | | | | | | | | | | | | |
| 1964-68 | 5 yr. | +4.36 | 16.8 | -3.83 | 5.50 | 5.32 | +5.0 | +5.08 | +2.17 | +8.52 | +5.52 | +2.9 |
| 1969-73 | 5 yr. | -2.06 | 14.6 | -0.34 | 7.96 | 6.97 | +3.5 | +6.13 | +1.12 | +9.58 | +4.42 | +5.1 |
| 1959-68 | 10 yr. | +4.82 | 18.1 | -1.83 | 5.25 | 4.94 | +4.5 | +3.62 | +1.47 | +8.97 | +4.75 | +2.1 |
| 1964-73 | 10 yr. | +3.13 | 16.8 | -1.86 | 5.86 | 5.33 | +3.7 | +3.94 | +0.84 | +7.14 | +3.94 | +3.1 |

Data includes all FRB revisions. (e): Estimate; (*): Quarterly % changes at annual rates.