S. HRG. 107–521

EFFECTS OF SUBTITLE B OF S. 1766 TO THE PUBLIC UTILITY HOLDING COMPANY ACT

HEARING

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

TO EXAMINE THE EFFECTS OF SUBTITLE B OF S. 1766, AMENDMENTS TO THE PUBLIC UTILITY HOLDING COMPANY ACT, ON ENERGY MARKETS AND ENERGY CONSUMERS

FEBRUARY 6, 2002

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EFFECTS OF SUBTITLE B OF S. 1766 TO THE PUBLIC UTILITY HOLDING COMPANY ACT

WEDNESDAY, FEBRUARY 6, 2002

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, D.C.

The committee met, pursuant to notice, at 9:32 a.m., in room SD–366, Dirksen Senate Office Building, Hon. Jeff Bingaman, chairman, presiding.

OPENING STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

The CHAIRMAN. Why do we not go ahead with the hearing?

This is a hearing to examine the effects of the repeal of the Public Utility Holding Company Act of 1935 on energy markets and energy consumers and whether the recent events, particularly related to the collapse of Enron, raise concerns that there are protections that are afforded by PUHCA that need to remain in place. And the obvious question is whether the legislation that we are preparing to consider on the Senate floor has adequate protections in it. Senator Daschle and I have introduced a bill that contains a repeal of PUHCA, but there are many issues that continue to be raised about the adequacy of the protections against some of the abuses involved with the Enron collapse.

It may seem unusual to people to be having a hearing on this type of major provision in legislation so late in the process or so soon before we actually get to consideration of a bill on the floor, but I do think that questions that have been raised justify us going ahead with the hearing.

The Holding Company Act clearly creates barriers to entry into the electricity and the gas businesses. That was a purpose of the legislation. Obviously, as we move to a market-based industry, rather than a monopoly-based industry, the appropriateness of maintaining those barriers has been brought into question.

There are protections for consumers and shareholders as well in the Public Utility Holding Company Act, and many of those do not constitute barriers to entry. I think there is a consensus that those should be preserved in some form, and the question is whether we have the right form. We have provisions in the bill that we have proposed that are intended to replace some of the key provisions in PUHCA and to supplement existing authority in order that we can assure that consumers are adequately protected if PUHCA is repealed.

We want to hear from the witnesses today about the adequacy of the provisions we have included in our proposed bill, if there is something else that is needed before Congress proceeds to consider repeal of PUHCA, and what the effect of all of this will be on the structure of the electricity market in particular, the electricity industry in particular, in the future.

I believe, although Senator Murkowski is not here, the prime sponsor of the bill to repeal PUHCA in the Banking Committee, a bill which has been reported out of the Banking Committee with a substantial vote, is here, and that is Senator Shelby. And I was going to ask him to make any short statement he would like before we got to the witnesses.

STATEMENT OF HON. RICHARD C. SHELBY, U.S. SENATOR FROM ALABAMA

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, as you have just said, the Senator Banking Committee reported S. 206, the Public Utility Holding Company Act of 2001, favorably by a vote of 18 to 1.

I appreciate your calling this hearing, Mr. Chairman, and welcome the opportunity to clarify and reinforce the need for reform of the Public Utility Holding Company Act of 1935 that we know as PUHCA.

If the purpose of this hearing, Mr. Chairman, is to bring to light the problems with Enron and their business practices and how PUHCA could have saved the day, then I think this hearing is misguided and inappropriately timed. If, Mr. Chairman, on the other hand, the goal is to highlight the realities of PUHCA, in light of Enron's collapse, then I think that we should take this opportunity to distinguish fact from fiction just to be sure we are all working with the same information.

It has long been my belief that PUHCA has become a barrier to innovation and competition in the utility industry. Numerous studies have found that the conduct that gave rise to the act has all but disappeared, and since PUHCA's inception in 1935, comprehensive Federal securities regulations have been developed that, in essence, duplicate those required by the act. At the same time, changes in the industry have brought into question the continuing relevance of a monopoly-based model of regulation.

Mr. Chairman, I believe the facts clearly show that Enron's collapse had nothing to do with the Public Utility Holding Company Act of 1935. Enron, for example, was not subject to the registration requirements of PUHCA. The SEC had numerous opportunities to review Enron's activities to determine whether or not the provisions of PUHCA applied to them.

After close review and consideration of the act, the SEC either issued no-action letters, which I would interpret to mean the SEC did not believe Enron was engaging in activities covered under the Public Utility Holding Company Act, or they issued a single-State exemption, which was clearly provided for under the law. I am pleased, Mr. Chairman, that Commissioner Hunt is here to detail for us what PUHCA was intended to do, under what circumstances it was intended to apply, and how it was ultimately implemented.

For more than a decade, industry, regulators, Congress, and consumer groups have called for repeal and/or reform of PUHCA. I appreciate this opportunity to review PUHCA and clarify the need for reform.

Mr. Chairman, I want to thank you for allowing me to make a statement out of turn on this issue, and I believe this will be a good hearing.

I have a conflict, Mr. Chairman, that requires me to leave, but I hope you have a long and interesting hearing.

The CHAIRMAN. Thank you.

I am told that some of the other members here wanted to make short statements. Let me just call on them, if they do. Senator Wyden, did you wish to make any statement?

STATEMENT OF HON. RON WYDEN, U.S. SENATOR FROM OREGON

Senator WYDEN. I would and I will be very brief, Mr. Chairman.

I am anxious to explore this issue because a coalition of consumer groups recently has raised some very troubling questions in a letter to our committee about how Enron avoided regulation under PUHCA. These groups asserted that if Enron had been regulated as a holding company under the act, the collapse of Enron might have been avoided.

Whether one supports or opposes PUHCA, the law is still on the books. It is Congress' job, not that of the regulators, to decide whether it ought to be repealed or not. So, I want to see how it was that Enron was able to fly under the regulatory radar screen. I think we need to examine whether there was proper enforcement of the law, whether there was a adequate review when Enron self-certified that it qualified for exemption under PUHCA.

So, there are a number of questions I want to ask the witnesses about this, and I appreciate your holding this hearing so promptly, Mr. Chairman.

The CHAIRMAN. Very good. Senator Campbell, did you wish to make a short statement?

STATEMENT OF HON. BEN NIGHTHORSE CAMPBELL, U.S. SENATOR FROM COLORADO

Senator CAMPBELL. Very short, Mr. Chairman. Thank you for holding this hearing.

Repeating, PUHCA has been discussed and criticized for several years, and I think we have done six or eight hearings in this committee on it. In fact, many PUHCA critics argue that the 66-year-old act amounts to an outdated, burdensome, and duplicative set of regulations. They believe that existing State regulation over retail sales, Federal oversight of wholesale transmission, and existing antitrust regulations provide sufficient security for the ratepayers. Others strongly argue that PUHCA should not be repealed. They believe that the Public Utility Holding Company Act is the only regulation that effectively prohibits companies from risky investments and under-capitalization that could hurt ratepayers.

I, like many of the members of this committee, tend to support limited government involvement because I think all parties can act more efficiently without too much government involvement. But surely the government's oversight should be streamlined as much as possible.

I am also concerned that streamlining government oversight to some degree might harm consumers. This year, of course, the Enron debacle has added a new twist to our hearings that we did last year, but I like Senator Shelby think we should probably not focus on whether to repeal PUHCA solely in terms of the Enron situation.

It is well documented that Enron was an exempted company because it was a trading company, owning only one utility in Oregon. Some might argue that if Enron was not exempted from PUHCA, then sufficient government oversight would have prevented the company's collapse. I think that is not only highly unlikely, but I think that this line of argument takes us away from the central focus of whether PUHCA should be repealed because it has outdated its usefulness.

In any event, I am looking forward to the hearing and I appreciate your calling it. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Thomas, did you have any statement you wish to make?

STATEMENT OF HON. CRAIG THOMAS, U.S. SENATOR FROM WYOMING

Senator THOMAS. Thank you, Mr. Chairman. I just agree with the Senator that hopefully this is not an Enron hearing. I hope it is on PUHCA. That is what we are talking about.

The CHAIRMAN. Let me ask. Senator Craig, did you have any statement you wish to make?

STATEMENT OF HON. LARRY E. CRAIG, U.S. SENATOR FROM IDAHO

Senator CRAIG. I wish to associate myself with the remarks of the Senators from both Alabama and Colorado. Let us have the hearing. Let us talk PUHCA.

The CHAIRMAN. Senator Hagel, did you have any statement?

Senator HAGEL. I have never heard of Enron, Mr. Chairman.

[Laughter.]

Senator HAGEL. I look forward to hearing the witnesses. Thank you.

The CHAIRMAN. Senator Murkowski, did you have a statement you wish to make?

STATEMENT OF HON. FRANK H. MURKOWSKI, U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. Thank you, Senator Bingaman. I appreciate the opportunity to address this subject once again. We have had this before the committee for an extended period of time. This topic began long before my chairmanship, and hopefully under your chairmanship, we can dispose of it.

I think it is fair to recognize that PUHCA was created in 1935 to address abuses associated with power generation. Since that time, we have had a number of layers of regulatory oversight that I feel address the concerns that we have in the oversight responsibility of the committee.

I noted when I came in the reference to Enron. I think I would echo that the cause of Enron's demise was primarily due to bad business judgment, bad accounting practices, fundamental lack of honesty and control within the management. It was not because there were not enough regulations. PUHCA, specifically, had absolutely nothing to do with these matters. With or without PUHCA, Enron would have gone bankrupt. I do not think there is any question about that. Crooks rob banks because that is where the money is, and even though there are laws against it, it still occurs.

Now, I think it is curious that we are having a debate on the eve of the Senate taking up a comprehensive energy bill, in which we believe PUHCA reform should be included. It has been around a long time, as I have said. It is well understood. This committee held extensive hearings in the 104th, 105th, 106th, and early on in the 107th Congress on electricity and the implications of PUHCA repeal.

Incidentally, PUHCA repeal has been reported out by the Banking Committee four times since 1995. There is joint referral, with the Banking Committee on that issue. In fact, it is the Banking Committee's jurisdiction.

PUHCA repeal in the Daschle bill, which is pending, is word for word, from the Banking Committee's reported bill, which was reported out by a bipartisan vote of 19 to 1. The Banking Committee fully understands the issue. It was not willing to create a super-PUHCA at FERC to replace an antiquated PUHCA at the SEC.

Had our committee held a business meeting, I venture that we would have agreed with the Banking Committee. But that was not allowed to happen. As a consequence, Senator Bingaman and I have had a discussion about this. I indicated I was for PUHCA reform. He feels that it is necessary to have this hearing to examine it even further. The consequences of Enron as a probable cause of this I can only reflect on with some conjecture.

In any event, I would hope that this hearing today does not stop the momentum on PUHCA reform. I have supported PUHCA repeal on its merits. It is supported by the Bush administration. It is a key part of their national energy plan. PUHCA repeal was also reported by the Clinton administration, the Clinton administration. It was a key part of their electricity legislation.

PUHCA repeal is both pro-competitive and pro-consumer. PUHCA repeal does not eliminate consumer protections. It was President Clinton's Securities and Exchange Commission that recommended repeal of PUHCA. That recommendation was endorsed by President Clinton and his FERC.

To meet consumer demands, we must get rid of the regulations that prevent companies from responding to changing market conditions. We have seen changing market conditions over the last year in power generation. To meet consumer needs, we have to get rid of those unnecessary regulations. I feel that participants in the electric power industry are deterred from taking competitive actions out of fear of becoming tangled up with PUHCA.

How does this prevent companies from competing in the sense of benefitting consumers? Some assert that PUHCA repeal will allow consumers to be harmed. I find that false, and I would hope that somebody might be able to enlighten me this morning. FERC will retain authority and responsibility for wholesale electric rates. Wholesale rates can go up only if allowed by FERC. States retain authority and responsibility for retail electric rates. Retail rates can go up only if allowed by State regulatory authorities. What is wrong with that? PUHCA repeal does not diminish these authorities. There is no so-called regulatory gap created by PUHCA repeal. Moreover, the Banking Committee language guarantees Federal and State regulators access to utility books and records necessary to protect consumers.

In addition, nothing in this language prevents other regulatory agencies from protecting consumers, whether it be the Federal Trade Commission, the U.S. Department of Justice, and the State antitrust.

I have had these three principles for good electric legislation, which has been coined by professional staff. One, we must deregulate where we can. Two, we must streamline where we cannot deregulate. Three, we must not stand in the way of States' efforts to address local concerns and needs. I think PUHCA repeal advances all of these three principles.

My position is clear. I will not support any electricity title that does not include PUHCA repeal. In addition, I will not support any electricity title that replaces PUHCA with more draconian regulations.

Finally, PUHCA is 66 years old. It was designed to cure the problems of a long-gone, depression-era industry structure.

It is time to retire PUHCA.

The CHAIRMAN. Senator Johnson, did you have any opening statement?

Senator JOHNSON. Mr. Chairman, I have a statement, but I am going to simply submit it for the record. And I look forward to the testimony of the panel.

The CHAIRMAN. Okay.

[The prepared statement of Senator Johnson follows:]

PREPARED STATEMENT OF HON. TIM JOHNSON, U.S. SENATOR FROM SOUTH DAKOTA

Mr. Chairman, this is an important and timely hearing on PUHCA. The Enron situation has brought new attention to PUHCA, its effectiveness, and whether it is still needed in a competitive energy environment.

For years, PUHCA has been attacked as a law that is outdated for today's more competitive environment, and that it is a relic of Depression-era laws. In response, there have been continuous attempts to repeal PUHCA. I have always believed that this must be approached cautiously. Today's energy world is not a truly competitive environment. There is competition on the wholesale market but very little competition in the retail market. In addition, some states have enacted electricity restructuring, but others have not, leaving a unevenness to the competition in the field. I have always been concerned about undue concentration and believe that we must have enough safeguards to ensure that sustainable, competitive markets are in place.

As you all know, S. 1766 includes provisions to repeal PUHCA but also included provisions that would strengthen merger review, strengthen FERC's ability to review market-based rates, and increase market transparency. At the time of the bill's introduction in December, there appeared to be a fair amount of consensus that this was a good approach to take if PUHCA was to be repealed.

However, the Enron collapse has resulted in another review of PUHCA repeal and has raised new questions. As an exempt holding company, some of PUHCA's stricter rules would not have applied to Enron. On the other hand, perhaps if PUHCA was not in place, Enron would have expanded its utility business far beyond what it did, causing even greater havoc on customers and employees.

We must look at this issue very carefully before decisions are made because there are substantive arguments on both sides of this issue. Protecting consumers is of paramount importance and we must consider whether PUHCA continues to play an important role there. We must also must consider whether PUHCA's presence is creating more barriers than are necessary to enter electricity markets. We also must consider whether additional safeguards are needed either on the state and/or federal level to ensure that the activities of electricity utilities and entities are properly reviewed.

Mr. Chairman, there is not much time before the Senate is due to consider the energy legislation but holding this hearing is an important opportunity to hear the viewpoints of those concerned. There are strong views on both sides on this issue and the only way to move forward is to find some consensus. Ultimately, the needs of energy consumers are the most important factor in this debate. The only way to protect consumers is to determine the most rational solution. It is clear that this is your goal and I pledge to work with you and the rest of the Senate in the coming weeks to help achieve consensus that helps our consumers.

The CHAIRMAN. We have five very distinguished witnesses here. Let me introduce them all and then we will just call on them in the order that I introduce them and give them each about 10 minutes. If they could try to summarize their main points, they do not need to take 10 minutes, but they have got that long if they want to.

First, the Honorable Isaac C. Hunt, Jr., who is a Commissioner with the Securities and Exchange Commission, is here to speak on behalf of the Securities and Exchange Commission.

Next is the Honorable Roy Hemmingway, who is Chairman of the Oregon Public Utility Commission, in Salem, Oregon.

Next, Ms. Cynthia Marlette, who is the General Counsel for the Federal Energy Regulatory Commission.

Mr. David Sokol, who is the chairman and CEO of MidAmerican Energy Holdings Company in Des Moines, Iowa.

And Mr. Scott Hempling, who is an attorney at law in Silver Spring, Maryland.

We appreciate their being here. Why do we not just proceed in that order? Mr. Hunt, why do you not begin and we would be anxious to hear your point of view.

STATEMENT OF ISAAC C. HUNT, JR., COMMISSIONER, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. HUNT. Thank you. Good morning, Chairman Bingaman, ranking member Murkowski, and members of the committee. I am Commissioner Isaac Hunt of the U.S. Securities and Exchange Commission.

I am pleased to have this opportunity to testify before you on behalf of the SEC regarding the provisions in title II of S. 1766, the Energy Policy Act of 2002, which would repeal much of the Public Utility Holding Company Act of 1935.

As you know, for almost 20 years, the SEC has consistently supported repeal of those provisions of PUHCA that either duplicate laws administered by other regulators or that are no longer necessary. Since I last testified on PUHCA repeal in December, the magnitude of the Enron debacle and the harm that Enron's collapse has tragically inflicted on the company's investors and employees has become clearer. Congress and various regulatory agencies, including the SEC, are appropriately investigating what happened at Enron, why it happened, and what should be done to prevent Enron-like debacles in the future.

As we continue to investigate and learn from the events surrounding that collapse, we remain open-minded and, of course, would reconsider our views on conditional PUHCA repeal if warranted. Currently, however, we are not aware of anything that would cause us to conclude that there is reason to abandon our longstanding support for conditional PUHCA repeal.

Before discussing the SEC's current views on PUHCA, it is useful to review the history of the SEC's longstanding support of repeal. As you know, PUHCA was enacted in 1935 in response to abuses that had occurred in the gas and electric industry during the first quarter of the last century. These abuses included misuse of the holding company structure, inadequate disclosure of the financial position and earning power of holding companies, unsound accounting practices, excessive debt issuances, and abusive affiliate transactions. The 1935 act was enacted to address these problems.

In the early 1980's, however, the SEC concluded that many aspects of the 1935 act duplicated other State and Federal regulation. In addition, changes in the investment banking industry had provided investors and consumers with additional protections unforeseen in 1935. The SEC, thus, unanimously recommended that Congress repeal the 1935 act.

However, repeal legislation was not enacted during the 1980's.

In response to accelerating changes in the utility industry during the early 1990's, in 1994, then-Chairman Arthur Levitt directed the SEC's staff to undertake a study of the 1935 act. The resulting report both recommended repeal and identified areas in which the Commission could adopt administrative initiatives to streamline regulation under the 1935 act.

Currently, as I have indicated, the Commission continues to support repeal of PUHCA as long as repeal is accomplished in a way that gives the Federal Energy Regulatory Commission and State regulators sufficient authority to protect utility consumers. Not surprisingly, however, in light of recent events, there are those who are now asking whether Enron's collapse should cause those who support PUHCA repeal to reconsider.

As I stated at the beginning of my testimony, the harm that Enron's collapse has tragically inflicted on that company's investors and employees is now readily apparent.

Enron is currently an exempt holding company under PUHCA. When Enron acquired Portland General Electric in 1998, it claimed an exemption under our rule 2 under PUHCA as an intrastate holding company. Enron was able to claim this exemption because it was incorporated in Oregon, Portland General, its only utility subsidiary, was incorporated in Oregon, and Portland General's utility operations were located in Oregon. Enron recently agreed to sell Portland General to Northwest Natural Gas, a transaction that is subject to Commission approval under PUHCA.

In 1994, Enron Power Marketing Inc., a subsidiary of Enron, received a no-action letter from the staff in our Division of Investment Management in which the staff agreed not to recommend enforcement action against Enron Power if it engaged in power marketing activities without its or Enron's registering under the 1935 act. In its request for no-action relief, Enron Power argued that the contracts, books, records, and other materials underlying its power marketing activities were not "facilities used for the generation, transmission, or distribution of electric energy for sale;" that the power market subsidiary was, therefore, not an electric company for purposes of PUHCA; and that Enron was, thus, not a utility holding company for purposes of PUHCA. Enron Power's request stated that at the time other companies were already engaged in similar power marketing activities. The staff gave Enron Power the requested no-action relief. Since that time, the staff has given analogous no-action relief to approximately 20 other companies.

With respect to PUHCA, as we continue to investigate and learn from the events surrounding Enron's collapse, we remain open-minded and, of course, will reconsider our views on repeal if warranted. Currently, however, it appears that the tragic collapse of Enron is not a result of its classification or lack of classification as a public utility holding company.

Enron is a tragedy for the entire system of disclosure regulation.

All investors, including investors in the public utility holding companies, are entitled to a regulatory system that produces disclosure that is meaningful and intelligible. To address flaws in the current system, we are considering ways to ensure that investors receive more current disclosure, better disclosure of trend and evaluative data, and clear and informative financial statements.

Likewise, in order to prevent our system of accounting from being abused, whether by public utility holding companies or other types of companies, we are working to establish a better system of private regulation of the accounting profession and to make sure that the Federal Accounting Standards Board, or FASB, responds expeditiously and clearly to establish needed accounting standards.

As I stated earlier, we as a commission continue to believe that Congress should repeal PUHCA in a way that ensures the protection of utility consumers.

First, FERC and the State regulators should be given additional authority to monitor, police, and regulate affiliate transactions. As long as the electric and gas utilities continue to function as monopolies, there will be a need to protect against cross-subsidization. The best means of guarding against such cross-subsidization is likely to be audits of books and records and Federal oversight of affiliate transactions. Any move to repeal PUHCA should include provisions giving FERC and State regulators the necessary tools to engage in this type of oversight. In addition, Congress should consider giving FERC the authority to issue rules prohibiting or limiting those types of affiliate transactions that it concludes are inherently abusive.

Second, repeal of PUHCA would remove barriers that now exist to consolidation within the utility industry, as well as barriers that prevent diversified, non-utility companies from acquiring utilities. Removal of these restrictions may raise competitive issues related to the market power of utilities. Although PUHCA gives the SEC authority to review the potential anti-competitive effects of utility acquisitions, in recent years the SEC has looked to other regulators, such as FERC, the Department of Justice, and the Federal Trade Commission, for their expertise in assessing competitive issues, an approach of "watchful deference" to the work of our fellow regulators.

Therefore, repeal of PUHCA is unlikely to affect how market power issues are reviewed at the Federal level. Nonetheless, because repeal of PUHCA may increase consolidation in the utility industry, Congress could conclude that provisions such as section 202 of S. 1766 are necessary to give FERC sufficient authority to ensure that what consolidation does occur in the utility industry does not harm consumers.

Third, I know that Congress and others are considering other types of consumer protections in the utility area. For example, there has been discussion of whether FERC needs additional ratemaking authority in the wholesale electricity markets. Likewise, there has been discussion of whether FERC or the Commodity Futures Trading Commission should be given additional authority to oversee trading in energy-related derivatives to prevent manipulation. While I recognize that it is important for Congress to consider issues of these types, the SEC does not have statutory authority to regulate utility rates under PUHCA. Likewise, PUHCA does not give the SEC authority to attempt to prevent manipulation in the energy trading markets. The SEC therefore lacks the expertise to express a view on whether reforms are needed in these two just-mentioned areas.

Finally, repealing the act should not be viewed as a magic solution to the current problems facing the U.S. utility industry. For example, because the act does not currently limit investment in generation facilities, repeal would not directly affect the supply of electricity in the United States. Instead, repeal of the act would eliminate regulatory restrictions that prohibit utility holding companies from owning utilities in different parts of the country and that prevent non-utility businesses from acquiring regulated utilities.

Repeal of the act would also eliminate any impediment that exists to other regulators' attempts to modernize regulation of the utility industry. For example, during the past year, questions have arisen about how the act will impact the ability of FERC to implement its plans to restructure the control of transmission facilities in the United States. While we believe that we have the necessary authority under the act to deal with the issues created by FERC's restructuring, without impeding that restructuring, repeal of the act would, nonetheless, effectively resolve those issues.

This example, however, raises the broader issue of the relationship between FERC's and the SEC's regulation of the utility industry. FERC is clearly the agency that Congress intended to take the lead role in regulating the utility industry. The SEC, in contrast, as you know, is primarily devoted to regulating the securities markets. Although we always attempt to work together with FERC to ensure that, to the extent possible, our regulation of utility holding companies under PUHCA does not impede FERC's ability to regulate the utility industry, sometimes conflict is inevitable. Given this, if Congress chooses not to repeal PUHCA, we believe that responsibility for that act, whether in its current form or in a modified form, should be transferred from the SEC to FERC. Given the nature of FERC's responsibilities and its expertise in regulating the utility industry, it is simply in a better position to balance the goals of PUHCA and the other statutes it administers and thereby regulate the utility industry in a more consistent and effective manner.

The SEC takes seriously its duties to administer faithfully the letter and spirit of the 1935 act and is committed to promoting the fairness, liquidity, and efficiency of the U.S. securities markets. By supporting conditional repeal of the 1935 act, the SEC hopes to reduce unnecessary regulatory burdens on America's energy industry, while providing adequate protections for energy consumers.

Thank you, Mr. Chairman. I would be glad to try to answer any questions you might have.

[The prepared statement of Mr. Hunt follows:]

Prepared Statement of Isaac C. Hunt, Jr., Commissioner, Securities and Exchange Commission

I. INTRODUCTION

Chairman Bingaman, Ranking Member Murkowski, and Members of the Committee: I am pleased to have this opportunity to testify before you on behalf of the Securities and Exchange Commission ("SEC") regarding the provisions in Title II of S. 1766, the Energy Policy Act of 2002, that would repeal much of the Public Utility Holding Company Act of 1935 ("PUHCA" or "the Act"). As you know, for almost twenty years the SEC has consistently supported repeal of those provisions of PUHCA that either duplicate laws administered by other regulators or that are no longer necessary. The SEC has always stressed, however, that in order to protect the customers of multistate, diversified utility holding companies, it is necessary to give the Federal Energy Regulatory Commission ("FERC") and state regulators authority over the books and records of holding companies and authority to regulate their ability to engage in affiliate transactions. Since I last testified on PUHCA repeal in December, the magnitude of the Enron debacle, and the harm that Enron's collapse has tragically inflicted on the company's investors and employees, has become clearer. Congress and various regulatory agencies, including the SEC, are appropriately investigating what happened at Enron, why it happened and what should be done to prevent Enron-like debacles in the future. As we continue to investigate and learn from the events surrounding Enron's collapse, we remain open-minded and, of course, would reconsider our views on conditional PUHCA repeal if warranted. Currently, however, I am not aware of anything that would cause us to conclude that there is reason to abandon our longstanding support for conditional PUHCA repeal.

II. BACKGROUND

Before discussing the SEC's current views on PUHCA, it is useful to review the history of the SEC's longstanding support of repeal. PUHCA was enacted in 1935 in response to abuses that had occurred in the gas and electric industry during the first quarter of the last century.[1] The abuses included misuse of the holding company structure, inadequate disclosure of the financial position and earning power of holding companies, unsound accounting practices, excessive debt issuances, and abusive affiliate transactions.

The 1935 Act addressed these problems by giving the Commission authority over various practices of holding companies, including their issuance of securities and their ability to engage in affiliate transactions. The Act also placed restrictions on the geographic scope of holding company systems and limited registered holding companies to activities related to their gas or electric businesses. Because of its role in addressing issues involving securities and financings, the SEC was charged with administering the Act. In the years following the passage of the 1935 Act, the SEC worked to reorganize and simplify existing public utility holding companies in order to eliminate abuses.

In the early 1980s, however, the SEC concluded that many aspects of the 1935 Act regulation had become redundant. Specifically, state regulation had expanded and strengthened since 1935, and the SEC had enhanced its regulation of all issuers of securities, including public utility holding companies. The SEC therefore concluded that the 1935 Act had accomplished its basic purpose and that many of its remaining provisions were either duplicative or were no longer necessary to prevent

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[1] *See* 1935 Act section 1(b), 15 U.S.C. § 79a(b).

the recurrence of the abuses that had led to the Act's enactment. The SEC thus unanimously recommended that Congress repeal the Act.[2]

For a number of reasons—including continuing concern about the potential for abuse through the use of a multistate holding company structure, related concerns about consumer protection, and the lack of a consensus for change—repeal legislation was not enacted during the early 1980s. Because of continuing change in the industry, however, the SEC continued to look at ways to administer the statute more flexibly.

In response to accelerating changes in the utility industry during the early 1990s, in 1994, then-Chairman Arthur Levitt directed the SEC's Division of Investment Management to undertake a study, under the guidance of then-Commissioner Richard Y. Roberts, to examine the continued vitality of the 1935 Act. The study was undertaken as a result of the developments noted above and the SEC's continuing need to respond flexibly in the administration of the 1935 Act. The purpose of the study was to identify unnecessary and duplicative regulation, and at the same time to identify those features of the statute that remain appropriate in the regulation of the contemporary electric and gas industries.[3]

The SEC staff worked with representatives of the utility industry, consumer groups, trade associations, investment banks, rating agencies, economists, state, local and federal regulators, and other interested parties during the course of the study. In June 1995, a report of the findings made during the study ("Report") was issued. The staff's Report outlined the history of the 1935 Act, described the then-current state of the utility industry as well as the changes that were taking place in the industry, and again recommended repeal of the 1935 Act. The Report also outlined and recommended that the Commission adopt a number of administrative initiatives to streamline regulation under the Act.

Since the report was published, the utility industry in the United States has continued to undergo rapid change. Congress has facilitated many of these changes. For example, as a result of various amendments to the Act, any company, including registered and exempt holding companies, is now free to own exempt wholesale generators and foreign utilities and to engage in a wide range of telecommunications activities.[4] In addition, the SEC has implemented many of the administrative initiatives that were recommended in the Report.[5] In sum, during the past decade, while the SEC has continued to support repeal of the Act, we have also recognized that

[2] *See Public Utility Holding Company Act Amendments: Hearings on S. 1869, S. 1870 and S. 1871 Before the Subcomm. On Securities of the Senate Comm. On Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 359-421 (statement of SEC).

[3] The study focused primarily on registered holding company systems. There were, at the time of the study, 19 such systems. The 1935 Act was enacted to address problems arising from multistate operations, and reflects a general presumption that intrastate holding companies and certain other types of holding companies, which the 1935 Act exempts and which now number 119, are adequately regulated by local authorities. Despite their small number, registered holding companies account for a significant portion of the energy utility resources in this country. As of September 30, 2001, the 27 registered holding systems (which included 35 registered holding companies) owned 133 electric and gas utility subsidiaries, with operations in 44 states, and in excess of 2500 nonutility subsidiaries. In financial terms, as of September 31, 2001, the 27 registered holding company systems owned more than $417 billion of investor-owned electric and gas utility assets and received in excess of $173 billion in operating revenues. The 27 registered systems represent over 40% of the assets and revenues of the U.S. investor-owned electric utility industry and almost 50% of all electric utility customers in the United States.

[4] Sections 32 and 33 of the Act, which were added to it by the Energy Policy Act of 1992, permit, subject to certain conditions, the ownership of exempt wholesale generators and foreign utility companies. The impact of section 32 on the electricity industry is discussed in more detail below. Section 34, which was added by the Telecommunications Act of 1996, permits holding companies to acquire and retain interests in companies engaged in a broad range of telecommunications activities.

[5] The Report recommended rule amendments to broaden exemptions for routine financings by subsidiaries of registered holding companies (*see* Holding Co. Act Release No. 26312 (June 20, 1995), 60 FR 33640 (June 28, 1995)) and to provide a new exemption for the acquisition of interests in companies that engage in energy-related and gas-related activities (*see* Holding Co. Act Release No. 26667 (Feb. 14, 1997), 62 FR 7900 (Feb. 20, 1997) (adopting Rule 58)). In addition, the Report recommended and the SEC has implemented changes in the administration of the Act that would permit a "shelf" approach for approval of financing transactions. For example, during calendar year 2000, all eleven of the new registered holding companies received multi-year financing authorizations that included a wide range of debt and equity securities. The Report further recommended a more liberal interpretation of the Act's integration requirements which has been carried out in our merger orders. The Report also recommended an increased focus upon auditing regulated companies and assisting state and local regulators in obtaining access to books, records, and accounts. Six state public utility commissions participated in the last three audits of the books and records of registered holding companies.

we need to administer it faithfully, while streamlining and adding flexibility to the regulatory structure where permitted by the Act.

III. REPEAL OF PUHCA

A. The Commission's Continuing Support of Repeal

As I have stated, the Commission continues to support repeal of PUHCA, as long as repeal is accomplished in a way that gives the FERC and state regulators sufficient authority to protect utility consumers. Not surprisingly, however, in light of recent events, there are those who are now asking whether Enron's collapse should cause those who support PUHCA repeal to reconsider.

As I stated at the beginning of my testimony, the harm that Enron's collapse has inflicted on the company's investors and employees is now readily apparent. The SEC, various other regulatory agencies and the Congress are now all investigating what happened at Enron, why it happened and what should be done to prevent Enron-like debacles in the future. These investigations are not only appropriate, but are necessary if the implications of Enron for a broad range of policy issues are to be fully understood. Currently, however, I am aware of nothing with regard to Enron that would change our opinion on PUHCA repeal.

Enron is currently an exempt holding company under PUHCA. When Enron acquired Portland General Electric in 1998, it claimed an exemption under rule 2, 17 C.F.R. § 250.2, as an intrastate holding company. Enron was able to claim this exemption because it was incorporated in Oregon; Portland General, its only utility subsidiary, was incorporated in Oregon; and Portland General's utility operations were located in Oregon. Enron recently agreed to sell Portland General to Northwest Natural Gas, a transaction that is subject to Commission approval under PUHCA.

In 1994, Enron Power Marketing Inc. ("EPMI"), a subsidiary of Enron, received a no-action letter from staff in the SEC's Division of Investment Management in which the staff agreed not to recommend enforcement action against EPMI if it engaged in power marketing activities without it or Enron registering under the Act. In its request for no-action relief, EPMI argued that the contracts, books and records and other materials underlying its power marketing activities were not "facilities used for the generation, transmission, or distribution of electric energy for sale" (see PUHCA § 2(a)(3)), that the power market subsidiary was therefore not an "electric utility company" for purposes of PUHCA, and Enron was thus not a utility holding company for purposes of the Act. EPMI's request stated that, at the time, other companies were already engaged in similar power marketing activities. The staff, without necessarily concurring in EPMI's legal analysis, gave EPMI the requested no-action relief. The staff has given analogous no-action relief to approximately twenty companies.[6]

As Chairman Pitt testified before a House Subcommittee earlier this week, the speed and tragic consequences of Enron's collapse demonstrate the need for a variety of reforms in our administration of the securities laws that the Chairman and others at the SEC have been discussing in recent months. All investors, including investors in public utility holding companies, are entitled to a regulatory system that produces disclosure that is meaningful and intelligible. To address flaws in the current system, we are considering ways to ensure that investors receive more current disclosure, better disclosure of "trend" and "evaluative" data, and clear and informative financial statements. Likewise, in order to prevent our system of accounting from being abused, whether by public utility holding companies or other types of companies, we are working to establish a better system of private regulation of the accounting profession and to make sure that the FASB responds expeditiously and clearly to establish needed accounting standards.

Enron is a tragedy for our entire system of disclosure regulation. What happened to investors of Enron should be prevented from happening to investors in any company. However, the tragic collapse of Enron is not a result of its classification or lack of classification as a public utility holding company.

B. Affiliate Transactions and Cross-Subsidization

Thus, we continue to believe that repeal of PUHCA will not sacrifice any needed investor protections. As we have testified in the past, however, we continue to be-

[6] Since that time, the Commission has given exempt and registered holding companies the authority necessary to engage in power marketing as a nonutility activity. For example, rule 58, 17 CFR § 250.58, which was adopted in early 1997, permits registered holding companies to engage in "[t]he brokering and marketing of energy commodities, including but not limited to electricity, natural or manufactured gas and other combustible fuels" as a permitted nonutility activity.

lieve that, in order to provide needed protection to utility consumers, the FERC and state regulators should be given additional authority to monitor, police, and regulate affiliate transactions.

Specifically, although deregulation is changing the way utilities operate in some states, electric and gas utilities have historically functioned as monopolies whose rates are regulated by state authorities. Some regulators subject these rates to greater scrutiny than others. There is a continuing risk that a monopoly, if left unguarded, could charge higher rates and use the additional funds to subsidize affiliated businesses in order to boost its competitive position in other markets. Because repeal of PUHCA would eliminate existing restrictions on both the size of utility holding companies and their ability to engage in non-utility activities, this risk may be magnified if holding company systems become bigger and more complex. Thus, so long as electric and gas utilities continue to function as monopolies, the need to protect against this type of cross-subsidization will remain. The best means of guarding against cross-subsidization is likely to be audits of books and records and federal oversight of affiliate transactions. Any move to repeal PUHCA should include provisions giving the FERC and state regulators the necessary tools to engage in this type of oversight.

As we testified last year with respect to S. 206, the bill upon which the PUHCA repeal provisions of S. 1766 appear to have been based, S. 1766 represents a form of this type of conditional repeal. In particular, S. 1766 would provide the FERC with the right to examine books and records of holding companies and their affiliates that are relevant to costs incurred by associate utility companies, in order to protect ratepayers. S. 1766 would also provide an interested state commission with access to such books and records (subject to protection for confidential information), if they are relevant to costs incurred by utility companies subject to the state commission's jurisdiction and are needed for effective discharge of the state commission's responsibilities in connection with a pending proceeding. S. 1766 thus gives the FERC and state regulators the ability to review affiliate transactions after-the-fact and to exclude unjustified costs arising from affiliate transactions from a utility's rate base. While this is a significant power, and one we believe that state and federal rate regulators should possess, we also believe that Congress should consider giving the FERC the authority to use its rulemaking authority to prohibit or limit on a prospective basis those types of affiliate transactions that it concludes are so abusive that they should not be allowed.

C. Market Power Issues

Repeal of PUHCA would remove barriers that now exist to consolidation within the utility industry as well as barriers that prevent diversified, non-utility companies from acquiring utilities. Removal of these restrictions may raise competitive issues related to the "market power" of utilities. PUHCA was intended to address, among other things, the concentration of control of ownership of the public-utility industry. In particular, section 10(b)(1) of the Act requires the SEC to disapprove a utility acquisition if it will tend toward concentrated control of public-utility companies in a manner detrimental to the public interest or the interest of investors or consumers.[7] Traditionally, the SEC's analysis of utility acquisitions under section 10(b)(1) includes consideration of federal antitrust policies.[8] More specifically, the anticompetitive ramifications of an acquisition have traditionally been considered in light of the fact that public utilities are regulated monopolies subject to the ratemaking authority of federal and state administrative bodies.[9]

However, the SEC is not the only agency that reviews the potential anticompetitive effects of utility acquisitions. In many instances, proposed utility acquisitions are subject to FERC and state approval. Like the SEC, the FERC must consider antitrust implications of matters before it.[10] In addition, the potential anticompeti-

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[7] The SEC must also consider whether the purchase price is reasonable; whether the purchase will unduly complicate the capitalization of the resulting system; and whether the transaction will serve the public interest by tending toward the economic and efficient development of an integrated public-utility system.

[8] *Municipal Electric Association* v. *SEC*, 413 F.2d 1052, 1056-07 (D.C. Cir. 1969) (section 10(b)(1) analysis "must take significant content" from "the federal anti-trust policies"), cited in *City of Holyoke* v. *SEC*, 972 F.2d 358, 363; *Environmental Action, Inc.* v. *SEC*, 895 F.2d 1255, 1260 (9th Cir. 1990) ("Federal antitrust policies are to inform the SEC's interpretation of section 10(b)(1)").

[9] *Entergy Corp.*, Holding Co. Act Release No. 25952 (Dec. 17, 1993), citing Northeast Utilities, Holding Co. Act Release No. 25221, *request for reconsideration denied*, Holding Co. Act Release No. 26037 (Apr. 28, 1994), *remanded sub nom. Cajun Electric Power Cooperative, Inc.* v. *SEC*, 1994 WL 704047 (D.C. Cir. Nov. 16, 1994).

[10] *See Gulf States Utilities Co.,* v. *FPC*, 411 U.S. 747 (1973).

tive effects of utility acquisitions are independently reviewed by the Department of Justice or the Federal Trade Commission.

In recent years, the SEC has looked to all these regulators for their expertise in assessing operational and competitive issues, particularly in situations in which the combined entity resulting from a merger would have control of key transmission facilities and of surplus power. Thus, although the SEC does independently assess the transaction under the standards of PUHCA, we have generally relied upon the FERC's greater expertise regarding issues related to utility competition. The Court of Appeals for the District of Columbia Circuit has stated that "when the SEC and another regulatory agency both have jurisdiction over a particular transaction, the SEC may 'watchfully defer' to the proceedings held before—and the result reached by—that other agency."[11]

Therefore, repeal of PUHCA is unlikely to affect how market power issues are reviewed at the federal level. While PUHCA provides an additional layer of regulatory approval for certain utility mergers, the Commission's reliance, where appropriate, on other regulators for the key market power determination make its review of market power issues largely redundant. Nonetheless, because repeal of PUHCA may increase consolidation in the utility industry, Congress could conclude that provisions such as section 202 of S. 1766 are necessary to give the FERC sufficient authority to ensure that what consolidation does occur in the utility industry does not harm consumers.

D. Other Consumer Protection Issues

I know that Congress and others are considering other types of consumer protections in the utility area. For example, there has been discussion of whether the FERC needs additional ratemaking authority in the wholesale electricity markets. Likewise, there has been discussion of whether the FERC or the Commodity Futures Trading Commission should be given additional authority to oversee trading in energy-related derivatives to prevent market manipulation. While I recognize that it is important for Congress to consider issues of these types, the SEC does not have statutory authority to regulate utility rates under PUHCA. Likewise, PUHCA does not give the SEC authority to attempt to prevent manipulation in the energy trading markets. The SEC therefore lacks the expertise to express a view on whether reforms are needed in these areas.

E. PUHCA Repeal and National Energy Policy

Repealing the Act is not, however, a magic solution to the current problems facing the U.S. utility industry. PUHCA repeal can be viewed as part of the needed response to the current energy problems facing the country—notably, the Administration's recent report on energy policy includes a recommendation that PUHCA be repealed.[12] But repeal of the Act will not have any direct effect on the supply of electricity in the United States. The Act does not, for example, currently place significant restrictions on the construction of new generation facilities. As part of the Energy Policy Act, Congress amended the Act in 1992 to remove most restrictions on the ability of registered and exempt holding companies (as well as companies not otherwise subject to PUHCA) to build, acquire and own generating facilities anywhere in the United States. These types of facilities—exempt wholesale generators or "EWGs"—are not considered to be electric utility companies under PUHCA, and, in fact, are exempt from all provisions of PUHCA. The only limitation that remains under PUHCA is one imposed by Congress on registered holding companies' investments in EWGs—namely, that a registered company may not finance its EWG investments in a way that may "have a substantial adverse impact on the financial integrity of the registered holding company system."[13] In short, the Energy Policy

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[11] *Madison Gas and Electric Company* v. *SEC*, 168 F.3d 1337, (D.C. Cir. 1999); *City of Holyoke* v. *SEC*, *supra* note 10, citing *Wisconsin's Environmental Decade, Inc.* v. SEC, 882 F.2d 523 (D.C. Cir. 1989).

[12] *See* National Energy Policy: Report of the National Energy Policy Development Group at 5-12 (May 2001) (recommending the reform of "outdated federal electricity laws, such as the Public Utility Holding Company Act").

[13] While no Commission approval is required for the acquisition of an EWG as a result of the Energy Policy Act, Commission approval is required, for example, before a registered holding company can issue securities to finance the acquisition of, or guarantee securities issued by, an EWG. Under the Energy Policy Act, Congress directed the SEC to adopt rules with respect to registered holding companies' EWG investments. Pursuant to these requirements, in 1993 the SEC adopted rules 53 and 54 to protect consumers and investors from any substantial adverse effect associated with investments in EWGs. Rule 53 created a partial safe harbor for EWG financings. Rule 53 describes circumstances in which the issue or sale of a security for purposes of financing the acquisition of an EWG, or the guarantee of a security of an EWG, will be

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Act removed restrictions on the ability of registered and exempt holding companies to build, acquire and own generating facilities anywhere in the United States. As a result, a number of registered holding companies now have large subsidiaries that own generating facilities nationwide. Numerous other companies not subject to the Act have also entered the generation business.[14]

Instead, repeal of the Act would eliminate regulatory restrictions that prohibit utility holding companies from owning utilities in different parts of the country and that prevent nonutility businesses from acquiring regulated utilities. In particular, repeal of the restrictions on geographic scope and other businesses would remove the impediments created by the Act to capital flowing into the industry from sources outside the existing utility industry. Repeal would thus likely have the greatest impact on both the continuing consolidation of the utility business as well as the entry of new companies into the utility business.

Repeal of the Act would also eliminate any impediments that exist to other regulators' attempts to modernize regulation of the utility industry. For example, during the past year, questions have arisen about how the Act will impact the ability of the FERC to implement its plans to restructure the control of transmission facilities in the United States.[15] Specifically, in order to "ensure that electricity consumers pay the lowest price possible for reliable service," the FERC recently implemented new regulations designed to create "independent regionally operated transmission grids" that are meant to "enhance the benefits of competitive electricity markets."[16] As a result of FERC's new regulations, many utilities will cede operating control—and in some cases, actual ownership—of their transmission facilities to newly-created entities. The status of these entities, as well as the status of utility systems or other companies that invest in them, raise a number of issues under the Act. Most prominently, it has been asserted that the limits the Act places on the other businesses in which a utility holding company can engage will create obstacles for nonutility companies that may wish to invest in or operate these new transmission entities. While the SEC believes it has the necessary authority under the Act to deal with the issues created by the FERC's restructuring without impeding that restructuring, repeal of the Act would nonetheless effectively resolve these issues.

This example, however, raises the broader issue of the relationship between the FERC's and the SEC's regulation of the utility industry. The FERC is clearly the agency that Congress intended to take the lead role in regulating the utility industry. The SEC, in contrast, is primarily devoted to regulating the securities markets. Although we always attempt to work together with the FERC to ensure that, to the extent possible, our regulation of utility holding companies under PUHCA does not impede their ability to regulate the utility industry, sometimes conflict is inevitable. Given this, if Congress chooses not to repeal PUHCA, we believe that responsibility for the Act, whether in its current form or in a modified form, should be transferred from the SEC to the FERC. Given the nature of the FERC's responsibilities and its expertise in regulating the utility industry, it is simply in a better position to balance the goals of PUHCA and the other statutes it administers, and thereby regulate the utility industry in a more consistent and effective manner.

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The SEC takes seriously its duties to administer faithfully the letter and spirit of the 1935 Act and is committed to promoting the fairness, liquidity, and efficiency of the United States securities markets. By supporting conditional repeal of the 1935 Act, the SEC hopes to reduce unnecessary regulatory burdens on America's energy industry while providing adequate protections for energy consumers.

The CHAIRMAN. Thank you very much, Commissioner Hunt.

Let me go ahead with Mr. Hemmingway. We appreciate your being here, and go right ahead with your testimony.

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deemed not to have a substantial adverse impact on the financial integrity of the system. For transactions outside the Rule 53 safe harbor, a registered holding company must obtain SEC approval of the amount it wishes to invest in EWGs. The standards that the SEC uses in assessing applications of this type are laid out in Rule 53(c).

[14] *See, e.g.*, National Energy Policy: Report of the National Energy Policy Development Group at 5-11 (May 2001) (noting that "[m]ost new electricity generation is being built not by regulated utilities, but by independent power producers").

[15] *See* FERC Order 2000, "Regional Transmission Organizations," 65 FR 810 (Jan. 6, 2000) (codified at 18 C.F.R. § 35.34).

[16] Order 2000, 65 FR at 811.

STATEMENT OF ROY HEMMINGWAY, CHAIRMAN, OREGON PUBLIC UTILITY COMMISSION, SALEM, OR

Mr. HEMMINGWAY. Mr. Chairman, members of the committee, my name is Roy Hemmingway. I am the chairman of the Oregon Public Utility Commission. I am here today on behalf of the National Association of Regulatory Utility Commissioners, commonly known as NARUC. I appreciate the opportunity to testify before you today, and I wish to have my written remarks included in the record and I will summarize those written remarks.

NARUC supports the provisions found in S. 1766, sections 223 through 228, as they pertain to reform of the Public Utility Holding Company Act and increasing Federal and State access to books and records, as well as moving Federal responsibility over holding companies to the Federal Energy Regulatory Commission.

In 1935, Congress enacted PUHCA in response to widespread financial abuse of electric and gas consumers and investors by multistate holding companies. Incidentally, the Holding Company Act was signed into law almost simultaneously with the Federal Power Act, which created the Federal Power Commission, which eventually became FERC.

PUHCA had three basic goals: to simplify corporate structure of utility companies so that they would aid Federal and State regulatory efforts; second, to focus utility management on the efficient operation of an integrated utility company operating in a limited geographic area and restricting diversification; and three, to protect utility consumers and investors through the disclosure of appropriate information, limitations on issuance of securities and guarantees, and regulation of inter-affiliate contracting practices within holding company systems.

There have been three significant changes to PUHCA in recent years. In the Public Utility Regulatory Policies Act of 1978, PURPA, Congress exempted owners of cogeneration and small powerplants from PUHCA's restriction on ownership of generating facilities. In 1992, in the Energy Policy Act, Congress exempted owners of any powerplant selling power exclusively at wholesale or an owner of a utility operating in a foreign country from the same restrictions. And in the Telecommunications Act of 1996, Congress amended PUHCA to allow utility holding companies to own subsidiaries providing telecommunications.

PUHCA, for the last 65 years, has been the principal determinant of the structure of the electric and natural gas utility industries. Repeal of PUHCA, although it is appropriate today, will require the addition of regulatory tools to prevent shifts in the structure of those industries from negatively affecting the consumers whom we as State commissioners are sworn to protect.

The energy utility industries today are the least concentrated major industries in the Nation. Over 100 different investor-owned utilities serve electricity customers and about 200 natural gas utilities serve customers today. There is no question that creating so many simply structured, geographically distinct entities was in the public interest 6 decades ago. These small companies were easier to regulate, were big enough to capture the economies of scale of the day, and provided greater assurance of responsiveness to local needs than did the absentee owners of their predecessor holding companies.

Repeal of PUHCA will likely lead to greater consolidation of the energy utility industry. As more local companies merge, more of their costs become federally jurisdictional and States lose some of their regulatory power. This shift away from State jurisdiction is happening in any case in the electricity industry, as increasing amounts of electricity are traded in the federally regulated wholesale market, relative to the State-regulated, utility-owned generation.

Today, it is questionable whether the industry structure mandated by the Holding Company Act is appropriate for a national electricity system characterized by active competitive markets. If the Holding Company Act is repealed, the Federal Government will no longer be mandating this industry structure that has resulted in so many relatively small utility companies that are geographically distinct. And States have some concerns about greater consolidation and greater complexity that is likely to result even if PUHCA repeal is a desired result. As a State commissioner, I have concerns about diversification into non-utility areas, about utilities dealing with affiliated interests, and the potential cross-subsidization of these interests from the regulated enterprises.

Access to books and records by State and Federal regulators of all the affiliates of a holding company is a very important tool for regulators in dealing with complex corporate structures involving utilities.

In addition, continuing my authority as a State regulator over mergers and strengthening FERC's authority over mergers is an important aspect of what needs to be done if PUHCA is repealed.

Finally, I think it is difficult to predict what will happen in the electricity and natural gas industries once PUHCA is repealed. The degree of consolidation and concentration that may result is not possible to predict today, and the problems that may result I think are not possible to predict. So, I urge this committee and the Congress to continue to monitor these industries. The Department of Justice, the Federal Trade Commission also should be actively involved in monitoring the developments in these industries if PUHCA is repealed.

That concludes my testimony, Mr. Chairman. I will be happy to answer questions at the appropriate time.

[The prepared statement of Mr. Hemmingway follows:]

PREPARED STATEMENT OF ROY HEMMINGWAY, CHAIRMAN, OREGON PUBLIC UTILITY COMMISSION, SALEM, OR

Mr. Chairman and Members of the Committee: My name is Roy Hemmingway. I am the Chairman of the Oregon Public Utility Commission. I am here today on behalf of the National Association of Regulatory Utility Commissioners, commonly known as NARUC. I greatly appreciate the opportunity to appear before the Senate Committee on Energy and Natural Resources and I respectfully request that NARUC's written statement be included in today's hearing record as if fully read.

NARUC is a quasi-governmental, nonprofit organization founded in 1889. Its membership includes the State public utility commissions for all States and territories. NARUC's mission is to serve the public interest by improving the quality and effectiveness of public utility regulation. NARUC's members regulate the retail rates and services of electric, gas, water and telephone utilities. We have the obligation under State law to ensure the establishment and maintenance of such energy utility services as may be required by the public convenience and necessity, and to ensure that such services are provided at rates and conditions that are just, reasonable and nondiscriminatory for all consumers.

NARUC supports the provisions found in S. 1766, sections 223 through 228 as they pertain to reform of the Public Utility Holding Company Act (PUHCA) and increasing Federal and State access to books and records as well as moving Federal responsibility to the FERC. Access to books and records required to verify transactions directly affecting a companies regulated utility operations is of vital importance to State commissions. Requests for such books and records by a commission, its staff, or its authorized agents should be deemed presumptively valid, material, and relevant, with the burden falling to the company to prove otherwise.

Additionally, the company should be required to commit to providing an audit trail for all corporate and affiliate transactions that impact the companies regulated utility operations. This would give a great deal of access to the State Commission for information that will be needed to audit affiliated activities of a company on a going-forward basis. More importantly, this will greatly diminish the burden of a State Commission and its staff to have to prove each time requested, the need to gain access to the books and records. On the other hand, the companies are protected from potential requests for access to books and records not pertaining to utility operations. Thus, these provisions have a symmetry which balances the regulators need to see with the companies' need to protect.

In 1935, Congress enacted PUHCA in response to widespread financial abuse of electric and gas consumers and investors by multistate holding companies. PUHCA had three basic goals. (1) To simplify the corporate structures of utility holding companies to aid State and Federal regulatory commissions in their efforts to regulate the rates and services of their utility subsidiaries; (2) To focus utility management on the efficient operation of an integrated utility company operating in a limited geographic area and to restrict diversification into non-utility activities; and (3) To protect utility consumers and investors through the disclosure of appropriate information, limitations on issuance of securities and guarantees, and regulation of inter-affiliate contracting practices within holding company systems.

There have been three significant changes to PUHCA in recent years. In the Public Utility Regulatory Policies Act of 1978, Congress exempted owners of cogeneration and small power plans from PUHCA's restrictions on ownership of generating facilities. In the Energy Policy Act of 1992, Congress exempted owners of any power plant selling power exclusively at wholesale or any owner of a utility operating in a foreign country from the same restrictions. In the Telecommunications Act of 1996, Congress amended PUHCA to allow utility holding companies to own subsidiaries providing telecommunications service.

I want to focus now on three issues regarding repeal of PUHCA. These are issues around industry structure, utility diversification, and utility transactions with affiliates.

INDUSTRY STRUCTURE

PUHCA, for the last 65 years, has been the principal determinant of the structure of the electric and natural gas utility industries. Repeal of PUHCA, although it may well be appropriate today, will require the addition of regulatory tools to prevent shifts in the structure of those industries from negatively affecting consumers.

The energy utility industries are today the least concentrated major industries in the nation. Over a hundred different investor-owned electric utilities and about 200 natural gas utilities serve customers today. There is no question that creating so many simply structured, geographically distinct entities was in the public interest six decades ago. These small companies were easier to regulate, were big enough to capture the economies of scale of the day, and provided greater assurance of responsiveness to local needs than did the absentee owners of their predecessor holding companies.

Repeal of PUHCA will likely lead to greater consolidation in the energy utility industry. As more local companies merge, more of their costs become federally jurisdictional, and states lose some of their regulatory power. This shift away from state jurisdiction is happening in any case in the electricity industry, as increasing amounts of electricity are traded in the federally regulated wholesale market relative to state-regulated, utility-owned generation.

Today, it is questionable whether the industry structure mandated by PUHCA is appropriate for a national electricity system characterized by active competitive markets. Repeal of the structural requirements of PUHCA, coupled with FERC review of mergers, will allow for the market to decide the appropriate level of industry concentration without bringing too much risk of concentrations of market power.

Regardless of the changing industry structure, states need access to the books and records of the holding company, so that they can effectively regulate the retail utility.

DIVERSIFICATION

Shortly after the enactment of the Energy Policy Act of 1992, which allowed electric utilities significant latitude to invest in non-utility and foreign activities, utilities began to diversify their investments in these non-utility and foreign ventures. Since this was new territory for State regulators as to how to protect consumers from the risk of these diversification efforts, some State regulators looked to negotiate "Chinese wall" agreements with the companies to be filed with the SEC. These agreements contained protective safeguards for utility customers from the risks associated with diversification through provisions for transfer pricing among affiliates on a basis other than cost, for access to books and records of affiliates, and for auditing transactions between utility and non-utility affiliates.

State commissions are responsible for protecting ratepayers from the risks associated with diversification by utilities and their holding companies into non-utility businesses and associated with future acquisitions by these entities of additional utility and non-utility businesses. Although it has become common practice for electric utilities to diversify into non-utility and foreign businesses, this diversification carries more risk than the core regulated utility business. NARUC believes that this risk should not be borne or shifted to the customers of the regulated utility, since the beneficiaries of these investments are the shareholders.

Currently, absent a negotiated agreement, when a company falls under the PUHCA, rather than having direct authority over financial transactions, cost allocations, and affiliate transactions, State Commissions are relegated to applying for relief as a party before the Securities and Exchange Commission (SEC), and the SEC rarely if ever holds hearings under PUHCA. Thus, the SEC staff makes its recommendations to the SEC based on the exchange of paper pleadings among parties and bypasses the traditional evidentiary process. In general, the registered holding company structure creates opportunities for regulatory forum shopping, in that, if a registered holding company and its subsidiaries do not receive the cost recovery result they want from State regulators, they can ingeniously find a way to make the costs at issue subject to the SEC's jurisdiction under PUHCA by creating a company in which to house such costs or moving such costs to a common service company or by some other means.

Additionally, regulation by the SEC under PUHCA has been greatly relaxed since the 1980s with regard to its interpretation to meet changing circumstances in the industry. The SEC staff, which is at a minimal level, is not adequate to conduct compliance audits of the numerous registered holding companies under its jurisdiction, while the number of registered holding companies has increased significantly in recent years. In fact, the SEC staff has, in the past, solicited the help of State regulatory auditors in these undertakings. However, States may not always benefit from participating in such joint audits with the SEC. Participating State auditors could have difficulty obtaining confidential data from the company being audited because the company can protest as to whether the State had clear authority to access this data.

In sum, the SEC cannot and does not adequately protect retail customers from the risks of diversification by holding companies and their affiliate enterprises.

TRANSACTIONS WITH AFFILIATES

Section 13 of PUHCA and related regulations generally govern the oversight by the SEC of contracts for goods and services among affiliated companies. Section 13, and the implementation of Section 13 by the SEC, is inadequate for addressing abusive affiliate transactions. The allocation of common overhead costs anticipated to be consolidated as a result of the merger would fall under the regulation of the SEC under PUHCA, including the use of the "at cost" standard for affiliate transactions, regardless of whether the SEC requires the creation of a separate service company to house these common overhead functions.

As I alluded to earlier, abusive affiliate transactions, including intercompany loans and stock issuances and price gouging, led to the enactment of PUHCA in the first place. Although most of these abuses were cleaned up as a result of PUHCA's passage, there is still ample opportunity for registered holding companies to pass off bad business decisions to the regulated utility side of their businesses. Thus, there is a concern that the SEC's "at cost" standard can prevent State regulators from exercising meaningful authority over the prudence of a utility's business dealings with its affiliated companies. If these affiliates happen to be in non-utility businesses, the possibility of cross-subsidization of unregulated activities by regulated utilities also arises.

PUHCA insured that affiliate transactions could occur only at cost, thus slamming the lid on affiliates charging prices way above cost to their sister utility companies for goods and services. There have been cases where the "cost" of an affiliate for a good or service exceeds what a utility could buy the same good or service for in the market. For example, suppose that a registered holding company creates a subsidiary to buy real estate and lease it back to its affiliate utility subsidiaries. Suppose that the real estate subsidiary leases the building to the utility subsidiaries for $10 million annually, which is cost. Under the SEC's "at cost" rule for affiliate transaction pricing, the regulated utility subsidiaries would pay and charge their ratepayers $10 million annually, without reference to the current market for similar real estate in the area. If the same utility subsidiaries could lease office space for $5 million annually in the local market, then under the "at cost" rule for affiliate transactions, ratepayers would be subsidizing the activities of the real estate subsidiary. These circumstances are very similar to those in the *Ohio Power* case, where the utility subsidiary was forced to pay the costs of coal from its affiliated coal company, which exceeded market coal prices by 30 percent. Thus, affiliate transactions can raise the issue not only of imprudent decision-making, but also of handcuffing state regulators under pre-emption by the SEC under PUHCA.

In conclusion, NARUC believes that Congress should reform PUHCA in the manner proposed in S. 1766, but in doing so, should allow the States to protect the public through maintaining effective oversight of holding company practices and expanding State access to holding company books and records, independent of any similar authorities granted to the federal regulatory bodies. NARUC also believes that given recent events, FERC and the States ought to be given greater access to corporate documents to conduct investigations into financial dealings than is contemplated in S. 1766. Each time statutory exemptions were made to PUHCA, safeguards to protect utility consumers were included. The enhanced State and Federal access to data and information we have suggested will provide consumer protection safeguards in an environment without the PUHCA safety net as we know it today. Additionally, I have attached to this statement, a copy of NARUC's National Electricity Policy, adopted at our Annual Convention held last November. This document presents NARUC's positions on those issues that help to frame the PUHCA debate. Thank you for your attention, I look forward to your questions.

* * * * *

NARUC's National Electricity Policy

I. GENERAL PRINCIPLES

The nation's energy policy should assure adequate, reasonably priced, reliable, safe, and environmentally sound electricity. To achieve this goal, Federal legislation should:

1. Encourage additional fuel- and technology-diverse supply resources to meet the nation's growing energy demands;
2. Promote demand-side management to achieve the most efficient use of electricity;
3. Provide for reliability standards and their enforcement;
4. Assure open and effective regional wholesale markets;
5. Minimize the environmental impacts of energy generation, delivery and use; and
6. Respect, preserve and strengthen the States' traditional roles in regulating distribution systems, planning, siting approval, reliability assurance, and consumer protection.

II. DIVERSE, PLENTIFUL AND ENVIRONMENTALLY RESPONSIBLE ENERGY SUPPLIES

A. Congress should encourage environmentally responsible electricity generation and the increased use of renewable energy technologies as a tool to achieve fuel diversity and greater energy security.

B. Congress should encourage domestic exploration and production of new natural gas supplies and expansion of natural gas transmission and delivery infrastructure in an environmentally sound manner at reasonable costs, but should avoid an overreliance on natural gas for new electric generation.

C. Coal fuels a significant portion of the nation's electric power and is expected to do so for the foreseeable future. However, because of coal's air emissions, it is important that Congress and States work together to reduce such air emissions and encourage development of low ?polluting central station generation, including clean-coal technology.

D. Congress or the Administration should increase the efficiency for licensing and relicensing processes of hydroelectric and nuclear facilities, without compromising substantive environmental and safety standards.

E. Although nuclear facilities create long-term radioactive waste problems, they should continue to play an important part of our national electric supply portfolio because they provide a significant portion of the nation's electricity supply and do not produce air emissions.

F. Congress needs to fulfill its commitment to provide the long-term storage of spent nuclear fuel very quickly. To accomplish this, Congress should ensure that the Nuclear Waste Fund revenue and appropriations are managed responsibly and used only for the establishment of a permanent repository. Pending development of a permanent repository, it is better to store spent fuel at one (or more) central location(s) on an interim basis than to leave it at reactor sites.

G. The States support ongoing and renewed efforts to maintain the security of nuclear power plants and prevent the proliferation of weapons-grade byproducts.

H. Congress should enact legislation to lift the Public Utility Regulatory Policies Act's mandatory purchase requirement, but should allow the States to determine appropriate measures to protect the public interest in resource acquisition and to address mitigation and cost recovery issues associated with these contracts.

III. DEMAND MANAGEMENT

A. Congress should promote energy efficiency programs through increased funding, tax credits, and the setting of increasingly more efficient national building codes and standards for motors, lighting and appliances.

B. Congress should promote planning strategies for maintaining a proper balance between supply and load that includes demand-side management techniques (including price-responsive demand mechanisms), intermittent and renewable resources, conservation/energy efficiency programs, as well as traditional supply and transmission options.

C. Congress should continue to provide funding for energy efficiency and conservation for low and moderate income consumers through programs that provide education, weatherization, housing improvements, installation of higher efficiency appliances, and similar usage reduction measures.

IV. RTOS, RELIABILITY, PLANNING & DELIVERY INFRASTRUCTURE

A. Regional Transmissions Organizations

1. Congress should require the FERC, in cooperation with the States, to determine boundaries, structure, and functions for regional transmission organizations (RTO).

2. Congress should require the FERC to give RTOs sufficient authority to perform regional grid management, expansion, and efficient system operations that are built and operated in the most economical, reliable and environmentally acceptable way to realize short-term as well as long ?term reliability and facilitate efficient wholesale market transactions.

3. Congress should require the FERC to recognize States' rights to active participation in RTO governance. This would include development (and revision) of market rules, reliability and planning, access to RTO market monitoring information, development, with federal authorities, of market power mitigation programs.

B. Long-Term Planning

1. Congress should require that RTOs or other regional bodies have sufficient authority to conduct long term planning for their regions and, working with the States and transmission owners, implement long-term planning that should:

   (a) Take into account fuel diversity including renewables resources;
   (b) Recognize the need for new investment in generation and transmission facilities that provides adequate reserve margins;
   (c) Assure that reliability is not compromised by resource imbalances;
   (d) Reduce any decisional role for entities with unreasonable generation or transmission market power;
   (e) Include broad public participation and collaboration among market participants and third party participation in offering competitive alternatives such as demand-side and distributed generation options;
   (f) Develop a cost allocation method that is objective, non-discriminatory, weighs environmental and societal risk, and associates costs with benefits;
   (g) Allow the use of competition, subject to appropriate regulatory oversight, to encourage robust wholesale markets; and

(h) Assure adequate resources in all regions of the nation.

2. Congress should support the States' authority over local distribution utilities to provide interconnection arrangements for self-generation and generation units that utilize the local distribution network.

C. Reliability

1. Congress should mandate compliance with industry-developed reliability standards on the bulk power system that includes adequate reserve margins and preserves the authority of the States to set more rigorous standards when deemed to be in the public interest.

2. Congress should ensure that States continue to have the authority to establish effective price signals that allow consumers to choose alternative levels of reliability and power quality.

D. Delivery Infrastructure

1. States should retain authority to site electric facilities, while Congress should support the States' authority to negotiate and enter into cooperative agreements or compacts with federal agencies and other States to facilitate the siting and construction of electric transmission facilities as well as to consider alternative solutions to such facilities, such as distributed generation and energy efficiency.

2. Congress should pursue policies that promote and ensure pipeline safety, and streamline existing siting processes to increase administrative efficiency, including the coordination of all federal, State and local participation in these processes, without compromising substantive environmental and safety standards.

V. ENERGY MARKETS

A. Access to Information

1. Congress should recognize that States implementing competitive retail markets and those with traditional regulatory structures, and Federal, State and regional agencies and organizations overseeing the development of wholesale energy markets require comprehensive and timely market information. Congress should adopt policies that safeguard public access to information necessary to enable the monitoring of these markets, while also providing protection for information demonstrated to be commercially, or otherwise, sensitive.

B. Retail Markets

1. Congress should not interfere with the States' authority over all aspects of retail service including the authority to determine just and reasonable retail rates, and those retail rates designed to encourage reductions in peak demand and to encourage demand-side management options.

2. Congress should not mandate retail electricity competition.

C. Wholesale markets

1. Congress should require the FERC to promulgate clear and consistently applied market rules that foster investment in generation, transmission and demand-side management resources.

2. Congress should mandate effective and independent monitoring of the wholesale electricity markets and empower the relevant States and federal agencies with authority to investigate, enforce, and remedy problems resulting from the exercise of market power or other abusive behavior that distorts market operations. Such remedies should include the use of structural remedies, codes of conduct, or affiliate rules.

3. Congress should preserve a State's ability to require that a utility's retained generation be used to serve native load.

VI. ENVIRONMENTAL PROTECTION

A. Congress should assure that State and federal energy and environmental policies be coordinated and complementary.

B. Congress should address all air emissions from all electric power generation in ways that: 1) minimize adverse environmental impacts; 2) are comprehensive and synchronized to reduce regulatory costs; 3) rely, to the extent possible, on market-based trading mechanisms, and 4) identify, to the extent possible, the net impact of resource decisions, including external factors, on public health, the environment and the economy.

C. Congress should assist States and utilities to establish programs to phase out power plants grandfathered under the Clean Air Act with facilities that utilize clean coal technology or by other means, in a way that preserves the integrity of the bulk power system and minimizes the economic impact on local areas.

VII. CONSUMER PROTECTION

A. Congress should not limit State authority to prescribe and enforce laws, regulations or procedures regarding consumer protection.

B. Congress should reinforce the States' authority to require all load serving entities to disclose generation sources and accompanying environmental impacts.

C. Congress should address the preservation of public benefits in any electric industry restructuring legislation. Societal costs and benefits should be studied prior to the adoption of any particular implementation or funding mechanism.

D. Congress should require regional transmission organizations, system operators, reliability counsels and other regional agencies to adopt policies that allow public access to information necessary to enable adequate monitoring of energy markets, while also providing protection for information demonstrated to be commercially sensitive.

E. Congress should reform the Public Utility Holding Company Act (PUHCA), but, in doing so, should allow the States to protect the public through maintaining effective oversight of holding company practices and expanding State access to holding company books and records, independent of any similar authorities granted to the federal regulatory bodies.

The CHAIRMAN. Thank you very much.

Ms. Marlette, why do you not go right ahead?

STATEMENT OF CYNTHIA A. MARLETTE, GENERAL COUNSEL, FEDERAL ENERGY REGULATORY COMMISSION

Ms. MARLETTE. Thank you, Mr. Chairman, and members of the committee. My name is Cynthia Marlette, and I am General Counsel of the Federal Energy Regulatory Commission. I appreciate the opportunity to be here today to discuss the effects of repealing the Public Utility Holding Company Act of 1935 and whether, if PUHCA is repealed, the provisions of S. 1766 are sufficient to ensure competitive energy markets and provide adequate customer protection.

I appear here today as a commission staff witness and I do not speak on behalf of the commission or any one of the commissioners.

At this critical stage in the evolution of the electric utility industry, it is important to take all reasonable measures to support the development of competitive energy markets and to provide appropriate incentives for electric and natural gas infrastructure to meet this Nation's energy needs. Legislative reform, including repeal or reform of PUHCA, would help to more rapidly accomplish the goal of wholesale power competition which the Congress endorsed a decade ago in the Energy Policy Act of 1992. However, any legislative reform must ensure adequate protection of electric and natural gas ratepayers from abuse of market power and inappropriate affiliate cross-subsidization.

PUHCA, as it currently exists, may actually impede competitive markets and appropriate competitive market structures. In particular, it encourages greater geographic concentrations of generation ownership which may increase market power. Further, it may cause unnecessary regulatory burdens for utilities who seek to form or join regional transmission organizations, or RTO's, and it could serve as a significant disincentive for investments in independent for-profit transmission companies which are RTO's or which operate under an RTO umbrella.

PUHCA should be repealed or reformed so long as the following matters are addressed. First, Congress should ensure that the FERC and State regulatory authorities have adequate access to the books and records of all members of public utility holding company systems when that information is relevant to their statutory ratemaking responsibilities. Second, any exemptions from a new holding company act should be crafted narrowly. While it may be appropriate to grandfather previously authorized activities or transactions, no holding company should be exempt from affiliate abuse or market power oversight.

The PUHCA repeal provision of S. 1766, as introduced on December 5, 2001, in conjunction with other provisions in the bill would, from the FERC regulatory standpoint, help remove remaining competitive barriers and provide additional regulatory tools to create and sustain competitive wholesale power markets and to protect wholesale customers. If PUHCA if not repealed, the Congress needs to close the current regulatory gap, which was created by a 1992 court decision interpreting PUHCA, which impairs the FERC's ability to protect customers of registered holding companies from affiliate abuse and cross-subsidization.

I appreciate the opportunity to be here, and I would be happy to answer any questions the members may have.

[The prepared statement of Ms. Marlette follows:]

PREPARED STATEMENT OF CYNTHIA A. MARLETTE, GENERAL COUNSEL, FEDERAL ENERGY REGULATORY COMMISSION

Mr. Chairman and Members of the Committee: Good morning. My name is Cynthia A. Marlette, and I am General Counsel of the Federal Energy Regulatory Commission (FERC or Commission). Thank you for the opportunity to appear here today to discuss the effects of repealing the Public Utility Holding Company Act of 1935 (PUHCA) and whether, if PUHCA is repealed, the provisions of S. 1766 are sufficient to ensure competitive energy markets and provide adequate customer protection. I appear today as a Commission staff witness and do not speak on behalf of the Commission or any Commissioner.

In light of the Commission's primary statutory mission and expertise in regulating interstate transmission and rates charged in wholesale energy markets, my comments today focus on wholesale customer (ratepayer) protection. They do not address whether any provisions of PUHCA or other legislative measures are necessary to protect the interests of shareholders or employees of electric or gas holding companies or their subsidiaries or affiliates. I defer to other agencies with greater expertise on these important issues.

At this critical stage in the evolution of the nation's electric industry, it is important to take all reasonable measures to support the development of competitive energy markets and to provide appropriate incentives for electric and natural gas infrastructure to meet our nation's energy needs. Legislative reform, including repeal or reform of PUHCA, would help to more rapidly accomplish the goal of wholesale power competition which the Congress endorsed a decade ago in the Energy Policy Act of 1992. As I will discuss further in my testimony, the PUHCA repeal provisions of S. 1766 in conjunction with other provisions in the bill would, from the FERC's regulatory standpoint, help remove remaining competitive barriers, provide additional regulatory tools to sustain competitive wholesale power markets, and ensure adequate protection of electric and natural gas ratepayers from abuse of market power and inappropriate cross-subsidization.

We are now at a pivotal juncture in the development of competitive power markets, and it is appropriate for the Congress to reexamine the framework for regulating electric utilities, including unnecessary restrictions that PUHCA places on the activities of certain participants in these power markets. Although PUHCA was enacted to protect against corporate structures that could harm investors and ratepayers, today some of PUHCA's restrictions may actually impede competitive markets and appropriate competitive market structures, harming ratepayers and shareholders in the long run.

Since the legislative debate on PUHCA repeal began before the Congress almost six years ago, two major events have caused policy makers to more carefully examine PUHCA repeal and the adequacy of regulatory tools and protections under existing law and under various pending legislative proposals. These events are the California energy crisis and the recent collapse of Enron with its devastating effects on shareholders and employees. Both events have heightened scrutiny of competitive markets and the appropriate regulatory framework for the future of the electric industry. However, the majority of industry observers, including the Commission, continue to support competitive power markets, rather than traditional cost-based regulation, as the best means of serving energy customers in the long run.

In past testimony, FERC witnesses have raised no objection to repeal or reform of PUHCA, so long as certain ratepayer issues are addressed. Today, we continue to take the position that PUHCA needs to be repealed or reformed, so long as the following matters are addressed:

- First, Congress should ensure that the FERC and state regulatory authorities have adequate access to the books and records of all members of all public utility holding company systems when that information is relevant to their statutory ratemaking responsibilities. This is necessary to prevent affiliate abuse and subsidization by electricity and natural gas ratepayers of the non-regulated activities of holding companies and their affiliates.
- Second, any exemptions from a new holding company act should be crafted narrowly. While it may be appropriate to grandfather previously authorized activities or transactions, no holding company should be exempt from market power and affiliate abuse oversight.
- Third, if Congress retains any existing PUHCA functions and transfers them from the SEC to the FERC, instead of repealing PUHCA in its entirety and replacing it with broader access to books and records, Congress needs to provide FERC with staff and administrative support necessary for us to carry out the additional responsibilities.

Title II of S. 1766, as introduced on December 5, 2001, adequately addresses the above substantive concerns with respect to PUHCA reform. Title II of S. 1776 also provides additional regulatory tools to help promote a competitive marketplace for electric energy and protect wholesale customers. We believe these new provisions would significantly enhance the Commission's current authority under the Federal Power Act (FPA) to create and sustain competitive power markets and ensure customer protection. The one matter that is not addressed in S. 1766, and which would help promote a competitive marketplace and avoid potentially lengthy litigation, is a clarification of the Commission's authority to require regional transmission organizations (RTOs) where it finds RTOs to be in the public interest. RTOs will broaden regional energy markets, allow greater market efficiencies and eliminate remaining discrimination in transmission access and grid operations.

BACKGROUND

Under current law, the two major federal statutes affecting electric utilities are PUHCA and the FPA. Both statutes were enacted as part of the same legislation in 1935 to curb widespread financial abuses that harmed electric utility investors and electricity customers. While there is overlap in the matters addressed by these Acts, they each have different public interest objectives. The areas of overlap in the two statutes, and specific issues raised if PUHCA is repealed or amended, are described in detail in the Attachment to this testimony. As a general matter, however, the Securities and Exchange Commission (SEC) regulates registered public utility holding companies under PUHCA while FERC regulates the operating electric public utility and gas pipeline subsidiaries of the registered holding companies under the FPA and Natural Gas Act (NGA). The agencies often have responsibility to evaluate the same general matters, but from the perspective of different members of the holding company system and for different purposes. The FERC focuses primarily on a transaction's effect on utility ratepayers. The SEC focuses primarily on a transaction's effect on corporate structure and investors.

In June 1995, the SEC issued a report entitled "The Regulation of Public-Utility Holding Companies" and recommended that Congress conditionally repeal PUHCA and enact certain ratepayer safeguards in its place. We agree with a fundamental premise of the SEC's report that rate regulation at the federal and state levels has become the primary means of ensuring ratepayer protection against potential abuse of monopoly power by utilities that are part of holding company systems.

We also believe that PUHCA, in its current form, may actually encourage market structures that impede competition. In particular, under PUHCA acquisitions by registered holding companies generally must tend toward the development of an "integrated public-utility system." To meet this requirement, the holding company's system must be "physically interconnected or capable of physical interconnection" and "confined in its operations to a single area or region." This requirement tends to create greater geographic concentrations of generation ownership, which may increase market power and diminish electric competition.

In addition, PUHCA may cause unnecessary regulatory burdens for utilities who, in compliance with Commission policy and regulations, seek to form or join RTOs. RTOs will provide the major structural reform needed in the electric industry to mitigate market power and operate an efficient, reliable transmission system. These institutions will operate, or both own and operate, the interstate transmission grid within their regions, provide transmission services on an open, non-discriminatory basis, and perform regional transmission planning. They may be non-profit independent system operators (ISOs), or they may be for-profit transmission companies (transcos), or a combination of the two. The cornerstone requirement for the institutions, however, is that they be independent from power market participants, i.e., independent from those that own, sell or broker generation. Under PUHCA, any entity that owns or controls facilities used for the transmission of electric energy—such as an RTO—falls within the definition of public utility company, and any owner of ten percent or more of such a company would be a holding company and potentially could be required to become a registered holding company. This could serve as a significant disincentive for investments in independent for-profit transcos that qualify as RTOs or that operate under an RTO umbrella.

REVIEW OF S. 1766 TITLE II ELECTRICITY PROVISIONS

S. 1766 PUHCA Amendments

Title II, Subtitle B, of S. 1766 would repeal PUHCA and, in its place, enact the Public Utility Holding Company Act of 2002. The new Act would do five major things:

- provide the FERC with access to books and records of holding companies and their associate and subsidiary companies, and of any affiliates of holding companies or their subsidiaries (section 224);
- give state commissions that have jurisdiction over a public utility company in a public utility holding company system access to books and records of a holding company, its associates or affiliates (section 225);
- require the FERC to promulgate a final rule, no later than 90 days after enactment, to exempt from the books and records access requirements of section 224 any person that is a holding company solely with respect to one or more: qualifying facilities under the Public Utility Regulatory Policies Act of 1978; exempt wholesale generators; or foreign utility companies (section 226);
- provide that nothing in the Act precludes the FERC or a state commission from exercising its jurisdiction under otherwise applicable law to determine whether a public utility or natural gas company may recover in rates any costs of an activity performed by an associate company, or any costs of goods or services acquired from an associate company (section 227); and
- grandfather activities in which a person is legally engaged or authorized to engage on the effective date of the new act (section 231).

With these protections in place, and with the Commission's other regulatory authorities under the FPA in place, we do not believe that the S. 1766 PUHCA provisions would impair or diminish protection of wholesale ratepayers.

If PUHCA is not repealed, however, Congress should address what has come to be called the *Ohio Power* regulatory gap, which was created by a 1992 court decision and which is discussed in greater detail in the Attachment to this testimony. Briefly, in a decision by the United States Court of Appeals for the District of Columbia Circuit, *Ohio Power Company* v. *United States*, 954 F.2d 779 (D.C. Cir. 1992), the court held that if a public utility subsidiary of a registered holding company enters into a service, sales or construction contract with an affiliate company, the costs incurred under that affiliate contract cannot be reviewed by FERC. The court reasoned that because the SEC has to approve the contract before it is entered into, FERC cannot examine the reasonableness or prudence of the costs incurred under that contract. FERC must allow the costs to be recovered in wholesale electric rates, even if the utility could have obtained comparable goods or services at a lower price from a non-affiliate.

The Ohio Power decision has left a gap in rate regulation of electric utilities. The result is that utility customers served by registered holding companies under PUHCA have less rate protection than customers served by non-registered systems. If PUHCA is repealed, as in S. 1776, this problem will be solved. If the contract approval provisions of PUHCA are retained, however, this regulatory gap should be closed to restore FERC's ability to regulate the rates of utilities that are members of registered holding company systems.

S. 1766 Federal Power Act Amendments

In addition to the PUHCA repeal provisions in Subtitle B of S. 1766, Subtitle A of S. 1766 contains several amendments to Part II of the FPA: *Electric Utility Merger Authority (Section 202 of Subtitle A).* Commission authority over mergers and other corporate dispositions under FPA section 203 would be clarified or expanded to include authority over: an electric public utility's purchase, lease or other acquisition of existing facilities for the generation of electric energy or for the production or transportation of natural gas; a merger of a holding company whose holding company system includes a transmitting utility or an electric utility company with another holding company whose holding company system includes a transmitting utility, electric utility company or gas utility company; and any merger, sale, lease or disposition of generation-only facilities. In addition, the value of facilities covered by FPA section 203 would be increased from $50,000 to $1 million before Commission review would be triggered.

Thus, while overlapping SEC-FERC merger review would be eliminated by the repeal of PUHCA, the Commission's review authority would be clarified or strengthened under the new S. 1766 provisions. This would provide effective Federal oversight over corporate structures that include FPA public utilities, and the effect of such structures on wholesale competition and rates. *Market-based Rate Authority (Section 203 of Subtitle A).* In making a determination of whether market-based rates are just and reasonable and not unduly discriminatory or preferential, the Commission would be required to consider whether: the seller and its affiliates have adequately mitigated market power; whether the sale is made in a competitive market; whether market mechanisms such as power exchanges and bid auctions function adequately; the effect of demand response mechanisms; the effect of mechanisms or requirements to ensure adequate reserve margins; and such other considerations as the Commission may deem appropriate. Further, if the Commission finds under section 206 of the FPA that a market-based rate is not just and reasonable, it would determine the just and reasonable rate and order such other action as would in the judgment of the Commission adequately ensure a just and reasonable market-based rate.

While this provision directs the Commission to consider matters which it already has authority to consider under the existing FPA, it would appear to give the Commission significant new authority to order whatever remedies are necessary ("such other action") to ensure reasonable rates, once the Commission has completed its rate investigation. *Refund Effective Date (Section 204 of Subtitle A).* The refund effective date under an FPA section 206 investigation could be as early as the date a complaint is filed or the date the Commission issues a notice of intention to initiate an investigation. This would provide greater refund protection for customers and a stronger deterrence against overpricing by generators. *Transmission Interconnections (Section 205 of Subtitle A).* The Commission would be directed to establish, by rule, technical standards and procedures for interconnection. Transmitting utilities that are not regulated as public utilities (e.g., governmental and most electric power cooperative entities) would be required to interconnect upon application by a power producer or on the Commission's own motion.

This provision would strengthen the existing FPA section 210 interconnection authority of the Commission. It also would reduce procedural costs for new generators and transmitting utilities alike and lower overall electricity costs by helping efficient new generators get interconnected to the transmission grid more quickly. *Open Access by Unregulated Transmitting Utilities (Section 206 of Subtitle A).* The Commission would have authority to require open access transmission services by unregulated (governmental and most rural electric power cooperative) transmitting utilities at rates comparable to what they charge themselves and terms and conditions comparable to what public utilities must offer. The Commission would be required to exempt small entities, entities that do not own or operate transmission facilities necessary for operating an interconnected transmission system, or entities that meet other criteria that the Commission determines to be in the public interest. The Commission would have authority to remand rates to an unregulated transmitting utility.

This provision would help eliminate a major barrier to creating a seamless national power grid, by allowing the Commission to require open access over the approximate one-third of the transmission grid which currently is beyond the Commission's open access authority under sections 205 and 206 of the FPA. At the same time, the provision recognizes the unique circumstances of governmental and rural cooperative utilities and allows flexibility (e.g., remand of rates that are not just and reasonable) in asserting narrow transmission jurisdiction. This measure should produce transmission cost savings for many customers by reducing or eliminating pancaked transmission rates and discriminatory terms and conditions of transmission service and interconnection. *Electric Reliability Standards (Section 207 of Subtitle A).* The Commission would be required to establish and enforce one or more systems of mandatory electric reliability standards. It could certify one or more self-regulatory reliability organizations which may include the North American Electric Reliability Council, one or more regulated reliability councils, one or more RTOs, or any similar organization to monitor and enforce compliance. This would benefit customers by ensuring that there is Federal public interest oversight over electric industry reliability activities, and creating the ability to mandate compliance with what are now voluntary standards. *Market Transparency Rules (Section 208 of Subtitle A).* The Commission would be required to issue rules establishing an electronic information system to provide information, on a timely basis, about the availability and price of wholesale electric energy and transmission services to the Commission, state commissions, buyers and sellers of wholesale electric energy, users of transmission and the public. The Commission would require each RTO to provide statistical information about available capacity and capacity constraints on the transmission facilities operated by the RTO and also would require each broker, exchange or other market-making entity to provide statistical information about the amount and sale price of sales it transacts of electric energy at wholesale in interstate commerce. This information would have to be posted on the Internet. The Commission would be required to exempt from disclosure commercial or financial information that it determines to be privileged, confidential or otherwise sensitive.

These provisions would help prevent potential litigation about the Commission's ability to require market information disclosure where appropriate. They would improve market transparency through better electronic dissemination of information about trades in the energy markets and the transfer capabilities of the transmission infrastructure. The measures would help the Commission establish sound competitive wholesale markets by validating and broadening the agency's authority to compel such reporting and information dissemination. They also would help the Commission and financial market regulators and players to better monitor individual companies' participation and diminish the ability of any individual player to misbehave or misrepresent in the marketplace. There are two cautions, however:

First, while the S. 1766 provisions address actual trades, they do not appear to address at least two of the issues at the heart of Enron's situation—how the Enron companies handled and reported the risks and valuation underlying the trades they were conducting, and how they represented the value of the trades flowing through their platforms as corporate revenue. Those are broader financial reporting and regulation issues that are outside the scope of the Commission's jurisdiction and expertise.

Second, there is a difficult balance to be struck between information that must be disclosed to make markets work and information that is commercially proprietary. It is clearly to the public benefit to implement rules that disclose more information and improve market transparency, but it is not always easy in practice to find the appropriate point between reasonable information disclosure and protection. S. 1766's requirement to exempt commercial or financial information that the Commission determines is privileged, confidential or otherwise sensitive appears to give the Commission sufficient discretion on this important matter. *Access to Transmission by Intermittent Generators (Section 209 of Subtitle A).* The Commission would be required to ensure that all transmitting utilities provide transmission service to intermittent generators in a manner that does not penalize such generators for characteristics that are inherent to intermittent energy resources and are beyond the control of such generators.

These provisions would allow more renewable energy to be integrated into market operations at lower operating costs. This would enhance customers' ability to choose more environmentally clean energy sources. *Enforcement (Section 210 of Subtitle A).* The entities that could file a complaint under the FPA would be expanded to include electric utilities, and the entities against whom a complaint could be filed would be expanded to include transmitting utilities. Similarly, the Commission would have authority to investigate whether transmitting utilities have violated the FPA. The Commission's civil penalty authority under FPA section 316A ($10,0000 per day per violation) would be extended to cover any violation under Part II of the FPA.

The Commission currently has very limited civil penalty authority under section 316A of the FPA. This provision would significantly expand the Commission's ability to enforce Part II of the Act which would in turn enhance the Commission's ability to bring the benefits of competitive electric markets to customers.

S. 1766 PURPA AMENDMENTS

Subtitle C of S. 1766 would amend some of the provisions currently under the FERC's jurisdiction under the Public Utility Regulatory Policies Act of 1978: *Termination of Mandatory Purchase and Sale Requirements (Section 244 of Subtitle C.)* The mandatory purchase and sale requirements of PURPA (between qualifying facilities (QFs) and electric utilities) would be terminated; contracts existing on date of enactment would be grandfathered; and statutory ownership limitations for qualifying facilities would be eliminated.

These provisions would eliminate statutory requirements which are inconsistent with today's competitive power markets but, at the same time, would not disrupt expectations associated with pre-existing contracts. *Net Metering (Section 245 of Subtitle C).* Electric utilities would be required to make net metering service available upon request to an electric customer that the electric utility serves. The Commission would be permitted to adopt by rule control and testing requirements for on-site generating facilities and net metering systems, in addition to the other requirements in the statute, if the Commission determines they are necessary to protect public safety and system reliability.

CONCLUSION

Legislative reform, including repeal or reform of PUHCA, would help to more rapidly accomplish the goal of wholesale power competition. However, any repeal of PUHCA must ensure adequate protection of ratepayers, including state and federal regulator access to books and records of holding company members. The PUHCA repeal provisions of S. 1766 in conjunction with other provisions of the bill would, from the FERC's regulatory standpoint, help remove remaining competitive barriers and provide additional regulatory tools to sustain competitive wholesale power markets and protect wholesale and retail customers.

Thank you again for the opportunity to be here today. I would be happy to answer any questions you may have.

ATTACHMENT TESTIMONY OF CYNTHIA A. MARLETTE

EXISTING STATUTORY FRAMEWORK: FERC/SEC JURISDICTION

The FERC's primary function under the FPA is ratepayer protection. The FERC regulates public utilities as defined in the FPA. These include individuals and corporations that own or operate facilities used for wholesale sales of electric energy in interstate commerce, or for transmission of electric energy in interstate commerce. The FERC does not regulate all utilities. For example, publicly-owned utilities and most cooperatives are exempt from our traditional rate regulatory authority.

The FERC ensures that rates, terms and conditions for wholesale sales of electric energy and transmission are just, reasonable and not unduly discriminatory or preferential. In addition, the FERC has responsibilities over corporate mergers and other acquisitions and dispositions of jurisdictional facilities, transmission access, certain issuances of securities, interlocking directorates, and accounting. In exercising its responsibilities, the Commission must take into account any anticompetitive effects of jurisdictional activities.

There is overlap in the jurisdiction of the FERC and the SEC. As a general matter, the SEC regulates registered utility holding companies whereas the FERC regulates the operating electric utility and gas pipeline subsidiaries of the registered holding companies. The agencies often have responsibility to evaluate the same general matter, but from the perspective of different members of the holding company system and for different purposes. The FERC primarily focuses on the impact of a transaction on utility ratepayers. The SEC, on the other hand, primarily focuses on the impact of a transaction on corporate structure and investors.

There are four major areas of overlap in the jurisdiction of the FERC and the SEC with respect to regulation of the electric industry:

(1) Accounting—The SEC has authority to establish accounting requirements for every registered holding company, and every affiliate and subsidiary of a registered holding company. Many of these companies are public utilities that are also under the FERC's jurisdiction and subject to its accounting requirements.

(2) Corporate regulation—The SEC must approve the acquisition of a public utility's securities by a registered holding company. The FERC must approve the disposition or acquisition of jurisdictional facilities by a public utility.

(3) Rates—The SEC must approve service, sales and construction contracts among members of a registered holding company system. The FERC must approve wholesale rates reflecting the reasonable costs incurred by a public utility under such contracts.

(4) PUHCA Exemptions—Under the PUHCA section 32 amendment contained in the Energy Policy Act of 1992, the FERC must determine whether an applicant meets the definition of exempt wholesale generator, and thus is exempt from the Holding Company Act. With minor exceptions, the SEC continues to make PUHCA exemption determinations under the pre-Energy Policy Act PUHCA provisions as well as under the new section 33 of PUHCA (concerning foreign utility companies).

Congress recognized the overlap in FERC-SEC jurisdiction when it simultaneously enacted PUHCA and the FPA in 1935. It included section 318 in the FPA, which provides that if any person is subject to both a requirement of the FPA and PUHCA with respect to certain subject matters, only the requirement of PUHCA will apply to such person, unless the SEC has exempted such person from the requirements of PUHCA. If the SEC has exempted the person from the PUHCA requirement, then the FPA will apply.

During the half-century following enactment of PUHCA and the FPA, there were no significant problems resulting from the overlap in FERC-SEC jurisdiction, until a series of court decisions involving the wholesale rates of the Ohio Power Company. Under the last of these court decisions, a 1992 decision by the United States Court of Appeals for the District of Columbia Circuit (*Ohio Power Company* v. *FERC*, 954 F.2d 779 (D.C. Cir. 1992) (*Ohio Power*)), the FERC does not have the extent of rate jurisdiction which it previously thought it had over public utility subsidiaries of registered electric utility holding companies.

Under the 1992 *Ohio Power* decision, if a public utility subsidiary of a registered holding company enters into a service, sales or construction contract with an affiliate company, the costs incurred under that affiliate contract cannot be reviewed by the FERC. The SEC has to approve the contract before it is entered into. However, the FERC cannot examine the reasonableness or prudence of the costs incurred under that contract. The FERC must allow those costs to be recovered in wholesale electric rates, even if the utility could have obtained comparable goods or services at a lower price from a non-affiliate.

This decision has left a major gap in rate regulation of electric utilities. The result is that utility customers served by registered holding companies have less rate protection than customers served by non-registered systems. If PUHCA is repealed, the *Ohio Power* problem goes away. This is a significant advantage of S. 1766, introduced December 5, 2001. S. 1766 would repeal PUHCA and enact a new, more limited law that does not give rise to an *Ohio Power* problem. Short of repeal of PUHCA, however, the existing regulatory gap needs to be addressed.

ISSUES RAISED IF PUHCA IS REPEALED OR AMENDED

There are several ratepayer protection issues on which Congress should focus in considering PUHCA legislation. S. 1766 adequately addresses these issues. An important aspect of ratepayer protection is preventing affiliate abuse and the subsidization by ratepayers of the non-regulated activities of non-utility affiliates. These issues can arise in virtually every area of the FERC's responsibilities. In the case of public utilities that are members of holding companies, there are increased opportunities for abuses. There are several reasons for this.

First, registered holding companies have centralized service companies that provide a variety of services (e.g., accounting, legal, administrative and management services) to both the regulated public utility operating companies in the holding company system, and to the non-regulated companies in the holding company system. The FERC's concern in protecting ratepayers is that when the costs of these service companies are allocated among all members of the holding company system, the ratepayers of the public utility members bear their fair share of the costs and no more; ratepayers should not subsidize the non-regulated affiliates of the public utilities.

Thus far, FERC has had few, if any, problems with inappropriate allocations of service company costs. The services provided by the centralized service companies have been relatively limited. In recent years, however, there has been a substantial increase in the services being performed by these types of service company affiliates. In many registered company systems, the majority of the costs of operating and maintaining the operating utilities' systems, which previously were incurred directly by each individual utility, are now being incurred by the service company and billed to the public utility under SEC-approved allocation methods. These costs can be significant for ratepayers. This means that rate regulatory oversight of service company allocations is imperative.

A second concern involves special purposes subsidiaries. In addition to the centralized service companies, registered holding companies increasingly are forming special purpose subsidiaries that contract with their public utility affiliates to supply services, as well as goods and construction. This can include fuel procurement, services such as operation of power plants, telecommunications, and construction of transmission lines and generating plants.

The FERC's primary concern with affiliate contracts for goods and services is that utilities not be allowed to flow through to electric ratepayers the costs incurred under affiliate contracts if those costs are more than the utility would have incurred had it obtained goods or services from a non-affiliate. As discussed earlier, under the 1935 PUHCA the FERC cannot provide adequate protection to ratepayers served by registered systems because of the 1992 *Ohio Power* court decision.

The Commission recently has made some progress in protecting customers served by registered holding companies by using its conditioning authority over registered holding company public utilities that seek approval to sell power at market-based rates. The Commission has said that if such utilities want to sell at market-based rates, they must agree not to purchase non-power goods and services from an affiliate at an above-market price; they must agree that if they sell non-power goods and services to an affiliate, they will do so at the higher of their cost or a market price. However, the Commission's market rate conditioning authority is not enough to protect all registered system ratepayers against abusive affiliate contracts. Short of repeal of PUHCA, legislation is needed to fully remedy the regulatory gap.

According to the SEC's 1995 report, service companies render over 100 different types of services to the operating utilities on their systems, with non-fuel transactions aggregating approximately $4 billion annually. This growth adds to the potential for ratepayer subsidies involving both the centralized and the special-purpose service companies.

Another reason for heightened concern regarding affiliate abuses in all holding company systems, both registered and exempt, is the large number of holding company subsidiaries that engage in non-utility businesses. According to the SEC 1995 report, since the early 1980's the number of non-utility subsidiaries of registered companies had quadrupled to over 200. The trend in exempt companies is also likely to be significant as well. The sheer number of non-utility business activities brings greater potential for improper allocation of centralized service company costs to the non-utility businesses (i.e., electric ratepayers subsidizing the non-utilities' fair share of the costs). It also increases the opportunities for affiliate contracting abuses.

To protect against affiliate abuse and cross-subsidization, federal and state regulators must have access to the books, records and accounts of public utilities and their affiliates. Under section 301 of the FPA (and section 8 of the Natural Gas Act), the FERC has substantial authority to obtain such access. It can obtain the books and records of any person who controls a public utility, and of any other company controlled by such person, insofar as they relate to transactions with or the business of the public utility. This, however, may not necessarily reach every member of the holding company. Thus far, there has been no significant problem in obtaining access to books and records and in monitoring and protecting against potential abuses. However, the SEC's regulatory role with respect to registered systems has been an added safeguard.

It is critical that both state and federal regulators have access to books and records of all companies in a holding company system that are relevant to costs incurred by an affiliated utility. This is equally true with respect to both registered and exempted holding company systems. If Congress modifies or repeals PUHCA, it should clearly confirm the FERC's mandate and authority to ensure that ratepayers are protected from affiliate abuse. Similarly, we encourage Congress to be mindful of concerns expressed by state commissions and provide states with appropriate access to relevant books and records of all holding company systems.

In addition to the above ratepayer protection concerns, there are several other matters that should be considered in analyzing PUHCA reform. These include future corporate structures in the electric industry, diversification activities, and the issuances of securities affecting public utilities.

As mentioned earlier, the FERC must approve public utility mergers, acquisitions, and dispositions of jurisdictional facilities. This is an area in which the Commission has overlapping jurisdiction with the SEC, but also an area in which in some instances there is no overlap. Jurisdictional facilities under the FPA are facilities used for transmission in interstate commerce, or for sales for resale in interstate commerce. FERC has claimed jurisdiction over transfers of jurisdictional sales contracts but has disclaimed jurisdiction over dispositions that solely involve physical generation facilities. It appears that most state regulators have authority to regulate dispositions of physical generation assets. Further, such dispositions or acquisitions would be subject to the antitrust laws.

The FERC does not have any explicit jurisdiction to approve or disapprove diversification activities of public utilities or holding companies. Thus, if PUHCA were repealed, the only federal oversight of diversification activities of holding companies or their public utility members would be through FERC auditing of books and records. However, the SEC does not directly review public utility diversification activities of other holding companies and public utilities, and this has not posed any significant problems in the FERC's protection of ratepayers. In addition, many state commissions regulate diversification by public utilities that sell at retail.

A final area involves issuances of securities. The FERC must approve issuances of securities by public utilities that are not members of registered holding company systems, unless their security issuances are regulated by a state commission. Because the majority of states regulate issuances by public utilities, the FERC does not regulate most public utilities' issuances. If PUHCA were repealed, it appears that there would be no federal review and approval of issuances of securities by holding companies or their public utility members. The SEC can more appropriately address whether any federal oversight is necessary in this area.

The CHAIRMAN. Thank you very much.

Mr. Sokol, why don't you go right ahead?

STATEMENT OF DAVID L. SOKOL, CHAIRMAN AND CEO, MIDAMERICAN ENERGY HOLDINGS COMPANY, DES MOINES, IA

Mr. SOKOL. Thank you, Mr. Chairman.

MidAmerican Energy Holding Company is a diversified international energy company headquartered in Des Moines, Iowa, with approximately $13 billion in assets. Our largest investor is Berkshire Hathaway, one of the only AAA-rated industrial companies in the United States.

I would like to commend you for your persistence in working to include electricity modernization provisions in the Senate energy bill. S. 1766 addresses critical issues that only Congress can fix, covering such areas as reliability, changes to PURPA, FERC jurisdiction over transmission assets, PUHCA reform, a more thorough FERC merger review policy, and other consumer protection measures and information transparency requirements.

As you requested, I will focus on PUHCA and the specific issues you have asked me to address which include consumer protection, barriers to investment in market entry, and appropriate forums for regulatory oversight.

These issues are closely linked. 10 years ago, Congress passed the Energy Policy Act of 1992 in order to encourage open competitive wholesale electricity markets. PUHCA, passed in 1935 at the height of the depression, remains a significant impediment to that goal.

Our largest investor, Warren Buffett, has stated that he would intend to invest up to $15 billion in the industry once PUHCA is repealed or modified. Sadly, we have not invested in the United States for the last 2 years, but we have now purchased our second United Kingdom utility for $1.5 billion last summer. It is absurd that PUHCA's barriers to entry limit the ability of high credit quality investors like Berkshire Hathaway from investing in the U.S. utility market, thus forcing us to look overseas where we can invest more freely.

There are really two stories before this committee today. The first is what actually happened to energy markets as a result of the

Enron collapse, and the second is the story that is often spun by those who have long opposed market modernization measures.

On the first story, at your hearing on this topic last week, there was consensus that energy markets responded to the Enron collapse with little, if any, disruption. The lights stayed on, natural gas flowed, and the consumer prices did not rise. This was true for the broad markets and for the consumers of Enron's regulated subsidiary, thus proving a point that PUHCA reform supporters have been making for almost 20 years. Aggressive, effective State and Federal regulation are the true keys to consumer protection.

It is hard to imagine a company collapsing more swiftly or completely than Enron, yet the customers of its subsidiary, Portland General Electric, have been unaffected by that bankruptcy. This is the result of the effect of State and Federal regulation and the ability of State PUC commissioners to oversee issues of utility financing and cost recovery.

Now, the second story, what did not happen with Enron, first Enron was not working to build a multistate insulate utility empire as has been reported. To the contrary, it had been looking to sell Portland General for over the past 2 years. In fact, Enron probably would not even have been in the regulated utility business at the time of its collapse if PUHCA had not hampered its efforts to exit the business.

And why is that? PUHCA artificially and materially limits the number of buyers for any utility to those utilities that can meet the law's physical integration provisions. For example, we were approached 2 years ago by Enron about buying Portland General, and in fact we concluded that we wanted to buy them but could not because of the PUHCA restrictions.

That is what is wrong with PUHCA. It did nothing to help or to protect Portland General, and to the contrary, by blocking high credit worthy companies like ourselves, PUHCA has limited Enron's options so that it is now selling the company to a local gas utility based upon a very highly leveraged financial structure. This is one of the core problems of the statute. It serves as a barrier to entry of investment and results in market concentration. This arcane and counterproductive requirement also limits California's options as the State considers how best to recapitalize its utilities.

Second, Enron did not lobby for PUHCA repeal. It was a leading opponent of stand-alone PUHCA legislation and testified before Congress numerous times that it would only support PUHCA repeal as a tradeoff for concessions that it wanted. This committee should also be aware that in the most recent congressional testimony by Enron on electricity policy, Enron opposed enhanced access to books and records, provisions that we and most in this industry have long favored.

Third, Enron did not receive any special exemptions from PUHCA. Enron received two PUHCA exemptions from the SEC and both were clear cases under the law. The first was a statutory exemption provided to more than 50 holding companies whose utility operations are located primarily in a single State. And the second exemption concerned a question of whether a power marketer should be considered a public utility under PUHCA. The issue here was also simple. Just because you engage in energy trading does not make you a public utility subject to PUHCA. If it did, then virtually every investment bank in America that participates in the energy markets would also be subject to PUHCA. The SEC decision was clearly correct under the facts and the laws.

And what about charges the Enron collapse could have been prevented had the company somehow been subjected to PUHCA? Since it is clear that Enron was properly an exempt holding company under PUHCA, this charge could only be true to the extent that Congress intends to pass a new law like PUHCA and apply it to every publicly traded company in America. If, as it has been reported, a company is willing to violate the '33 and the '34 securities acts, shred documents requested by Congress, engage in highly questionable accounting practices, knowingly mislead investors, and ultimately drive itself into bankruptcy, why would PUHCA have somehow protected those shareholders?

American business executives must be held criminally and financially accountable for their illegal activities. We do not tell a teenager who steals from a convenience store that he can go scot-free if he just returns half of what he stole. Why should we adopt different standards for corporate executives and auditors?

It may also be necessary to strengthen certain financial laws and regulations, but those changes need to be applied to all publicly traded companies not just to a small subset of companies in one industry.

And at the same time, it may be appropriate to address the oversight of the energy futures trading activities. FERC Chairman Wood is moving aggressively to bring transparency and vibrant competition to the wholesale electric market. Some think he is moving too quickly; others believe he is moving too slowly. But few would disagree with his goal or the benefits that consumers will gain. This market will never achieve the depth, the transparency, and the level of competition we all seek if PUHCA's barrier to entry and investment remain in place.

The reasons why you must eliminate the anti-competitive and anti-consumer aspects of PUHCA are clear.

PUHCA's arbitrary limitations hurt consumers. Just last month, the D.C. Circuit Court of Appeals, relying on PUHCA's single region and physical integration requirement, remanded the SEC's approval of a large utility merger between AEP and Central and Southwest that would have produced consumer savings, acknowledged by the court, of $2.1 billion.

The law's ownership restrictions keep capital out of one of this country's most critical industries at a time when the transmission sector alone requires tens of billions of dollars of new investment.

The law's counterproductive requirements of interconnection and geographic proximity foster regional concentration, which runs directly counter to 50 years of antitrust law and economic theory.

PUHCA hinders FERC's ability to establish large, multistate regional transmission organizations.

And lastly, foreign companies are not restricted by PUHCA's physical integration provisions, and this gives them an advantage on their first bite entry into U.S. markets and sends American dollars overseas.

Your bill strikes the proper balance on PUHCA reform. It repeals the outdated provisions and strengthens consumer protections. It endorses FERC policy and modern antitrust law by recognizing that ownership of utility assets should not be artificially concentrated, and that high credit quality companies should be permitted to enter the market. At the same time, it strengthens the books and records provisions of the law.

If you provide regulators with better tools to protect consumers and provide more access to the marketplace by high quality companies, you will strengthen the U.S. electricity market.

You cannot fix PUHCA by tinkering around its edges. The SEC concluded in 1995 that PUHCA had accomplished its goals by 1952. It is time to repeal this law's antiquated and arbitrary physical integration requirements and its ownership limitations. At the same time, you can replace PUHCA with enhanced books and records authority and other consumer protections, as recommended by the chairman, and move the country forward to a competitive pro-consumer market.

Thank you.

[The prepared statement of Mr. Sokol follows:]

PREPARED STATEMENT OF DAVID L. SOKOL, CHAIRMAN AND CEO, MIDAMERICAN ENERGY HOLDINGS CO., DES MOINES, IA

Thank you, Mr. Chairman. MidAmerican Energy Holdings Company is a diversified, international energy company headquartered in Des Moines, Iowa with approximately $11 billion in assets. Our largest investor is Berkshire Hathaway, one of the only AAA-rated companies in the United States.

The Company consists of four major subsidiaries: CE Generation (CalEnergy) a global energy company that specializes in renewable energy development in California, New York, Texas and the West, as well as the Philippines; MidAmerican Energy Company, an electric and gas utility serving the states of Iowa, Illinois, South Dakota and a small part of Nebraska; Northern Electric, an electric and gas utility in the United Kingdom; and HomeServices.com, a residential real estate company operating throughout the country.

I'd like to commend you for your persistence in working to include electricity modernization provisions in the Senate energy bill. We cannot pass a national energy plan for the new century while leaving in place a regulatory system that was already outdated at the end of the last. Your bill does not seek to do everything, but it does critical things that only Congress can do, among these are:

1. Establishing a mandatory, enforceable electric reliability regime
2. Replacing the outdated PURPA mandatory purchase requirement with measures to promote distributed generation and standardize interconnection procedures
3. Bringing all owners of significant transmission assets under FERC jurisdiction to create a more seamless interstate system
4. Adopting a variety of consumer protection measures and information transparency requirements
5. Replacing the PUHCA law of 1935 with enhanced regulatory access to the books and records of all utility holding companies while adopting a more thorough merger review policy

This package represents a consensus of those who have worked actively in support of legislation for many years and will result in a modernized electric infrastructure that will benefit consumers while providing for fair competition.

As the American economy begins to recover, demands on our electric system will increase once again, and if we have not moved forward with the critical elements of market modernization, consumers may once again pay the price for an outdated system. At the same time, we should recognize that the pending recovery is tenuous and take steps to encourage the markets and American consumers that there is bipartisan support for positive, pro-investment initiatives.

In your invitation to testify, you specifically asked me to comment on a number of issues related to the PUHCA law, including issues of consumer protection, barriers to investment and market entry, and appropriate forums for regulatory oversight.

These three issues are unavoidably linked. Ten years ago, Congress passed the Energy Policy Act of 1992 in order to create open, competitive wholesale electricity markets so that investors, not consumers, would bear the risks associated with capital-intensive, electric generation investment. That is when PUHCA changed from being primarily a nuisance for companies to a burden for consumers.

By keeping investment dollars out of the industry and perpetuating market fragmentation, PUHCA contributed to the failure of our electric infrastructure to keep pace with the demands of the growing competitive wholesale market. MidAmerican's largest investor, Warren Buffett, has publicly announced his intention to invest as much as $15 billion in the industry once PUHCA is repealed. However, PUHCA's barriers to entry prevent him from making these investments, particularly in transmission and distribution assets.

Last year, I testified in both the Senate and the House of Representatives as to how PUHCA blocked MidAmerican from making major investments in the California utilities that could have helped stabilize their financial positions during the early part of the energy crisis. PUHCA's ownership limitations and physical integration requirements stood in the way.

PUHCA is also complicating attempts by the company to make a major expansion of our geothermal development in the Imperial Valley in Southern California. While we have begun a smaller project, we cannot undertake any expansion that would require us to build significant new transmission facilities to bring this power to the grid without potentially running afoul of PUHCA.

Some have claimed in recent contacts to the SEC that one cannot invest in a regulated utility asset and also make good non-utility investments. No law can make a good investor or a bad investor. Nor should any law determine that a person who invests in one industry should not be able to invest in another provided there are no conflicts of interest.

PUHCA and those who support its predetermined limitations on who can invest in this industry take a shortsighted approach. The way to protect consumers is not to maintain a Chinese wall around investment in this industry it is to maintain effective separation of the financing and rate structures of regulated utilities and their assets and any affiliated operations.

There has not been much good news in energy markets in recent months, and even conservatively managed traditional utilities are feeling financial pressure. This will make it harder than ever for the industry to raise capital and build new infrastructure. And, as consumers in California and the West experienced in recent years, market failure is the ultimate anti-consumer result.

PUHCA is not, and never was designed to be primarily a consumer protection statute. The overwhelming focus of the law is on preventing corporate malfeasance that harms investors. By eliminating financial abuses, Congress certainly expected that consumers would benefit, but PUHCA does not address rates, and the implementing agency, the SEC, has no rate setting function or expertise.

Simply put, if the issue is protecting consumers from unfair rates, FERC and the states have developed the expertise over almost seventy years to perform these functions. The SEC has absolutely no rate-setting function and has emphasized this fact on many occasions before Congress.

On the issue of cross-subsidies, the appropriate protection against cross-subsidization is the books and records access provided in the bill. Using my own company as an example, if the state of Iowa had concerns that MidAmerican Energy was inflating rates in our retail electric or gas tariffs to support a competitive business in some other state, under the bill, state regulators would have an explicit right in federal court to gain access to the books and records of any affiliated business in any other state that had conducted business with the utility.

At the same time, the Committee should be wary of attempts to make FERC some type of super-regulator of retail rates in all fifty states in the name of stronger protections against cross-subsidization. FERC's expertise is wholesale rates. State commissions are closest to the details of retail rate-setting and capital structure decisions. Muddying the water on this fairly clear distinction would be a recipe for disaster. We've already seen during the California crisis the debilitating impact that finger-pointing between Washington and the states can have on effective regulation. We should not go down that road.

The only rate-related provision of PUHCA relates to "at cost" pricing. While the law seeks to ensure that utilities and their affiliates do not engage in inter-affiliate pricing schemes to inflate consumer costs, the "at cost" requirement in the PUHCA law actually limits the ability of state and federal regulators to require registered holding companies to price some goods and services at the lower of "at cost" or market rates.

Much of this ground has been well-covered in recent years. That is why the PUHCA provisions included in this bill have been part of virtually every electricity modernization bill introduced in the last several Congresses, have enjoyed the support of the last four Administrations and the regulatory agencies that enforce the laws, and passed the Senate Banking Committee earlier this year by a 19-1 vote.

What has changed then?

We are here this morning because a few long-time opponents of updating the PUHCA law have made new claims arising from the Enron collapse. It's worth noting that one of these advocates stated last December that he could support the electricity provisions of this bill in its present form. But, I suppose that Enron fell, and opportunity knocked.

There are really two stories before this Committee today. The first is the story of what actually happened to energy markets as a result of the Enron collapse. These events should reassure the Committee that you should move forward with this legislation.

The second story is the one spun by those who have long opposed market modernization measures. It poses a series of events that did not happen and attempts to force supporters of PUHCA legislation to prove that these events could not have happened. Taken to its logical conclusion, this "expand PUHCA" agenda would require Congress, FERC and the states to unravel more than a decade's efforts to create open, vibrant and transparent energy markets.

The reason why this is so is instructive. Virtually every element of modern competitive electricity markets exists either as an explicit statutory exemption from PUHCA or as a result of regulatory determinations that gave flexible interpretations to PUHCA.

A "fundamentalist" view of PUHCA, that every electric or gas company that sells on the grid should be registered, would result in complete market concentration, elimination of the marketing industry and gutting of the EWG exemption since almost all EWGs rely on either an affiliated marketing company or independent marketers to sell competitive electricity.

Let's start with the first story. What happened to energy markets as a result of the Enron collapse?

At your hearing on this topic last week there was consensus that energy markets responded to the Enron collapse with little, if any, disruption. The lights stayed on, natural gas flowed, and consumer prices did not rise. This is true not only for the markets generally, but also for wholesale and retail customers of Enron's subsidiaries.

In December, all four FERC Commissioners testified before the House Energy and Air Quality Subcommittee that electric and gas markets had responded to the Enron collapse with remarkable resiliency. Chairman Wood repeated that assessment before this committee last week, along with independent market analysts, market participants and a representative of the state regulators.

In fact, the situation of the customers of Enron's retail electric and gas pipeline subsidiaries proves the argument that PUHCA legislation supporters have been making for almost twenty years, which is that aggressive, effective state and federal regulation are the true keys to consumer protection, not a statute that deals primarily with details of corporate structure.

It's hard to imagine a company collapsing more swiftly or more completely than Enron, yet the customers of Portland General and Northern Natural Gas, Florida Gas Transmission, Transwestern Pipeline and North Border Partners have been unaffected by the bankruptcy.

PGE's assets and operations have both regulatory and contractual safeguards. PGE has its own legal identity as a corporation, separate from Enron. It owns its own assets, and its management runs day-to-day operations, and its financial health is in good standing, as confirmed recently by several securities rating services.

This is the result of effective state and federal rate regulation and the ability of state commissions to oversee issues of utility financing and cost recovery. This is where real consumer protection occurs in electric and gas markets.

On the separate issue of whether Enron had been manipulating forward electricity markets, I commend the Committee for bringing these concerns to light.

In December, I met with members and staff on both sides of the aisle of the House Energy and Commerce Committee and shared my view that if there was any part of Enron's energy assets that had the potential for abuse, it was that company's domination of the "mark-to-market" exchange.

The allegations that Enron may have manipulated forward markets are troubling, and I encourage the Committee to pursue these further.

However, I am not aware of any way these issues could be linked to PUHCA. For those who argue that this shows that the Enron collapse did impact energy markets, I would respond that, if these allegations are proven true, it appears to have affected them in a positive direction for consumers.

Let's now look at the second story, what did not happen.

1. Enron was not working to build a multi-state Insull-like utility empire

To the contrary, it was looking to sell Portland General. In fact, Enron probably would not even have been in the regulated utility business at the time of its collapse if PUHCA had not hampered its efforts to exit that business.

Why? PUHCA artificially limits the number of potential buyers of any utility to non-utilities and those utilities who can meet the law's physical integration requirements. The physical integration requirement demands that two utility systems must be capable of interconnection to be legally combined under PUHCA. This is one of the core problems of PUHCA. It serves as a barrier to entry and investment and results in market concentration.

This arcane and counterproductive requirement also limits California's options as the state considers how best to recapitalize its utilities.

2. Enron did not lobby for PUHCA repeal

It was a leading opponent of stand-alone PUHCA legislation and testified before Congress that it would only support PUHCA repeal as a trade-off for concessions it wanted.

Enron's overall policy position with regard to traditional utilities can perhaps best be described as disqualify and dominate: Work to keep asset-backed utilities out of emerging energy markets, then dominate those markets.

The Committee should also be aware that in its most recent congressional testimony on electricity policy, Enron opposed enhanced access to books and records, provisions that we have long favored.

On July 22, 1999, Enron's Executive Vice President Steven J. Kean testified before the House Energy and Power Subcommittee, "we have concerns that H.R. 2363 creates unneeded regulatory oversight of affiliated companies that have no need for additional regulation of their books and records."

Supporters of PUHCA modernization and reform want more competitors in the marketplace, not fewer, and support giving federal and state regulators more tools to protect consumers.

3. Enron did not receive special exemptions from PUHCA

Enron received two PUHCA exemptions from the SEC. Both were clear cases under the law.

The first was a statutory exemption provided to more than 50 other holding companies whose utility operations are primarily located in a single state.

The second exemption concerned the question of whether a power marketer should be considered a "public utility" under PUHCA. PUHCA defines an "integrated public-utility system" as, "a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of interconnection."

The claim that the "no action" letter Enron received for Enron Power Marketing Inc. constituted a special exemption for Enron that ultimately allowed the company to escape regulatory scrutiny is the entire basis for the claim before the Committee today. However, for the SEC to have found otherwise would have required it to find that the assets of marketers—office equipment, paper contracts, and computer data—are "facilities" of public utilities comparable to generating plants and transmission lines.

This raises the interesting question of how these types of "facilities" could meet PUHCA's "physical integration" requirement. Obviously, they could not, and no other decision by the SEC seems supportable under either the facts or the clear definition in the law.

More importantly, had the SEC decided otherwise, the entire power marketing industry would probably not have developed.

It's hard to think of any single decision that would have had a more negative impact on consumers and competitive wholesale markets.

4. What about the other exemption mentioned in the New York Times?

This exemption, to the Investment Company Act of 1940—not PUHCA—is the exemption that some have claimed allowed Enron to engage is some activities that played a significant role in the company's collapse.

This appears to raise some genuine issues—but these issues have nothing to do with PUHCA, and attempts to use the Investment Company Act exemption as a way to derail electricity modernization are clearly opportunistic.

5. But couldn't the Enron collapse have been prevented had Enron somehow been subjected to PUHCA?

Since it's clear Enron should not have been considered a registered holding company, this could only be true to the extent that Congress would apply PUHCA-like financial regulations to every other publicly-traded company, energy or non-energy. There is nothing unique about the energy industry concerning Enron's financial activities.

If, as has been reported, a company is willing to risk violating the '33 and '34 Securities Acts, shred congressionally requested documents, engage in highly questionable accounting practices, knowingly mislead investors, and ultimately drive itself into bankruptcy, why would we believe that PUHCA would somehow protect its shareholders.

Congress can and should conduct a thorough review of all the accounting, bookkeeping, pension and corporate governance issues raised by this scandal. In some cases, laws and regulations may need to be strengthened. But these changes should be applied to all publicly-traded companies, not to a small subset of companies in one industry.

FERC Chairman Wood is moving aggressively to bring the wholesale electric energy market to an end-state of transparency and vibrant competition. Some are concerned that he is moving too quickly; others may believe he is moving too slowly. Few would disagree with his goal of achieving that end-state or the benefits that consumers will gain when we get there.

In his testimony before the Committee last week, he said, "If Congress" policy goal is to promote wholesale energy competition and new infrastructure construction, then reform of the Public Utility Holding Company Act of 1935 (PUHCA), supplemented with increased access by the Commission to the books and state regulators to certain books and records, will help energy consumers. Energy markets have changed dramatically since enactment of PUHCA, and competition, where it exists, is often a more effective constraint on energy prices. In the 65 years since PUHCA was enacted, much greater state and federal regulation of utilities and greater competition have diminished any contribution PUHCA may make toward protecting the interests of utility consumers."

This is not just the view of Chairman Wood, but also all the members of the Commission, and all his predecessors in the last decade. They have understood that this market will never achieve the depth, transparency and level of competition we all seek if PUHCA's barriers to entry and investment remain in place. The reasons why you must eliminate the anti-competitive and anti-consumer aspects of PUHCA are simple:

PUHCA's arbitrary limitations hurt consumers. Just last month, The D.C. Circuit Court of Appeals remanded the SEC's approval of a large utility merger that would provide consumers and the companies involved more than $2 billion in savings, based solely on concerns related to PUHCA's single region and physical integration requirements.

While some have claimed that this decision represented some form of victory for consumer interests, I disagree. Quoting from the ruling, the Court wrote, "According to Petitioners, the Commission erred in accepting (the two companies') projections that the proposed merger would produce approximately $2.1 billion in cost savings. We disagree. We owe considerable deference to the Commission's assertion that it 'reviewed the assumptions and methodologies that underlie' the projections and found them 'reasonable and consistent with . . . precedent.' Moreover, Petitioners point to no evidence or expert testimony supporting their assertion that the companies' calculations were flawed."

The law's ownership restrictions keep capital out of one of this country's most critical industries at a time when needs in the transmission sector alone will require tens of billions of dollars in new investment. As I mentioned before, Mr. Buffett has publicly stated his intent to invest as much as $15 billion in the industry if PUHCA is repealed.

The law's counterproductive requirements of interconnection and geographic proximity foster regional concentration, directly counter to 50 years of antitrust law. As I mentioned during testimony in the House last year, one of the ironies of PUHCA is that the only other utility that MidAmerican could purchase without running afoul of the Act are the utility assets of the only other investor-owned utility in the state.

As representatives of FERC have testified on numerous occasions, PUHCA hinders their ability to establish large, multi-state regional transmission organizations.

PUHCA also provides foreign companies which are not restricted by the physical integration standard an advantage on their "first bite" entry into the U.S. market and, at the same time, sends overseas American dollars that could be invested here. In view of the series of negative events that have buffeted this sector beginning with the crisis in California and the West, the overall economic downturn and the negative financial impact of the Enron collapse on much of the sector, I believe we could see a substantial increase in this trend in the next several years.

Congress cannot fix PUHCA by tinkering around its edges. The physical integration requirement and ownership limitations that are it's main problems are embedded in the statute's core. You can, however, replace PUHCA with enhanced books and records authority and the other consumer protection measures recommended by Chairman Bingaman and move the country forward toward a competitive, pro-consumer market.

The CHAIRMAN. Thank you very much.

Mr. Hempling, you are the cleanup witness here on this panel. Go right ahead.

STATEMENT OF SCOTT HEMPLING, ATTORNEY AT LAW, SILVER SPRING, MD

Mr. HEMPLING. Thank you, Mr. Chairman and members of this committee. My name is Scott Hempling. My law practice represents many of those who are beneficiaries of the Public Utility Holding Company Act, State commissions and consumers. Repealing the act, without substituting modern regulatory tools will leave those interests unprotected.

Repeal of the act, they say, in competition will flourish. Let us examine this argument.

At the Federal level, in the summer of 2000, the electric industry moved from the back pages of the business section to the front pages of the main section. The California price hikes that summer were the natural culmination of 20 years of carelessness in the analysis of wholesale markets, in the design of mechanisms to make those markets work, and in the design of consumer protections for when those markets do not work.

Consider the shifting rationales supporting FERC's foray into market pricing since the late 1970's. First, the rationale was to increase supplies. Then the rationale was to increase performance and coordinating services. Then the rationale was to compensate utilities for new risks. Then the rationale was to stabilize the weaker companies. And then came two new rationales: first, that energy pricing was justified by a competitive market; and next, that market pricing was necessary to attract entry into a non-competitive market. Notice the 180 degree turn in the last two rationales. Both cannot be correct. Yet, for over 20 years, all of these rationales were accepted by the Federal Energy Regulatory Commission.

To its credit, the present FERC is bringing these issues forward openly and forthrightly. Recent issuances from the FERC on market analysis and refunds reveal how significant were the past errors and how difficult is the work ahead. But no one knows how long it will take to make wholesale markets work.

Concerning regional transmission policy, core to the competitiveness of wholesale markets, anyone not recently freed from solitary confinement knows that, after 30 years of discussion, almost every issue remains on the table: independence for market participants, geographic scope and configuration, operational authority, short-term liability authority, tariff administration design, congestion management, parallel path flow, ancillary services, market monitoring, inter-regional coordination. While the present FERC has made dramatic progress in the past 7 months, this FERC would be the first to admit that the date on which all markets will be served by RTO's that are independently governed, efficiently priced, reliably operated, and publicly accountable is known by no one. In both these areas, market pricing and transmission, the present FERC is grappling with the problems and alternative solutions, but no one objective can credibly pinpoint the date on which these defects will disappear.

On multistate mergers, the industry consolidation is accelerating, but FERC merger policy has failed to hold mergers to the efficiency tests which would be required in a competitive market. Specifically, the FERC does not compare a proposed merger to alternative outlets for investment. It does not, in comparing costs and benefits, take into account acquisition costs, but instead focuses only on implementation costs and accounts as benefits coordination savings which could be obtained without a merger. That's at the FERC level.

At the State level, significant barriers to wholesale competition remain. Utilities are still retail monopolies almost everywhere. Retail ratemaking, using techniques in place for most of the last century, still induces utilities to favor the rate-basing of their own plants rather than buying on the wholesale market, and there is a market trend toward questioning construction at the State level by independent, out-of-state entrepreneurs. Even perfect Federal policies cannot create wholesale competition when State policies discourage wholesale competitors.

These facts should not surprise us because for most of this century the Government has given to a select set of corporations exclusive control over some of the Nation's most important assets, facilities for the generation, transmission, and distribution of electricity. So, despite the talk of competition, most utilities retain exclusive franchises to sell at retail, plus control of the transmission highways, plus influence over who will compete to sell generation in their service territories, plus influence over who will compete to provide demand site management services, still plus the right to sell generation to other service territories inside and outside the United States.

Our electric utilities have what economists call market power, the power to prevent competitive markets from working. The Public Utility Holding Company Act is a statute about market power. Repealing the statute, without addressing the problem of market power, is contrary to competition.

Let us now look more closely at some of the arguments for repeal. The Holding Company Act addressed mergers with a simple rule: only those mergers justified by improvement in physical operations would be permitted and then only if those mergers did not cause concentration of control or produce a complex capital structure or otherwise harm the public interest. So, in 1935, the Congress blocked all non-integrating acquisitions because it saw no possible benefit from them. Neither wholesale competition nor retail competition was evident at the time.

Today we want more wholesale competitors, so there is a legitimate question about the value today of the Holding Company Act's prohibition on non-integrating acquisitions. And in 1992, in the Energy Policy Act, Congress eliminated the prohibition for wholesale generators.

That brings us to the question of retail competition. In those States where retail competition is legally authorized, it is true today that the Holding Company Act's prohibition on non-integrating acquisitions limits the number of players in that market to those whose physical operations are integrated with that market. A retail customer shopping there would be better served with more players. Thus, the question whether to relax the Holding Company Act's ban on non-integrating acquisitions in this specific context is worth considering, and the legislative treatment I explain in my testimony makes room for such an adjustment.

But this reasoning does not apply at all in a retail market for which competition has not been authorized. In that non-competitive context, the Holding Company Act presents a barrier not to competitive entry but to monopolistic acquisition. That distinction deserves emphasis. There is a significant difference between financial entry and competitive entry. The acquisition by one monopolist by another is a change in control, not an increase in competition. To call this entry and then to criticize the Holding Company Act because it blocks market entry is to misuse the term. It is entry into a new market from the perspective of the acquirer seeking new captive customers, but it is not a new competitive entrant from the perspective of those captive customers for the simple reason that there is no competition.

Turning to S. 1766, the central themes of the Holding Company Act remain relevant today: preventing utility acquisitions that are not justified by efficiencies, limiting speculative investments, prohibiting inter-affiliate transactions, and restricting unsound practices. Therefore, acquisitions need to be continued on findings that they are the product of a competitive market, that they produce measurable, guaranteed benefits for the ratepayers of both the acquirer and the acquiree, that they do not weaken the financial strength of either the acquirer or the acquiree, and that they do not deprive existing utility customers of the benefits associated with their past contributions.

Title II of S. 1766 makes important contributions by clarifying the FERC's jurisdiction over mergers and by emphasizing care in the granting of sellers the right to charge market-based rates. But with the repeal of the Holding Company Act, the commission will need more substantial affirmative authority so as to screen in those acquisitions which promote efficiency and competition and screen out those acquisitions which do not.

Congress should transfer the regulatory responsibilities concerning the Holding Company Act to FERC. There seems to be consensus on that subject, for while FERC has not always pleased all its constituents and while it has used methodologies for merger review and market pricing that are disconnected from economic logic, it has remained publicly committed to the Federal Power Act.

The Public Utility Holding Company Act has not enjoyed comparable respect. 20 years ago, the SEC took the position that the act no longer was necessary because regulators could protect the consumer, and the agency held to this position firmly, right through the era of nuclear cost overruns, right through the era of savings and loan failures, through the era of the bankruptcies of three multi-billion dollar utilities, right through to 1996 when FERC officially discovered, 2 decades later than everyone else, that transmission owners exercised market power in generation markets, and even through the California market failure, that transferred billions of dollars from customers to generators.

Now the rationale has shifted. If regulators do not protect the consumer, competition will. Yet FERC, the very agency to which the SEC claims to defer, acknowledges the difficulties in implementing competition.

A world without the Holding Company Act. What would it look like? Without the Holding Company Act or its modern replacement, we would have a world of unreviewed acquisitions of retail monopolies, unlimited mixing of businesses which serve captive customers businesses, which take their risks into competitive markets, and no advanced reviews of the prudence of securities issuances. All this would take place in a world in which most retail customers have no competitive choices and in which the Nation's chief electric regulator acknowledges that wholesale competition is a work in progress.

We can do much better. We can relax the integration requirement, as other witnesses have pointed out. We can put limits on diversification, but allow it upon a showing of customer benefit and competitive improvement. And we can establish clear obligations in FERC to apply economic efficiency and competitive market standards to mergers.

That brings me to Warren Buffett who wants to enter the industry. He is more than welcome. He can come in as an exempt wholesale generator under the Energy Policy Act. He can buy an unlimited number of generation companies anywhere in the country without review. He can come in as a retail marketer or broker under rule 58 of the SEC. He cannot come in at this time and acquire existing monopoly assets. Let me emphasize. There are three ways he can enter the industry. The first two ways, he would be subject to what everybody argues is heated competition. In the third way, he can come in as a monopolist. Who would not complain about a statute that prevented him from picking up monopoly assets and selling to customers who have no choice but to buy his product? But even in this third way, Mr. Buffett should not be denied. If he can show that his entry is the product of competition, real competition, where he has to fight tooth and nail to win the favor of the ratepayers that he seeks to serve, then in my mind we should amend the Holding Company Act to let him in.

In closing, the electric industry lacks effective competition in many markets. Congress cannot nurture competition by giving free rein to companies which for a century have avoided competition, and Congress cannot protect consumers by confusing financial entry with competitive entry. To repeal the Holding Company Act without establishing a modern regulatory regime, one that conditions acquisitions on real competition and attentive regulation, is to allow dominant incumbents to exploit unearned advantages. Calling the result competition is good fiction but it is not good policy.

Thank you for the opportunity to present this testimony. I look forward to your questions.

[The prepared statement of Mr. Hempling follows:]

PREPARED STATEMENT OF SCOTT HEMPLING, ATTORNEY AT LAW, SILVER SPRING, MD

Mr. Chairman and Members of the Committee:

My name is Scott Hempling. I am the principal in a law firm which advises public and private sector clients involved in regulated industries, particularly state regulatory commissions and organizations of consumers or consumer representatives. I have represented clients in many cases under the Public Utility Holding Company Act of 1935 (PUHCA), before the Securities and Exchange Commission (SEC) and the U.S. Court of Appeals. I have testified before this and other Congressional committees many times on PUHCA and other electric industry matters. My testimony today reflects my own views, and not necessarily those of any past or current client.

I. INTRODUCTION: IS COMPETITION HERE?

Proponents of PUHCA repeal assert that "competition is here," or, that competition will be here once the Act is gone. These statements suffer from a lack of precision. Competition remains elusive, and those seeking to implement it struggle with a long list of unresolved issues, at both the FERC and state levels.

A. Competition Remains Elusive

For most of the last century, the combined actions of federal and state policymakers have given a selected set of companies the exclusive power to own the strategic assets of the electric industry: generation, transmission and distribution.

In two major efforts, Congress tried to stimulate a substantial nonutility presence in the generation sector. The Public Utility Regulatory Policies Act of 1978, and the Energy Policy Act of 1992, created categories of wholesale generating companies that would avoid "electric utility" status under PUHCA. Avoiding PUHCA meant that anyone could acquire any number of these generating companies in any location, using any corporate structure, unaffected by the various PUHCA requirements.[1] The PUHCA repeal sought today, in the name of competition, was largely granted in 1978 and 1992 for the wholesale generating sector.

PUHCA repeal at wholesale has not brought effective competition at wholesale. Despite some inroads by independent companies, most generation remains concentrated in traditional utilities or their affiliates. As discussed in Part I.B and C. below, we face a long struggle before electric generation looks like the competitive commodity markets that characterize wheat, soybean and pork bellies.

In the meantime, those who control generation are exploiting their advantages. Mergers of utilities with market power have become almost routine. These efforts at "strategic positioning" might be benign in a competitive environment. But in an industry infected with market power in every major asset and service segment, these mergers are biasing markets against competition for years to come.

Under these conditions, the repeal of PUHCA, on a stand-alone basis, can only make matters worse. Freeing dominant incumbents to acquire others may improve their own standing, but it will not improve the electric industry. It will burden further our regulators, and the customers they try to protect.

As discussed in Part I.B below, the Federal Power Act, in its design by Congress in 1935 and in its implementation by the Federal Energy Regulatory Commission (FERC) today, has serious gaps. Meanwhile, state regulators are striving to keep up with today's changes. But state regulation was a tool designed primarily to regulate local utilities and local transactions. The number and complexity of multistate transactions today pose real difficulties for State regulation. Many state commission staffs are struggling with the burdens of rate cases, intervention in FERC proceedings concerning mergers and transmission access, as well as the numerous changes in the gas and telecommunications industries.

[1] The exception is the limit on the share of a PURPA "qualifying facility" that can be owned by a utility.

B. The Implementation Struggle at FERC

On three key issues—measuring competitiveness, regional transmission service and mergers—the industry and its regulators lack a common understanding and commitment.

1. Measuring Competitiveness

The California price spikes of 2000 were the natural culmination of 20 years of carelessness in the (a) analysis of wholesale markets, (b) design of mechanisms to make those markets work and (c) design of consumer protections for when those markets do not work.

Consider the shifting rationales supporting FERC's departure from cost-based ratemaking since the late 1970's:

—desire to increase supplies
—increase performance in coordination services
—desire to compensate for new risks
—financial stabilization of weaker companies
—market pricing is justified by a competitive market
—market pricing is necessary to attract entry into a noncompetitive market

The sixth rationale was offered by many generators during the California summer and repeated by the then-FERC Chairman. Notice the 180 degree turn from the preceding rationale. Only one of those rationales can be lawful. Yet both rationales, and most others rationales offered by applicants over the past 20 years, were accepted by the Commission, although not without dissent.

To its credit, the present FERC is bringing these issues forward, openly and forthrightly. Recent issuances on market analysis and refunds reveal how significant were the past errors and how difficult is the work ahead.

a. Recent Actions on Market Measurement

There finally has been official recognition of the illogic plaguing the "hub and spoke" and "delivered price test" approaches to market measurement, and the need to replace them. On the subject of "hub and spokes" method, FERC itself has explained its deficiencies:

> An accurate assessment of the effect on markets depends on an accurate definition of the markets at issue. The Commission's current analytic [hub-and-spoke] approach defines geographic markets in a manner that does not always reflect accurately the economic and physical ability of potential suppliers to access buyers in the market. . . .
>
> A drawback of this method of defining geographic markets is that it does not account for the range of parameters that affect the scope of trade: relative generation prices, transmission prices, losses, and transmission constraints. Taking these factors into account, markets could be broader or narrower than the first- or second-tier entities identified under the hub-and-spoke analysis. . . .
>
> Another concern with the [hub-and-spoke] approach . . . is its analytic inconsistency. It defines the scope of the market to include the directly interconnected utilities that are accessible due to the applicants' open access tariff, but does not expand the market to recognize the access afforded by other utilities' tariffs. This was acceptable before open access was established as an industry-wide requirement for public utilities.

Merger Policy Statement, Docket No. RM96-6-000, 61 Fed. Reg. 68595 at 68599 (Dec. 30, 1996) (emphasis added).

Yet FERC, until about two months ago (about five years after acknowledging its serious defects), continued to apply the "hub and spoke" test to all applications for market-based pricing.

Then, on November 20, 2001, FERC came to terms with the fact that market-based rates had been approved for entities able to exercise market power. *AEP Power Marketing, Inc.*, 97 F.E.R.C. para. 61,219 (Nov. 20, 2001) (order on triennial market power updates and announcing new, interim generation market power screen and mitigation policy). That day the Commission issued an order replacing its "hub and spokes" test for market pricing with a new interim test called the Supply Margin Assessment (SMA). The Commission stated that it had concluded that, "because of significant structural changes and corporate realignments that have occurred and continue to occur in the electric industry, our hub-and-spoke analysis no longer adequately protects customers against generation market power in all circumstances."

Under the SMA, FERC will ask whether the applicant for market pricing has an amount of capacity which exceeds the supply margin (excess of supply over peak demand) in the prospective buyer's control area, taking into account transmission constraints. Where it finds that the seller controls supply resources exceeding the supply margin, FERC will conclude that the applicant seller is in a position to exercise market power and may limit the buyer to a "split savings" price rather than a market price.

FERC's November 20 order applied the new test in pending cases for renewal of market rate authority involving American Electric Power Co., Entergy Corp. and the Southern Cos. Within the control areas of each of the companies, the Commission found that the companies could exercise market power "because [their] generation is needed to meet the market's peak demand." The Commission therefore imposed mitigation measures.

b. Recent Actions on Refunds

Only in the last two months has the Commission moved to establish an express refund mechanism that protects consumers from market rates which, while perhaps just and reasonable at the time they were authorized, might become unjust and unreasonable later due to a decline in competitive forces. *See Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 97 F.E.R.C. para. 61,220 (Nov. 20, 2001) (order establishing refund effective date and proposing to revise market-based rate tariffs and authorizations). The proposed order would amend all market rate tariffs to clarify that where FERC finds that a seller with market rate authority has acted anti-competitively, FERC may issue a refund order. The order indicates that in ordering refunds the Commission will focus on two types of anti-competitive behavior—physical or economic withholding of supplies.

In short, the present FERC is struggling, openly and determinedly, to solve, on many fronts at once, a set of problems that has smoldered for years. But this very struggle is cause for caution. As hardworking and determined as they are, the present FERC Commissioners, like any prudent regulators, likely would hesitate to name a date on which they expect to see effective competition in all wholesale markets.

2. Regional Transmission Service

As to regional transmission policy, anyone not recently freed from solitary confinement knows that after 30 years of discussion almost every issue remains on the table:

—Independence from market participants
—Geographic scope and configuration
—Operational authority
—Short-term reliability authority
—Tariff administration and design
—Congestion management
—Parallel path flow
—Ancillary services
—Market monitoring
—Transmission planning and expansion
—Interregional coordination

While the present FERC has made major progress in the past 7 months, this FERC would be the first to admit that the date on which all markets will be served by RTOs that are independently governed, efficiently priced, reliably operated and publicly accountable is known by no one.

3. Mergers

Under Section 203 of the Federal Power Act, the FERC must disapprove mergers that are not consistent with the public interest. 16 U.S.C. 824b. Beginning in 1985, a process of consolidation began and accelerated in the second half of the 1990s. Mergers are now routine; yet there has been neither consensus nor clarity concerning FERC's merger analysis. Merger review at FERC remains economically indefensible. This conclusion follows from four merger principles that have emerged from various FERC cases:

a. The public interest is protected if costs do not exceed benefits, even though there might be other mergers or other investments which can produce the same benefits at a lower cost.

b. In comparing costs to benefits, FERC disregards acquisition cost and counts only implementation cost.[2]

c. The FERC counts as "benefits" coordination savings which could be obtained without a merger.

d. The FERC counts as "benefits" elimination of pre-merger imprudence.

Put simply, the present merger review standards do not distinguish efficient mergers from inefficient mergers. In a competitive market, a merging partner employing this analytical casualness would lose its shirt; in a regulated monopoly setting, the shirts are the customers'. This policy, applied repeatedly for 16 years, has done long-term damage to the cause of competition. There remains no process, either competitive or regulatory, that distinguishes combinations based on efficiency from combinations based on market share maintenance or market dominance.

C. The Implementation Struggle at the State Level

The problem of wholesale competition is not FERC's alone. The most pro-competitive FERC policies will not produce wholesale competition if entry is blocked in other ways. Several clouds appear, not only on the horizon but directly overhead:

1. Accommodating utility preference for self-construction: Few states have policies mandating that retail utility monopolies purchase their needs on the wholesale market. Leaving the choice with the vertically integrated utility creates strong bias favoring vertical integration and disfavoring wholesale competition.

Only occasionally is it in a utility's interest to forego construction (which would add to its rate base and therefore add to its profit), in favor of purchasing power from others (which assigns the profit to the generator and makes the utility a mere cost conduit).

2. State concerns with independent generation: Most states work mightily to attract physical investment: investment which creates jobs, broadens the tax base and, in the case of exporting industries, increases the state's trade surplus. In the case of new non-utility generation, this practice does not seem to exist; in fact the trend is in the opposite direction. An increasing number of states are questioning the benefits of allowing generation construction by companies that do not have firm loads, or who have customers located outside the state. In some instances, legal and political opposition to such construction has come from the incumbent utilities, who do not want competitors to gain a beachhead in their home markets. In other instances, there is legitimate concern from citizens wishing to avoid excess construction. Some seek to limit construction of generation in a state to plants intending to serve load in that state, even though such "hoarding" of in-state benefits and obstruction of interstate trade is a per se violation of the Commerce Clause of the U.S. Constitution. *See New England Power Co.* v. *New Hampshire*, 455 U.S. 31 (1982) (invalidating state law, which preserved benefits of state hydroelectric power for in-state consumers, because the law was "designed to gain an economic advantage to in-state consumers" to the detriment of consumers out of state).

The opposition to new generation, whether strategic or citizen-based, legitimate or illegitimate, has similar effect: it discourages competitive entry.

These two examples—utility preference for utility construction and state concerns with independent generation—indicate that the interest in wholesale competition has limits, when the costs of that competition are felt close to home, or when the losing competitor might be the home team. The best RTO policies in the world will not bring us wholesale competition, if state policies obstruct new generators. RTOs without generation entry means highways without traffic.

D. Overview of this Testimony

The central facts discussed above—that competition remains elusive and that its success depends on FERC and the states getting dozens of decisions right—establish the proper context in which to consider change to PUHCA. This testimony does not argue against any change to PUHCA. Instead, it describes the conditions which must be in place before amendment or repeal, so that persistent market power does not harm the consumer or impede progress to effective competition.

This testimony has five remaining sections.

Part II describes how PUHCA's major themes remain relevant today.

Part III recommends that Congress modernize certain PUHCA protections, and transfer the regulatory responsibility to FERC.

Part IV shows the how the arguments for stand-alone repeal lack a factual basis.

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[2] One would not buy a rental property merely because the expected rent exceeded the costs necessary to rehabilitate and maintain the space for tenants. One would buy the property only if the expected rent exceeded these implementation costs plus the acquisition cost.

Part V underscores the continuing relevance of PUHCA, and the need for a federal corporate structure statute, by explaining that proper application of PUHCA would have identified and prevented Enron's ill-fated activities.

Part VI concludes this testimony by describing the consequences of a world without a federal corporate structure statute for the electric industry.

II. PUHCA'S MAJOR THEMES REMAIN RELEVANT TODAY

Congress passed PUHCA to protect the public, investors, and consumers from utility holding company abuses. Congress identified several categories of abuses and acted comprehensively to address them. Today we still have the risk of abuse, and we still have the public, investors and consumers to protect from abuse. Most of the themes of the Act remain relevant today, including:

a. Prevent acquisitions that are not justified by operational efficiencies
b. End abusive inter-affiliate transactions
c. Restrict unsound financial practices

I discuss these main themes next. For each of the three themes, I will explain the original purpose, describe how the statute addresses it and show that the original purpose remains necessary.

A. Prevent Acquisitions Unrelated to Operational Efficiencies

Original Purpose: Congress was concerned about acquisitions motivated by acquisitiveness rather than operational efficiencies. These acquisitions produced complex holding companies structures aimed at milking the individual utilities and their customers, using techniques that state regulators could not police. Congress concluded that such holding company "activities extending over many States are not susceptible of effective control by any State and make difficult, if not impossible, effective State regulation of public-utility companies." Section 1(a). Congress saw a need to require holding companies to maintain a focus on the core business of utility service to captive consumers, limit financial risks to ratepayers, and protect businesses in unregulated industries from anti-competitive cross-subsidies.

Tools: Review of Utility Acquisitions: Congress adopted geographic restrictions on the growth and extension of holding companies by precluding utility holding company acquisitions where the acquired utility is not physically integrated (the "integration" requirement) and coordinated with existing utility properties. Section 2(a)(29)(A).

Congress further required that utility acquisitions create new operational and managerial efficiencies. Acquisitions under the Act must therefore create positive operational benefits. Section 10(c)(2).

Congress prohibited acquisitions of utility assets where the acquisition will "tend towards interlocking relations or the concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers." Section 10(b)(1).

Congress restricted registered holding companies to engaging in businesses "reasonably incidental, or appropriate to the operations" of the public utilities. Section 11(b)(1).

Non-registered or "exempt" holding companies may diversify into other businesses only to the extent that such diversification is not "detrimental to the public interest, or the interest of investors or consumers." Section 3(a).

Current Relevance: In most states retail electric and gas customers remain unable to shop. They are no less captive today than they were in 1935. Even in states where retail competition has been adopted, effective competition is largely absent. At the same time, the industry, after several decades of quiet following breakups mandated by PUHCA, has regained much of its pre-1935 concentration and complexity. Many holding companies have dozens of affiliates, many of them making investments worldwide. This growth in affiliates has had little to do with improving service to customers.

B. End Unreasonable or Abusive Inter-affiliate Transactions

Original Purpose: Utility holding companies exploited utility operating companies through financial mismanagement, taking advantage of the inability of state regulators to analyze complex and multistate transactions.

Tools: Review of Inter-affiliate Transactions: Congress sought to ensure that holding companies could not use service, management, construction, and other contracts to allocate charges among subsidiaries in different states so as to obstruct effective state regulation. In Section 13 Congress prohibited registered holding companies from entering into contracts for services and goods (other than power, which is regulated by FERC) without SEC approval.

In Section 12, Congress placed strict limits, and in some cases outright bans, on certain financial transactions between utilities, their holding companies and other subsidiaries. For example, a registered holding company cannot borrow from its subsidiary utilities. Sec. 12(a). Other limitations apply to a holding company's loans to its subsidiaries and payments of dividends. All transactions are covered by Commission rules concerning fair accounting treatment, maintenance of competitive conditions, disclosure of interests, and other "public interest" factors. Sec. 12(f).

Current Relevance: Industry consolidation, combined with an increase in use of "service" companies that provide non-power goods and services to the various utility operating companies of a holding company system, means that consumers continue to be at risk from their jurisdictional utility's transactions with affiliates. State regulators do not have the ability and resources, and in some cases may lack authority, to review the many transactions between affiliates of utility holding companies. Further, without federal intervention state regulators may be unable to access the books and records necessary to review the costs of an inter-affiliate transaction.

C. Restrict Unsound Financial Practices

Original Purpose: Congress in 1935 found public harm from speculative and unsound securities issuances. Prior to the Act, holding companies issued securities based on inflated capital structures, fictitious or unsound asset values, pyramidal structures, and other market manipulations. Congress thus intended PUHCA to address the adverse consequences to the public "when . . . securities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from inter-company transactions, or in anticipation of excessive revenues from subsidiary public-utility companies." Section 1(b)(1).

Tools: Review of Financing: Without SEC approval, a registered holding company or its subsidiary may not issue or sell any stock, or exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of the company. Sec. 6(a). (There are various exceptions, including for private offerings, short-term securities, and others.)

In reviewing a holding company or its subsidiary's filing for approval, the SEC must ensure, under Sec. 7(d), that:

- issuance or sale of the security does not jeopardize the security structure of the holding company system;
- the security is reasonably adapted to the issuer's earning power;
- the type of financing is necessary or appropriate to the economical and efficient operation of the issuer's business;
- the fees and commissions paid are reasonable;
- where the security is a guaranty of, or assumption of liability on, a security of another company, the declarant is not taking an improper risk; and
- the terms and conditions of the issuance or sale are not detrimental to the public interest or the interest of investors or consumers.

If a State informs the SEC that State laws applicable to the transaction have not been complied with, SEC must reject the transaction. (Section 6(g)).

For utility acquisitions, the SEC must find that the amount paid bears a fair relation to the sums invested in, and earning capacity of, the underlying utility assets. (Section 10(b)(2)).

Relevance of Financing in the Current Industry Structure: As the Enron events demonstrate, federal disclosure statutes do not prevent a holding company or its subsidiaries from undertaking securities transactions which conceal the underlying value of the company. PUHCA's financial reviews do more than disclose; they apply a reasonableness test to assure that financial commitments are commensurate with utility service needs.

III. CONGRESS SHOULD MODERNIZE CERTAIN PUHCA PROTECTIONS, AND TRANSFER THE REGULATORY RESPONSIBILITIES TO FERC

Although PUHCA's main themes remain relevant, the statutory devices do not fit the industry today as well as they did in 1935. Some of these devices can be eliminated, while others must be modernized. This section describes the challenges posed by utility restructuring today, and then presents prerequisites for PUHCA repeal, including conditions on mergers and acquisitions, and on the mixing of utility and non-utility businesses. I then argue that Congress should transfer responsibility for the modernized protections from the SEC to FERC. Finally, I analyze the provisions of Title 2 of S. 1766.

A. The Challenge of Utility Restructuring Today

Mergers between monopolies are different from mergers in competitive industries. Competitive industries lack captive customers. Customers ill-served by an expensive merger can shop elsewhere. Customers of a regulated monopoly have no choice.

PUHCA addressed mergers with a bold stroke: only those mergers justified by improvement in physical operations would be permitted, and then only if those mergers did not cause a concentration of control, produce a complex capital structure or otherwise harm the public interest. See Section 10 of PUHCA. The effect of Section 10 was to block acquisitions or mergers involving companies that could not, because of physical separation, coordinate their electric operations after the merger.

The 1935 Congress blocked all non-integrating acquisitions because it saw no possible benefit from them. Neither wholesale competition nor retail competition was evident at the time. Today, we have a policy of promoting wholesale competition and, in some states, retail competition. Competition works best if there is a substantial number of entrants in each market. Especially when a market is dominated by the incumbent as many present markets are, a marked increase in the number of viable competitors is a prerequisite for real competition.

This need for new viable competitors raises a legitimate question about the value today of PUHCA's prohibition on non-integrated acquisitions. It is fair to say that until 1992, PUHCA's prohibition, if enforced, limited the number of new competitors in any market to those entities that operate physically only in that market. In 1992, Congress, intending to promote wholesale competition, removed this prohibition if the acquired company was an "exempt wholesale generator," that is, a company that owned a generator, which company's exclusive business was the sale of electricity at wholesale. Thus, with respect to wholesale competition, PUHCA does not present any prohibition on entry, and has not for almost 10 years. Utilities and non-utilities own many wholesale generation companies throughout the nation, on a non-integrated basis.

That brings us to the question of retail competition. In those states where retail competition is legally authorized, PUHCA's prohibition on non-integrating acquisitions normally would limit the number of players in that market to those whose physical operations are integrated with that market. However, in 1997 the SEC promulgated Rule 58, 17 C.F.R. 250.58. Rule 58 allows registered holding companies to create or acquire retail electricity marketing and brokering companies as well as other energy-related companies, provided these companies do not own utility assets and provided the aggregate investment in such energy-related companies does not exceed the greater of $50 million or 15% of the consolidated capitalization of the registered holding company. Thus, market entry at retail already is accommodated by SEC rule. What is not accommodated is the non-integrated acquisition of utility assets. Such acquisition could not increase competition where the assets are monopoly assets, like transmission and distribution. In that noncompetitive context, PUHCA presents a barrier not to competitive entry, but to financial entry.

This distinction warrants emphasis. There is a dramatic difference between financial entry and competitive entry. The acquisition of one monopolist by another is a change in control, not an increase in competition. To call this "entry," and thus to criticize PUHCA because it "blocks market entry," is to misuse the term. It is "entry into a new market" from the perspective of the acquirer seeking new captive customers. But it is not a "new competitive entrant" from the perspective of those captive customers, for the simple reason that there is no competition.

There is one circumstance under which the acquisition of distant monopoly assets might benefit the public: when the acquisition is the result of a competitive auction process designed to identify the most efficient and innovative provider of monopoly services. For that circumstance, some relaxation of the integration requirement is worth considering, under the specific conditions discussed next.[3]

Also, the regulator should be authorized to waive some or all of, these prerequisites where the customers of the acquirer and acquiree participate in markets subject to vigorous retail competition. In that context, the protection can come from the market rather than regulators.

[3] In all acquisition situations, including those in this subsection and the subsequent ones. the entity actually performing the acquisition may be a utility or an affiliate of the utility. If there is a utility with captive customers anywhere in the acquirer's corporate structure, these principles should apply. Corporate form should not create customer risk.

B. Prerequisites for PUHCA Repeal

1. Conditions on Mergers and Acquisitions Involving Utilities

The many PUHCA protections can be distilled into 5 modern prerequisites to the approval of a merger or acquisition involving utilities. Each is discussed next.

a. The acquisition must be the product of a competitive market; and must not reduce the effectiveness of competition in the acquirer's or acquiree's present or likely future markets.

The typical utility merger is not the product of real competitive forces; it is the product of two companies, each with 100% market share at retail, creating a combination which itself has 100% market share at retail; and then persuading regulators to accept it. True competitive market forces are not involved.

When the merging companies themselves, because of their retail franchises, are not subject to strong competitive forces, there is only one way for the merger itself to be the product of real competitive forces: create competition for the monopoly franchise. The regulators of the potential acquiree must host an auction, allowing multiple companies to bid for the right to acquire. Only through this bidding process can we identify the most efficient combination, the one most likely to lower costs and increase quality.

This bidding process would reverse the economic positions of the typical utility merger. In the typical utility merger, the acquiring company bids for the acquiree's shareholders, paying the price they demand. This process increases the cost of the merger to the acquirer. That increased cost either causes ratepayers to pay higher rates, or causes a decline in service quality due to the financial pressure. In contrast, bidding for the franchise means bidding for the favor of the ratepayers. That means the bidders are offering lower prices, better services and more accountability, relative to the status quo. And that is exactly what should happen in competition.

The requirement that the acquisition must be a product of a competitive market also means that both the acquiree and the acquirer should be subject to the maximum competitive forces allowed by law. Assuming no retail competition, wholesale competition must be vigorous in both the acquirer's and the acquiree's markets. Wholesale competition will be vigorous only if there is a functioning, independently governed regional transmission organization offering efficiently priced transmission and ancillary services; low barriers to entry for new generators and demand side management service companies; and clear market mechanisms for demand side options.

b. The acquisition should produce measurable, guaranteed benefits for ratepayers of both the acquirer and acquiree, by significantly increasing the quality of service or decreasing the cost to consumers of electric service.

Unlike an adjacent acquisition, which may produce operational efficiencies from joint operations, a distant acquisition free of PUHCA's integration requirement offers a less obvious "upside" to existing ratepayers. The public does not benefit if the only reason or effect of a merger is to increase the monopoly territory controlled by a single company. If the acquirer can show that it will run the utility better, then replacing one franchisee with another can benefit the public. That standard applies in a competitive market; it is no less appropriate in a retail monopoly context.

c. The acquisition should not weaken the financial strength of the acquirer or acquiree.

Where an acquisition is motivated by acquisitiveness rather than customer service, there can be a tendency to overpay for the merger (that is, overcompensate the departing shareholders relative to the real savings produced by the merger). The result is a financially weakened company, less able to invest internally for innovation, and more likely to seek government assistance in the form of rate increases. The regulator therefore needs to assure that the purchase price bears a reasonable relationship to the underlying costs and benefits of the combination.

d. The acquirer should compensate its existing ratepayers, at a market price, for the use of any resources which facilitate the acquisition or assist the acquired business, to the extent such ratepayers have borne the economic burdens associated with such resources.

When acquiring a new company, a utility may use resources for which ratepayers have paid. These resources might include valuable employees and equipment. Although these assets are owned nominally by the utility, the ratepayers have borne the associated economic risk, at least where the cost of the asset has been included in rates even though the market value of the asset might be lower. If the utility were able to make use of these assets without compensating the ratepayers at market value, the utility would be obtaining a reward from assets for which ratepayers bore the risk. This mismatch of risk and reward harms not only the existing ratepayers (by causing them to bear costs without realizing benefits), but also the effectiveness of competition (since the utility's competitors would not have had captive ratepayers to bear the cost of the assets involved). Requiring the utility to pay market price ensures that the utility is held to a market standard.

e. The acquiring utility may recover its acquisition cost from its existing utility customers, to the extent of tangible, measurable savings created for those customers.

This commonsense financial management applies to traditional utility investments, as well as in competitive markets. It prevents the acquirer from paying an artificially high price and then recovering that high price from ratepayers. It subjects the utility to the type of cost discipline that is imposed by effective competition. Under effective competition, the competitive market sets the price. An acquirer can recover its acquisition premium only if its post-acquisition costs are low enough to leave a margin with which to pay off the premium.

2. Conditions on the Mixing of Utility and Non-Utility Businesses

a. The Problem: With real retail competition almost nonexistent and wholesale competition uneven, customers remain vulnerable to their suppliers' business risks. Prominent among these risks is the risk of non-utility diversification.

The business risks associated with utility diversification are well-known. Utility holding company diversification has fared poorly.[4] Among the prominent examples was the failed investment by Pinnacle West, the holding company for Arizona Public Service, in a savings and loan institution. The failure resulted in Pinnacle West having to borrow several hundred million dollars from insurance companies to pay off bank depositors. As collateral for the loan, Pinnacle West pledged its only significant asset: Arizona Public Service.

Absent regulatory review of diversification, utility management has the incentive and opportunity to use ratepayer resources for shareholder ends. In a competitive market, ratepayers can protect themselves from such management decisions by shopping elsewhere. Absent a competitive market, protection must come from a neutral regulator.

The other side of the coin, distinct from the ratepayer harm, is the harm to competition in the industries entered by utilities or their affiliates. Utilities (typically through unregulated affiliates or subsidiaries) now routinely sell appliances; provide plumbing, heating, and cooling equipment and service contracts; engage in insulation work and sales of storm windows and doors; and provide outdoor lighting and interior lighting fixtures. Utilities also have entered the real estate, security and alarm monitoring markets, telecommunications, and related energy markets such as energy management and energy monitoring.

Exacerbating the problem is the proliferation of multi-state operations in which utility affiliates are engaged. Consider a holding company system, based in State X, that operates mechanical and electrical contracting affiliates in several other states. A non-affiliated competitor based in State Y, and injured as a result of cross-subsidization, may lack standing to file a complaint with the commission in State X because he is not a ratepayer of the subsidizing utility; meanwhile, his own state commission would not likely have jurisdiction over a non-utility affiliate of an out-of-state utility.

Further, a public utility's monopoly franchise may impart an ability and a legal right to gather customer site information regarding energy use, including a complete profile of each customer with respect to billing and credit history. Such information can be accessed or made available to unregulated affiliates while being withheld from non-affiliated competitors.

b. Solutions: The mixing of utility and non-utility business can occur in one of two ways: a utility acquires a non-utility business, or a non-utility business acquires a utility business. In each of these contexts, the diversification should be subject to standard regulatory techniques which anticipate and respond to the risks. Those techniques fall into five categories:

(i) Advance Review: Advance federal review of financing where effective State review does not exist, or where such review is requested by a State commission.

(ii) Financing Requirements: Required use of non-recourse (i.e., non-recourse to the holding company or any affiliate other than the affiliate undertaking the business) financing for all non-utility investment, and a ban on inter-affiliate loans or

[4] According to one commentator, the results were "horrendous in the aggregate and . . . satisfactory to disastrous for individual utilities." C. Studness, "Earnings From Utility Diversification Ventures," *Public Utility Fortnightly* 28-29 (September 1, 1992).

guarantees from the utility to the non-utility business. Non-utility businesses should pass the market test: they should be financeable by the market on their own merits.

(iii) Protections Against Excess Business Risks: To protect against excess business risks, there should be caps on diversified investment, and type-of-business and place-of-business reviews.

(iv) Protections Against Cross-Subsidies: A cross-subsidy occurs when utility ratepayers incur costs which benefit the non-utility affiliate, and the non-utility affiliate does not compensate the utility adequately. The problem of cross-subsidy exists whenever a single corporation, or corporate family, operates in monopoly and competitive worlds.

—Where the utility purchases goods or services from its affiliate, the proper compensation rule is "the lower of market or fully allocated book."

—Where the utility sells goods or services to its affiliate, the proper rule is market price.

(v) Access to Information: The regulators should have

access to books and records of the utility and all its affiliates, to the extent such access is relevant to the protection of ratepayers.

access to the books and records of any third party who is or will become a joint venturer of the utility or any affiliate of the utility, to the extent such access is relevant to the protection of ratepayers.[5]

3. Arguments Against Diversification Review

Some attack diversification review as "anti-business." This attack misperceives the purpose of regulation. The purpose is to assure that diversified investment pays its own way, and succeeds or fails on its merits, rather than by relying on ratepayer resources. This principle aligns completely with economic efficiency and business prudence.

Shareholders who view appropriate utility regulation as inconsistent with their overall financial objectives can pursue those objectives by investing in diversified enterprises separately from their utility investment. They do not need the option of investing in competitive businesses through their investment in the utility.

Some have argued that the diversification of a company's business portfolio strengthens the company and therefore produces ratepayer benefits. This reasoning misunderstands the nature of regulation. Regulation permits a prudent regulated monopoly to earn a fair rate of return. If a company is performing below par in its monopoly business, the solution is to improve its performance, not seek solace in other investments.

4. The Necessity for a Federal Role

Some have argued that PUHCA is no longer necessary—and needs no modern federal replacement—because state regulators can protect consumers. This argument fails for four real-world reasons.

a. Many states lack the authority to investigate the sources of risk: the investment practices or financial condition of affiliates which are not utilities or which are located out of state.

b. Some investment errors are too large to correct through ratemaking disallowance, because that disallowance could place the utility in financial jeopardy and endanger service.

c. A registered holding company can use its multistate status to avoid effective regulation of inter-affiliate transactions. In *Ohio Power* v. *FERC*, 954 F.2d 779 (D.C. Cir.), cert. denied, 113 S.Ct. 483 (1992), the Court of Appeals for the D.C. Circuit held, among other things, that the FERC (and, by implication, States) could not disallow from rates the costs incurred by Ohio Power, a utility subsidiary of a registered holding company, in purchasing coal from its subsidiary, even though the costs exceeded the market price.

The types and magnitude of inter-affiliate transactions are almost unlimited. Most registered holding companies already have one or more subsidiaries which provide goods and services to the utility subsidiaries. These arrangements have included coal mines and other fuel sources, computer services, billing, power supply planning, expert witnesses, legal services, buildings and land. More recently, some utility subsidiaries have transferred traditional functions—such as nuclear plant operations—to these companies.

[5] As with the merger review standards, the regulator should be authorized to waive some or all of these prerequisites where the customers of the acquirer and acquiree are subject to vigorous retail competition. In that context, the protection can come from the market rather than regulators.

d. The multistate nature of electricity markets requires a multistate review of the effect on competition. The policing of market power is not a single-state task because the exercise of market power is increasingly a multistate phenomenon. Market power obtained in one State, even legitimately, can be leveraged into market power in another State.

Moreover, in the acquisition by a multistate utility company of a new utility—and almost all mergers are multistate there often are one or more states lacking authority over the transaction. For example, when CSW proposed to acquire El Paso, the transaction certainly would have had an affect on the ratepayers of Arkansas, Mississippi and Louisiana, but these states did not have proceedings. Similarly, when Entergy acquired Gulf States, those states in which Gulf States did not operate did not have proceedings. Although the acquisition by the holding company serving Arkansas of a utility doing business elsewhere certainly could affect Arkansas ratepayers, there was no state statute making it clear that the Arkansas Commission would have jurisdiction to review the transaction to protect Arkansas ratepayers.

C. Responsibility for the Modernized Protections Should Lie With the FERC

1. The SEC's Staffing Situation

Although FERC has not always pleased all its constituents, and has in the past used methodologies for merger review and market pricing not based in economic logic (see Part I.B), it has remained publicly committed to its statute.

The Public Utility Holding Company Act has not enjoyed comparable respect. More than twenty years ago, the SEC took the position that the Act no longer was necessary because markets and other regulators protect the consumer and the investor. The agency has held to this position through the era of nuclear cost overruns, the savings and loan failures, the bankruptcies of several utilities, utility diversification, the "discovery" that transmission owners exercised market power in generation markets, and even through the California price spike troubles of Summer 2000. Untroubled by the facts on the ground, the SEC has held firm.

It is unclear which is the cause and which the effect. But roughly contemporaneous with its repeal position has been a staffing arrangement that is not commensurate with its statutory obligations. My focus is not on work ethic or dedication, but on professional expertise. Here are five concerns:

a. The analysis of large scale operational relationships requires expertise in engineering. The SEC's PUHCA has no engineers; it has had none for years.

b. The analysis of the competitive effect of mergers on the many affected electric markets, both product markets and geographic markets, demands expertise in economics at the highest level. The SEC's PUHCA office has no economists; it has had none for years.

c. The analysis of the risks associated with diversification conducted by well over 100 utility holding companies demands expertise in business management, including risk assessment, business strategy assessment, and managerial organization and effectiveness. The SEC's PUHCA office has no business management specialists.

d. The review of inter-affiliate sales of goods and services (Section 13) requires expertise in the pricing and procurement of a host of products—fuels, accounting services, nuclear operations services, real estate costs—literally any business activity affecting the production of electric service. The SEC's PUHCA office has no business procurement specialists.

e. The review of internal and external financial transactions of over 15 multibillion dollar registered holding company systems, some with global operations, would strain even a large staff. The SEC must review issuances of securities (Sections 6 and 7), inter-affiliate loans (Section 12), and capital structure (Sections 10(b) and 11(b)). Literally thousands of transactions occur involving billions of dollars. The SEC's PUHCA office has one accountant.

2. The Statutory Application Problems

The SEC also has issued a series of opinions that vary dangerously from the intent and language of the statute. The most prominent example is the integration requirement.

The Act allows holding acquisitions of public utilities only if the acquisition produces a single "integrated public-utility system," see Sections 11(b)(1) and 2(a)(29)(A);[6] and only if the acquisition "serves the public interest by tending towards the economical and efficient development of an integrated public-utility sys-

[6] There are exceptions to the "single system" rule in Section 11(b)(1)(A), (B) and (C) not relevant here.

tem." Section 10(c)(2). As utilities have sought to expand their reach, the Commission has left behind these principles and accommodated their proposals. The Courts have sometimes upheld the Commission and other times reversed it; but the trend is unmistakably towards consolidation and away from the competition-protective and consumer-protective features of the statute. Some examples follow.

In *WPL Holdings, Inc.*, 40 S.E.C. 634 (1988) the SEC disregarded the economical and efficient development test of Section 10(c)(2) when it approved an addition of a corporate holding company where there was no evidence of increased operational efficiencies resulting from the acquisition. The court of appeals reversed. *Wisconsin's Environmental Decade* v. *S.E.C.*, 882 F.2d 523 (D.C. Cir. 1989) (finding that the SEC decision "plainly gives no effect to the express language of the statute, which permits the SEC to approve acquisition of a utility only when the Commission has found that the acquisition 'tend[s] towards' the economical and efficient development of an integrated system). The Commission on remand found financial efficiencies.

Furthermore, in 1988 the Commission found that a utility holding company's participation in power plant construction consortium met the statutory requirement for integration despite the minimal interactions the plant would have with the utility. *Order Authorizing Acquisition of Common Stock of New Electric Generating Company*, Release No. 35-24566 (Jan. 28, 1988), *aff'd Environmental Action* v. *S.E.C.*, 895 F.2d 1255 (9th Cir. 1990). The Commission concluded that the facilities would be coordinated even though there was no certainty that the public utility would purchase power from the plant being acquired. The SEC based its Section 10(c)(2) finding that there would be new economies resulting from the acquisition on the utility's apparent need for power several years after the acquisition.

In *WPL Holdings, Inc.*, 66 SEC Docket 2256 (Apr. 14, 1998), *aff'd Madison Gas and Electric Co.* v. *S.E.C.*, 168 F.3d 1337 (D.C. 1999), the SEC approved under the integration standard the merger of several utility holding companies with utilities operating in Wisconsin, Minnesota, Iowa and Illinois. The commission found that the assets met the statutory requirement of interconnection even though the Iowa and Minnesota assets were separated from the Wisconsin and Illinois assets, with the only connection being a 3-year contract for transmission service and the companies' plan to build a transmission line in the future. The progression of the SEC's effort to deprive the statutory interconnection requirement of meaning is evident from a chronology of its decisions prior to *WPL Holdings.*[7]

Most recently, on January 18, 2002, the U.S. Court of Appeals vacated and remanded the Commission's approval of a merger between American Electric Power and Central & South West Corporation. *Nat. Rural Elec. Coop. Ass'n* v. *S.E.C.*, No. 00-1371 (D.C. Cir. Jan. 18, 2002).[8] The AEP merger created the nation's largest registered holding company, with utility properties extending from Virginia in the east, to Michigan in the north, to Texas in the southwest. The service territories of the operating utilities of AEP and CSW are separated by several hundred miles at their closest point. The only proposed "physical" connection between the two system was a one-way transmission contract for a token amount of electric capacity—less than one percent of the combined systems' generating capacity. The Commission's approval of the AEP-CSW merger culminated more than 20 years of SEC decisions approving virtually any proposal placed before it by utility holding companies coming under its purview.

The Court vacated the SEC's approval of the AEP merger on two grounds. First, the Court ruled that the SEC failed to explain how a one-way transmission contract

[7] *Conectiv, Inc.*, Release Nos. 35-26832, 70-9069, 1998 SEC LEXIS 326, *29 (Feb. 25, 1998) (approving use of contractual rights to transmission "when the merging companies are members of a tight power pool"); *New Century Energies Inc.*, Holding Co. Act Release No. 35-26748, 1997 SEC LEXIS 1583, *41-42 (Aug. 1, 1997)(approving under interconnection standard a contract for transmission service pending the planned construction of a physical tie within five years of the merger); Unitil Corp., 50 S.E.C. 961, 1992 SEC LEXIS 1016 (April 24, 1992) (lines could be built to connect the facilities located eight miles apart, but were unnecessary for coordination given the third-party contractual arrangements); *Northeast Utilities*, 50 S.E.C. 427, 1990 SEC LEXIS 3898, *48 (Dec. 21, 1990) (finding integration requirement satisfied where transmission contract was for at least ten years, and where companies were located within highly integrated power pool); *Centerior Energy Corp.*, 49 S.E.C. 472, 1986 SEC LEXIS 1655, * 16 (April 29, 1986) (merger partners owned the transmission facilities as tenants in common and the contract had "no termination date and remain[ed] in effect as long as the [generation facilities acquired] are in existence); *Electric Energy, Inc.*, 38 S.E.C. 658, 668-671, 1958 SEC LEXIS 807, *25-29 (Nov. 28, 1958) (acquisition of a single power plant where applicants had contractual use of necessary transmission facilities for the entire life of the acquired plant); *New England Electric System*, 38 S.E.C. 193, 198, 1958 SEC LEXIS 620, *12 (Feb. 20, 1958) (finding that "the necessary interconnections would be constructed forthwith if the present [transmission contract] arrangements with the non-affiliate companies were terminated") (emphasis added).

[8] This law firm represented the petitioners in this case.

could meet the interconnection requirement of the Public Utility Holding Company Act. The Commission also said the agency had failed to explain how its interconnection ruling was consistent with prior agency decisions, calling the SEC's explanation of its prior decisions "peculiar." Second, the Court ruled that the SEC erred in finding that the merged company satisfied the "single area or region" requirement of PUHCA Section 2(a)(29)(A). The Court found that the SEC had failed to cite any evidence in support of its "single region" finding, and that the agency's method of analyzing the single region requirement was flawed. Given these errors, the Court said "the Commission's decision that New AEP meets the region requirement cannot withstand even the most deferential review." Slip Op. at 8.

B. Comments on S. 1766

With this backdrop, I would like to comment on Title 2 of S.1766. Title 2 seeks to set forth the key prerequisites for competitive evolution and consumer protection. It is a solid beginning step. I offer some comments below on provisions relating to mergers and market-based rates.

1. Electric Utility Mergers (Section 202 of S. 1766)

a. Inclusion of important merger transactions: The bill correctly attempts to clarify the universe of transactions which require Commission approval. It appears, however, that several types of transactions are missing.

First, the language does not seem to address the type of acquisition where the acquiree is a retail seller but does not own generation. Such an acquisition can endanger the nascent retail competition efforts in some states. These acquisitions are likely to be multistate in nature, and one or more states might lack jurisdiction under state law. Moreover, some states that have reviewed retail mergers have said they will not look at the merger's effect on retail competition because they have not yet authorized competition, even where the very parties to the merger have defined their objective as "getting ready for retail competition."

Second, although the language does create FERC jurisdiction where the acquiree has generation, transmission and distribution facilities, it is not clear that FERC is obligated to assess the effect of the merger on retail competition. FERC's Merger Policy Statement establishes the odd principle that it will review such effect if the state commission requests. FERC's obligation to review the retail effects in all cases should be clear in the statute.

Third, concerning the phrase in new 203(a)(1)(C), "purchase, acquire, or take any security of any other public utility": consider amending it to add, after "security," the phrase "any indicia of ownership or control," since there may be forms of control like partnership shares, or leases, that do not come within the definition of "security."

Fourth, new section 203(a)(2) correctly clarifies FERC jurisdiction over mergers at the holding company level. But for purposes of this section, "holding company" should be defined to include structures, such as partnerships, in which the device by which ownership or control of companies or assets is achieved is not through stock but through other means.

b. Standards applicable to the merger: The amendments to Federal Power Act Section 203 should include standards applicable to the merger. Under PUHCA, an acquisition is allowed only after a finding that it produces operational efficiencies, and does not tend toward a concentration of control or create capital structure or corporate structure complexities. As discussed in Part I.B above, FERC's review of mergers does none of this, except for a review of competitive effects on generation and transmission, and that review has been uneven due to uncertainty of market concentration measures. Moreover, FERC's competition review does address the merger's effect on the incumbents' ability to protect their retail monopolies against future retail competition, even as merging companies often give as a reason for merging the need to "prepare for retail competition." FERC's approach, in short, fails to screen out mergers that are not the product of, and contributors to, real competition.

As explained above, moreover, FERC's review does not distinguish adequately efficient from inefficient mergers. The result has been an accelerated consolidation process in our industries that has set back substantially the cause of wholesale competition that FERC is trying to achieve elsewhere.

2. Market-Based Rates (Section 203 of S. 1766)

a. Prerequisites for market-based rates: Before authorizing market-based rates, the bill requires the Commission to "consider" various features of the market. These features are the correct features to consider. But the bill does not establish prerequisites to market-based rates. It does not equate "just and reasonable rates" with "rates which are the product of a fully competitive market." Under present law, some have argued that supra-competitive rates charged in a noncompetitive market are just and reasonable because they will attract new suppliers and thus make the market competitive. Under this formulation, consumers are not an interest to protect from the absence of competition, but a source of funds used to create competition. As discussed in Part I.B above, moreover, the Commission's past methodologies on determining market competitiveness are deeply flawed, by its own admission; and the Commission only now is beginning a new inquiry into the correct methodology. There is not a consensus about what are the minimum features of a competitive market, or about what prices should look like in such a market. Given this uncertainty, the legislation should be clear that vigorous competition is a prerequisite to market rates.

b. Demand response mechanisms: The bill deserves special praise for making clear that the adequacy of demand response is central to the effectiveness of competition. In the past 20 years, excess attention has been paid to creating incentives to suppliers, and insufficient attention to the demand side.

c. Refunds: The bill should codify FERC's recent policy of establishing, at the time it grants an applicant authorization for market rates, that the right to charge those rates lasts only as long as the rates are just and reasonable. With this approach, refunds can be made back to the date on which the rates became unjust and unreasonable, rather than the date on which someone filed a complaint alleging that the rates were unjust and unreasonable. There can be a significant time lapse between the time that (a) the market power is exercised to make the rates unjust and unreasonable, and (b) that exercise is noticed by someone and brought to the Commission's attention.

d. Litigation costs: It costs money to bring a complaint to the Commission. The complainant has the burden of proof, and it requires lawyers and market experts to create that proof and carry it through the litigation process. If successful complainants could recover their litigation costs it would reduce the large disincentive to bringing information to the Commission. Just and reasonable rates are the seller's obligation and the Commission's duty. The customer should not bear the cost of making the statute work. This feature could be eliminated later, when competitive markets are the norm.

IV. ARGUMENTS FOR STANDALONE REPEAL LACK A FACTUAL BASIS

To construct a logical argument for repeal, one must assert that the conditions requiring these protections no longer exist; specifically, that (a) consumers are protected, either by effective competition or careful regulation; and that (b) investors are protected, by their knowledge and their sophistication. As explained throughout this testimony, these assertions are inaccurate.

A. There is virtually no retail competition; and wholesale competition is ineffective in many places and endangered in all places, due to:

—the absence of regional transmission pricing and planning;

—the absence of a coherent merger policy that distinguishes efficient from inefficient mergers and that stops mergers which would damage wholesale or retail competition; and

—the absence of any feasible way to identify a real date when reliable wholesale competition will exist.

B. Wholesale rate regulation is uncertain, due to the absence of a consensus methodology and procedure on market pricing

C. Retail rate regulation is burdened by under-staffing and the inherent difficulties of regulating, state-by-state, multistate companies. Some argue that "States can use ratemaking disallowances and other devices to protect the consumer." Not when the company already is weakened by its errors. Not a year goes by when some investor group does not argue that a rate increase is necessary "to save the company." For example, when Pinnacle West had to borrow hundreds of millions of dollars to pay off depositors of its failed savings and loan affiliate, it had no choice but to pledge as collateral its only asset: the stock of Arizona Public Service. Had the State regulators tried to prevent this pledging, the outcome might have been worse. On the other hand, had the SEC acted on a timely basis to limit Pinnacle West's investments, the problems would not have occurred.

D. Securities regulation largely focuses on disclosure, not on prevention of abuse. On this subject, the following two statements appeared in the same testimony supporting repeal of PUHCA:

"The SEC retains full authority over securities functions."

"'Our securities laws are, in the main, nearly seventy years old, and reflect a time, and a state of technology, light years away from what we now confront daily.'" (quoting SEC Chairman-designate Harvey L. Pitt, Testimony before the Senate Banking Committee)

Testimony of David L. Sokol before the House Subcommittee on Energy and Air Quality, Committee on Energy and Commerce (July 27, 2001). Both views cannot be correct.

We need to assure the workability of our federal securities laws before we can rely on them as a basis for repealing PUHCA's reviews. In any event, as discussed in Part I, federal securities laws focus on disclosure only. PUHCA's protections are different: they focus on the quality of financial activities, and their appropriateness to an industry characterized by captive customers and unsophisticated, small investors seeking stable investments.

At the state level, state commissions generally review security issuances of utilities within their jurisdictions, but not issuances by holding companies or by non-utility companies associated with such utilities. The need for such review is underscored by the failures of exempt holding company diversification in the 1980s. Utilities are affected by such failures, both in their credit standing and in their access to capital.

Other factors argue for continued federal review. Some states lack authority to review financings by non-utility affiliates, and not all utilities have worked with State commissions and State legislatures to furnish this authority. Moreover, where utilities have mismanaged costs or taken risks with negative results, regulation tends to hesitate. The ultimate penalty in a competitive market, bankruptcy or takeover by a stronger company, causes regulatory uncertainty that regulators often prefer to avoid. There is a concern, for example, that the bankruptcy court will require payments to certain creditors, and then preempt state ratemaking to ensure that ratepayers are the source of these payments. The risk of this type of event can discourage state commissions from requiring companies to bear the costs of their own risks. Given this uncertainty of "back-end" accountability, "front-end" accountability in the form of advance review of financial risks is critical.

These factors support establishing federal minimum standards for the quality of financing, applied and monitored at the federal level.

Assuming there is a federal role in financial reviews, that role should be consolidated with the financial reviews conducted by FERC under the Federal Power Act.

E. Reliance on antitrust law is misplaced. Antitrust is aimed at markets that are competitive, protecting them from anti-competitive behavior. Antitrust does not address well markets that are monopolistic, where actions entrench the incumbents further. The purpose of advance regulatory review is to act as a "first line of defense," preventing market power problems before they infect a market.

Also: Who would address the problem through the federal antitrust laws? Antitrust lawsuits are expensive. An individual consumer lacks the resource, and attorneys general must reserve their resources for blockbuster cases like Microsoft and tobacco. They often can be brought only "after the fact."

V. ENRON: PROPER APPLICATION OF PUHCA WOULD HAVE IDENTIFIED AND PREVENTED ENRON'S ILL-FATED ACTIVITIES

Enron's acquisition of Portland General Electric, a utility, made Enron a "holding company" under PUHCA. Enron Corp., a global holding company, then obtained an "intrastate" exemption from the Act under Section 3(a)(1). Without that exemption, Enron's financial dealings and diversification efforts would have come under the full purview of the Act. More than likely, the Act, if conscientiously applied, would have limited or even prohibited the arrangements that apparently led to its bankruptcy. I explain here the process by which it obtained the exemption, and highlight the PUHCA provisions which the exemption allowed Enron to escape.[9]

A. The Exemption Process

Section 3 of the Act authorizes the SEC to exempt a holding company from provisions of the Act if the holding company satisfies one of the five exemptions described in Section 3(a)(1)-(5). The SEC has used this authority to exempt qualifying companies from all provisions of the Act except the pre-acquisition review standards of Sections 9 and 10. The key condition on a continued exemption is the "unless and except" clause of Section 3(a), which says an exemption is available

[9] This discussion focuses on Enron's exemption from registration, obtained under Section 3 and Rule 2 of the Act, not on its receipt of "no-action letters" stating that its brokering and marketing activities do not make it a "gas utility company" or an "electric utility company" under the Act because those businesses do not involve electric or gas "facilities" as defined by the Act. Enron Power Marketing, Inc., SEC No-Action Letter (Jan 5; 1994).

> . . . unless and except insofar as [the SEC] finds the exemption detrimental to the public interest or the interest of investors or consumers . . .

Section 3(c) also allows the Commission to revoke an exemption if it "finds that the circumstances which gave rise to the issuance of such order no longer exists."

The most common of the five examples is the "intrastate" exemption of Section 3(a)(1), which directs the SEC to issue an exemption if—

> such holding company, and every subsidiary company thereof which is a public-utility company from which such holding company derives, directly or indirectly, any material part of its income are predominantly intrastate in character and carry on their business substantially in a single State inwhich such holding company and every such subsidiary company thereof are organized. . . .

Although Enron is a global holding company with worldwide businesses, hardly "intrastate in character" and clearly doing business "substantially" in more than a single state, it obtained exempt holding company status under the intrastate exemption of Section 3(a)(1). The process for obtaining an exemption is as follows: An intrastate holding company make seek a Section 3(a)(1) exemption in two ways. It may obtain an official Commission order upon application under section 3; or it may self-claim an exemption by filing under the SEC's Rule 2, 17 C.F.R. sec. 250.2. Rule 2(a)(1) allows a company to obtain the exemption afforded by section 3(a)(1) by filing annual claim of exemption on form U-3A-2. Form U-3A-2 is a 2-page form seeking basic information about the holding company and its operations. No Federal Register notice is given to the public and no opportunity to comment afforded. The claim must be renewed by annual filings on or before March 1 of each year.

A claim to an exemption under Rule 2 is subject to Rule 6, 17 C.F.R. sec. 250.6. Under Rule 6, the exemption may be terminated by a registered letter from the Commission stating that a question exists about the holding company's entitlement to the exemption. A company receiving a termination letter has 30 days to either register under the Act or file a formal application for an exemption which, if filed in good faith, exempts the company from the Act until the Commission issues a final order.

On rare occasion, and in the very distant past (decades ago), the Commission has questioned a Rule 2 claim of exemption. However, we found no modern decisions indicating any such Commission activity.

Moreover, the Commission has no procedure by which a customer can file a complaint for revocation of an exemption should it become "detrimental to the public interest, or the interest of investors or consumers," as forbidden by Section 3. In the two situations where such a complaint has been filed, both involving extraordinarily serious situations, the Commission has taken no action.

Specifically, in May 1990, the Arizona Corporation Commission filed a complaint asking the Commission to revoke the intrastate exemption of Pinnacle West, the holding company Arizona Public Service Company. Pinnacle West had invested in Merabank, a savings and loan institution. The failure of that institution in the late 1980s forced Pinnacle West to borrow several hundred million dollars to bail out the depositors. As collateral for that loan, Pinnacle West pledged its only asset: 100% of the stock of Arizona Public Service.[10] The Commission took no action on the complaint. Also, last July the California Attorney General filed a complaint seeking revocation of the intrastate exemption for Pacific Gas & Electric as a result of its financial troubles. The Commission again has not acted.

B. Should Enron Have Received "Exempt" Status Under the Act?

There are two avenues by which the SEC could have found that Enron should not have been an exempt holding company.

First, the SEC could have refused the exemption to begin with. Enron clearly did not meet the requirements of Section 3(a)(1). Enron Corp., the holding company, although organized in the state of Oregon (the state from which it derived a material part of its income from its Oregon public utility subsidiary, Portland General Electric), has holdings and business activities throughout the United States and abroad. The business of Enron Corp. is not "predominantly intrastate in character," and Enron Corp. does not "carry on [its] business substantially in a single State." Enron Corp. is global in character and does business substantially in many states.

Second, the SEC could have found Enron's exemption would be, or had become, detrimental to the public interest or the interests of investors or consumers. Had the SEC investigated Enron's business activities during the exemption period, either before granting the exemption or as part of a periodic review, it should have been able to identify business dealings causing the detriment. But Enron's exempt status,

[10] The witness was counsel to the Arizona Commission in that matter.

plus the absence of any SEC review of exempt holding companies for detriment, meant that the statutory protections were not operating.

C. Customer and Investor Protections From Which Enron Was Exempt

Had Enron been treated as a registered holding company, those activities leading to its present state would have been curbed or prohibited, assuming the Act were applied conscientiously. Specifically:

Limitations on Utility Diversification: The off-shore financial transactions reported to be responsible for Enron's collapse should not have occurred if Enron had been treated as a registered holding company, because:

> Section 11(b)(1) limits the operations of registered holding companies and their subsidiaries to "businesses [that] are reasonably incidental, or economically necessary or appropriate to the operations" of their public utility operations. The SEC has interpreted the section 11(b)(1) language to permit non-utility businesses that are only "functionally related" to the utility business.
>
> Section 11(b)(2) requires the elimination of unnecessary corporate complexities and inequitable voting power among security holders. Specifically, the section requires the Commission to "ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system."

Regulatory Review of Accounting and Financing: Regardless of whether Enron's offshore transactions would been barred by the diversification provisions applicable to registered holding companies, Enron's excesses would have faced the prohibitions and limits of Sections 6 and 7:

> Sections 6 and 7 govern the issuances of securities of RHCs and their subsidiaries. Section 6 requires SEC approval of most issuances and sales of securities by registered holding companies and their subsidiaries, and section 7 establishes specific guidelines for the SEC to follow in approving such issuances and sales.
>
> Section 7 prescribes standards for the type and amount of securities for the registered holding company and its subsidiaries. Section 7(d), for example, requires that a security be reasonably adapted to the earning power of the issuing company and to the capital structure of the company and the holding-company system. Registered holding companies and their subsidiaries must also obtain SEC approval before acquiring any securities, utility assets, or any other interest in any business.

In sum, sections 6 and 7 demand much more than the accounting standards and private review standards that were applied to Enron's investments.

Regulatory Review of Inter-affiliate Relations: PUHCA Sections 12 and 13 would have required the SEC to police transactions among the various Enron affiliates.

> Section 13 governs service, sales and construction contracts between system service companies and associate companies in the same holding company system.
>
> Section 12 polices inter-affiliate transactions in loans and other securities, requiring arms length relations between affiliated companies.
>
> Section 12 also precludes registered holding companies from borrowing or receiving any extension of credit or indemnity from a public utility subsidiary. It also gives the SEC rulemaking authority over other types of affiliate transactions such as: intra-system loans; declaration and payment of dividends; acquisition, retirement or redemption of a company's own securities; disposal of assets and securities; solicitation of proxies in connection with holding company and subsidiary company securities; books, records, disclosures of interest, duration of contracts; and similar matters concerning affiliate transactions. From press reports, it would appear that many of Enron's financial dealings would have fallen under these standards applicable to registered holding companies.

VI. CONCLUSION: THE CONSEQUENCES OF A WORLD WITHOUT A FEDERAL CORPORATE STRUCTURE STATUTE

The repeal of the Public Utility Holding Company Act, with no change in other statutes, would allow:

A. Acquisitions by utilities of other utilities, undisciplined by market forces and without adequate review of

—the costs and benefits to present and future consumers,
—the effects on retail prices and retail competition, and
—the effects on wholesale prices and wholesale competition.

The risk of consolidation would be less if there were (1) comprehensive, nondiscriminatory and efficient retail competition; or (2) predictable, low-cost and efficient franchise competition. Both (1) and (2) are largely nonexistent, leaving the retail sector subject to utility market power. Unlimited and unreviewed retail acquisitions could increase this market power, thereby contradicting the claims that "competition is here."

B. Unlimited mixing of utility and non-utility businesses, where the risks of business failure are borne in part or in whole by consumers who are prohibited by law from shopping, subject only to post-failure regulatory devices of proven insufficiency; while ratepayer obtain none of the benefits.

C. Unlimited inter-affiliate transactions between the utility serving captive customers, and affiliates needing utility resources paid for by those customers.

D. Unlimited use of corporate structures that transfer ratepayer-funded assets to deregulated companies.

E. Unlimited use of corporate structures that cause Federal Power Act preemption of state review of the prudence or economic value of utility historic investments.[11]

F. Entry by utilities with government-granted market power into potentially competitive industries, while continuing to use resources financed by customers who lack competitive options.

The electric industry lacks effective competition in many markets. Congress cannot nurture competition by giving free rein to companies which for a century have avoided competition. And Congress cannot protect consumers by confusing financial entry with competitive entry. To repeal PUHCA without establishing a modern regulatory regime—one that conditions acquisitions on real competition and attentive regulation—is to allow dominant incumbents to exploit unearned advantages. Calling the result "competition" is good fiction, but it is not good policy.

Thank you for the opportunity to present this testimony. I look forward to any questions from the Committee.

The CHAIRMAN. Well, thank you very much. Thank you all for your testimony. I think it has been very useful.

Let me try to understand the differences in point of view that have been expressed here. I think it is fair to say that each of the first four witnesses essentially agreed with the proposition that we should repeal the Public Utility Holding Company Act and, at the same time, grant to FERC additional authority to protect consumers in some of the ways that currently are contemplated under the Public Utility Holding Company Act but are not working very well. That is sort of the impression that I am getting from the first four witnesses.

Now, Mr. Hempling's testimony is somewhat different, but he does take the position that, as I understand it—and this is on page 14 of your testimony—that Congress should modernize certain PUHCA protections and transfer regulatory responsibilities to FERC. So, there is no disagreement among any of the witnesses about the wisdom of transferring these responsibilities under PUHCA to FERC. Is that a fair statement? Do you agree with that, Mr. Hempling?

Mr. HEMPLING. That is correct, sir.

The CHAIRMAN. So, the real question then is, if these responsibilities to protect consumers and to oversee and insure against abuses in the utility business is transferred to FERC, what should the protections still be, what should the authority and the direction to FERC be to carry that out?

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[11] *See Mississippi Power & Light* v. *Mississippi ex rel. Moore*, 487 U.S. 354 (1988) (holding that where FERC issued an order allocating a specific portion of the costly Grand Gulf nuclear plant to a utility, the state could not regulate the utility as if it had bought a lesser portion); *Nantahala Power & Light* v. *Thornburg*, 476 U.S. 953 (1986) (holding that FERC order allocating a portion of a low-cost hydroelectric plant to a utility preempted the state from treating the utility as if it were entitled to a higher portion of the hydropower than FERC had assigned)

And that is where we have disagreement, as I understand it. And I need to try to understand better precisely what those disagreements are about the responsibilities that we are going to put on FERC. Mr. Sokol, did you have a comment?

Mr. SOKOL. I would only add to your comment, Senator, and then try to answer the question. I think that not only transferring a great deal of that opportunity to FERC but also to the States. The States deserve the right to have greater access to books and records, affiliate transactions, et cetera, because with all due respect to a lot of the discussion here—and by the way, Mr. Buffett is invested in a regulated utility today but limited to PUHCA to 9.9 percent of the voting rights.

The States are aware of consumer protections that exist today. There are effectively well in excess of 5,000 State professional regulators in the United States. There are 22 members of the SEC PUHCA staff. This notion that that 22-member staff can do a better job than the State regulatory bodies I think is wholly unreasonable. By moving to FERC and giving the States those additional rights, the States can protect the consumers. They will have access to both affiliate and books and records information, which they must have, and then FERC can have a much greater oversight on the wholesale activities that also play very, very significantly in the States' proper regulation.

I think those are where they need to be. The notion of arbitrarily, as Mr. Hempling would argue that it is a bad thing for a AAA-rated company like Berkshire Hathaway to own Portland General, if it is properly regulated and there is properly access to books and records—that somehow that is a bad thing I would just submit is comical.

Northwest Natural Gas is a fine small company, but by them being, if you will, forced to buy Portland General because Enron could not find anyone else, now Portland General is going to be forced to take on a very substantial debt load. We would buy them with cash. The regulator would have a much simpler time dealing with that situation. I am not trying to criticize Northwest Natural Gas.

The CHAIRMAN. Let me ask Mr. Hempling to comment, but let me just first clarify the question. Enron's ownership of the utility in Oregon has resulted in higher rates, as I understand it.

Mr. SOKOL. I do not think that is correct. I think the higher rates in Oregon—and the commissioner is here—that had to be raised the last couple of years were caused by the California problem and the west coast escalation of wholesale rates, not by Enron.

The CHAIRMAN. So, the higher rates are not a result of Enron's involvement, but looking forward, the complaint now, as I understand it, from some is that once this utility in Oregon is acquired by Northwest Natural Gas, the consumers, the customers of that utility, are going to be paying higher rates because they will, as you say, have to be paying to cover this debt load.

Mr. SOKOL. I think there is the fear of that. I do not believe the regulatory body will allow that to happen. There are consumers who are postulating that that is the case. The risk that comes, though, is that by a company becoming highly leveraged to own a regulated utility like Portland General—if they get into financial trouble, will there be an attempt to try and convince the regulator that they should raise the rates? I do not believe the transfer of Portland General to Northwest Natural Gas should cause any change in rates. Regulators are fully capable of imputing the proper cost of capital and not charging consumers——

The CHAIRMAN. Let me ask Mr. Hempling. Is it your view that Berkshire Hathaway or any other company should be prohibited from coming in and purchasing a utility in Oregon as they currently are under PUHCA, even though, as you point out, that does not add to the competition? It is essentially purchasing an existing monopoly. But the argument being made by Mr. Sokol is they will run the existing monopoly very well and it will be a benefit to the consumers for them to be the owner of it, rather than having someone else the owner. What is your response to that?

Mr. HEMPLING. My view, as stated expressly in the testimony, apparently disregarded by Mr. Sokol, is as follows. I would be delighted to have Mr. Buffett or anybody else in this industry acquiring any number of retail monopolies. I would be delighted for that to happen.

He needs to make a showing. He needs to make a showing that this acquisition is going to improve service for the customers of the acquiree. He needs to make a showing that his acquisition will not harm the customers of the utilities he presently owns. He needs to make a showing that his global investments in other businesses are sufficiently fenced off from the acquired company that there will be no risk.

He needs to do this in a context where there is a competition for the right to acquire this new utility because, sir, presently in the utility industry mergers are not subject to a competitive process. Mergers are back room deals brought to the commissions for approval. There is not, like there is in the competitive market, fights among companies for the right to acquire someone with the person who offers the most to the customer getting the arrangement. That is not how mergers work.

So, to say that because of the conditions I wish to place on the acquisition, conditions which mimic faithfully the competitive market, that I somehow think it would be bad for Mr. Buffett to enter this industry is intentionally to miss the point. Mr. Buffett happens to be exactly what we need in this industry if we can show that his entry is good for all involved.

The CHAIRMAN. You are saying there are certain conditions that ought to be required to be met by FERC, once they are given this new authority, if they are. If Congress shifts this authority over to FERC, we should insist that when they approve acquisitions, such as the one we are discussing here, they require certain conditions to be met.

Mr. HEMPLING. That is correct, sir.

The CHAIRMAN. My time is up. Senator Smith, let me call on you, since we are going back and forth here, and then I will call on Senator Wyden.

Senator SMITH. Thank you, Mr. Chairman. I thank all of our witnesses for being here, Roy, particularly you from Oregon. It is good to see you. I am very curious about your perspective on how this Enron debacle is affecting us in Oregon.

My own evaluation I think can best be summed up by an unnamed Enron executive, as quoted in the *New York Times* on November 10, 2001. He said Enron's achievement in creating a regulatory black whole fit nicely with what he called the company's core management philosophy, which was to be the first mover into a market and make money in the initial chaos and lack of transparency. Do you see that as an accurate description of what Enron was doing?

Mr. HEMMINGWAY. Senator Smith, I think with respect to Enron's wholesale trading activities, that in many cases that was the case.

Senator SMITH. You think they were doing that in Oregon?

Mr. HEMMINGWAY. No. With respect to their ownership of Portland General Electric, there was an entirely separate enterprise there, and Enron acted as an absentee owner and had relatively little activity on a day-to-day basis with respect to that company.

Senator SMITH. Do you have reason to believe, though, that they bought PGE to pick off the transmission rights into California?

Mr. HEMMINGWAY. Senator, there is no evidence that we have seen that they have abused those transmission rights into California.

Senator SMITH. And you would know that.

Mr. HEMMINGWAY. Not everything is transparent with respect to that. That is something that I think is subject to continuing investigation. Certainly transmission rights have an influence on their ability to exercise market power, and you had some evidence recently in front of this committee about their ability to exercise market power in the Western market. But I doubt that it is possible to use the transmission rights to exercise considerable market power alone.

Senator SMITH. I am glad to hear that.

You remember when Enron bought PGE in 1997. A condition of the merger was that Enron agreed that there would be $141 million in merger-related benefits to customers. Have those benefits been realized in Oregon?

Mr. HEMMINGWAY. Senator, by and large they have. There are some continuing obligations of that merger which are still owing because the time has not expired. Our last rate case that we concluded in August we think dealt with those final benefits, and they will be paid to customers.

Senator SMITH. So, you are satisfied we will get the full benefit of that.

Mr. HEMMINGWAY. Yes.

Senator SMITH. Are you concerned about the report in the *Oregonian* last Sunday that PGE collected more than $357 million from ratepayers, most of which are Oregonians, since it was acquired from Enron, in order to cover its Federal income taxes? And apparently it did not pay any income taxes in those years. Were you aware of that?

Mr. HEMMINGWAY. We were not aware of what Enron's tax situation was, Senator, until it was reported in the press.

Senator SMITH. You do not have access to those records.

Mr. HEMMINGWAY. We do not get their tax return.

But what we do as regulators—and I think this is true across the country with all utility subsidiaries—is we look at the companies that we regulate as if they were stand-alone businesses. And we erected a firewall in 1997 between Enron and Portland General Electric to ensure that Enron could not raid PGE's assets and vice versa, that Portland General customers would not be subject to any problems that Enron might run into. Part of that firewall is us looking at PGE as if it were a stand-alone company when we regulate it. So, we look at the income taxes that Portland General would have paid if they were a stand-alone company, and that is what is included in rates.

Now, if we were to do the opposite and tear down that firewall, the situation might occur that Portland General might be in a situation where one year they do not owe any income taxes, but Enron or its parent might owe income taxes. Then what do we do in that circumstance? Are we to charge ratepayers for taxes that they would not otherwise owe in a stand-alone company?

So, we have chosen to regulate it as if it were a stand-alone company. It is certainly something we will be looking at in the future as we deal with more complex ownership structures of utilities. But I think the decision in the past was completely defensible.

Senator SMITH. Very good. I want to say publicly that the Oregon Public Utilities Commission is very important, and we need you to succeed.

My next question is do you have the resources to succeed at the mission that we need you to do?

Mr. HEMMINGWAY. Senator Smith, thank you. I believe we do. We have been an independent regulatory agency. We are funded by utility fees, so we are not subject to the problems in the budget which are currently going on in the State of Oregon. We have generally good cooperation with the entities that we regulate. We do have concern, as I indicated in my testimony, that industry consolidation will make our job more complex, but with access to books and records and with cooperation of the entities that we regulate, we believe we can continue to regulate effectively.

Senator SMITH. Very good.

One final question, Mr. Chairman. Did PGE buy high-cost power from Enron last year?

Mr. HEMMINGWAY. Mr. Chairman, I do not know the details, but I imagine they did. The question is, was that high-cost power priced above market, and I do not believe it was. PGE bought power from literally dozens and dozens of different sources, and that power was priced at a very high price due to the market conditions largely due to the California problem. And those costs have been passed on to ratepayers such that PGE industrial customers are now paying 50 percent more for power than they were a year ago. That is not a fortunate situation. But if there was market manipulation, it occurred throughout the wholesale market and it was not something that PGE had any control over. So, we were forced to pass those costs along.

Senator SMITH. Can you just state, is there any instance in which this Enron debacle has unfolded in which Oregonians have been particularly victimized? From your regulatory standpoint, where have Oregonians suffered from this?

Mr. HEMMINGWAY. Well, certainly the employees, Senator, of Portland General Electric have suffered terribly in their loss of their 401(k) pension funds.

Senator SMITH. But as to ratepayers.

Mr. HEMMINGWAY. As to ratepayers, I do not believe so. Portland General Electric still has access to the capital markets. There is a question as to whether they are paying more as a result of Enron or whether they are paying more as a result of the problems in the industry as a whole. But overall, this utility is able to function just as well as it did before.

Senator SMITH. Thank you very much.

The CHAIRMAN. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. Thank you for holding this hearing. I want to explore with our witnesses the process and the decision that seems to have allowed Enron to self-certify as qualified for a PUHCA exemption.

I want to begin, Mr. Hempling, if I could, with you because in reviewing your written testimony last night, at page 29 of the testimony you make a number of important points.

First, you point out that Enron was a global company and therefore it should not have been eligible for an exemption from PUHCA for holding companies that are predominantly intrastate in character and carry on their business substantially in a single State.

Second, you make the point that a proper application of PUHCA would have prevented the activities that led to Enron's collapse.

On your first point, could you briefly tell us why Enron should not have qualified for an exemption from PUHCA?

Mr. HEMPLING. Yes, sir, Senator Wyden. The exemption under which Enron operated after its acquisition of Portland General Electric is the exemption set forth in section 3(a)(1) of the act. It is commonly known as the intrastate exemption.

The language of the statute literally requires that the holding company and each of the utility subsidiaries from which it gains a material amount of income must be predominantly intrastate in character and must do business substantially in a single State. These requirements apply distinctly to the holding company, as well as to the utility subsidiary.

So, the analysis is whether Enron Corp., the holding company, which owns pipelines, gas companies throughout the United States, which has holdings throughout the world, is predominantly intrastate in character and whether Enron Corp., the holding company, does business substantially in a single State. Common sense would tell you that it does not.

Senator WYDEN. Now, you also say in your written testimony that the SEC could have found that Enron should not have been an exempt holding company. Is it your view that the SEC abused its discretion in not challenging Enron's claim that it was exempt from PUHCA?

Mr. HEMPLING. As a lawyer, I probably would not use the term "abuse of discretion" because I do not think the SEC had any discretion in this area. The statutory language is plain that the "predominantly intrastate in character" requirement and the "doing business substantially in a single State" requirement applies to the holding company as well as to the utility. There is no discretion.

So, what we have is not an abuse of discretion. We have simply a disregard for the statutory language.

Senator WYDEN. The law does seem clear on its face to me, and you have now said that the SEC disregarded the plain language of the law. How in your view was it that Enron was able to get this exemption from PUHCA despite the clear language of the law? What was the process that caused this to happen?

Mr. HEMPLING. The process under the SEC regulations provides an applicant for exemption with two options. One is to ask the commission for an order, and the other is to certify on its own that it meets the exemption. It is my understanding that the self-certification approach that is made available under rule 2 of the SEC's regulations under the act was the path selected.

Senator WYDEN. So, there was no notice to the public here, no hearing. Basically the public just learns about the self-certification, as you call it, after the fact.

Mr. HEMPLING. I believe that is correct. Commonly, in contrast, under the Federal Power Act, when a utility wants something, it makes application. The application is noticed by the FERC in the *Federal Register*. Those who make a habit of reading the Federal Register daily find out about it, have an opportunity to intervene, protest, ask for a hearing, and upon being aggrieved by a commission decision, take the matter to court. That process does not exist under rule 2 under the Holding Company Act.

Senator WYDEN. Did this self-certification occur in 1997 when Enron acquired PGE?

Mr. HEMPLING. I think the form that was filed by Enron to gain the exemption was a 1997 filing, yes, sir.

Senator WYDEN. Now, has anyone tried to challenge these self-certification processes that Enron won? Or is it just sort of stacked against public scrutiny of these exemptions?

Mr. HEMPLING. Well, the scrutiny is possible because you can find out about it afterwards, Senator, but the process by which the exemption is granted is not readily accessible. I have a batting average in appealing SEC orders that is somewhat to the south of Sammy Sosa's, and one of the reasons why it is so low is because the appealability of an intrastate exemption does not exist. It is viewed by the courts as not an agency action and therefore one cannot—at the least the Ninth Circuit said one cannot—challenge an exemption that is obtained this way.

Senator WYDEN. Now, on your second point, you say—I'll quote you. "Had Enron been treated as a registered holding company, those activities leading to its present state would have been curbed or prohibited, assuming the act were applied conscientiously." Are you saying that SEC enforcement of PUHCA could have avoided or at least minimized the collapse of Enron?

Mr. HEMPLING. I think that is correct, Senator. Now, I do not want to pose as an expert on the Enron debacle. There are several million other people who are doing that right now. But I will say that as a registered holding company, Enron would have been subject to three types of provisions under the act.

The first provision, section 11(b)(1) would require Enron to have limited its activities to those that are incidental to or reasonably necessary or appropriate to the operation of an integrated public utility system. That means that any of the diversified activities, the ones that do not involve the core business of running an electric system, would have had to have been discarded. To the extent the Enron problems flowed from those types of businesses, the Enron problems would not have arisen had the required divestiture taken place.

The second type of provision relates to inter-affiliate transactions. Registered holding companies are subject to sections 12 and 13. Section 12, in particular, deals with financial transactions between affiliates. Issuances of securities, guarantees of debt, injection of equity, and those types of arrangements would have had to have been approved, as consistent with the public interest, by the SEC if Enron were a registered holding company. As an exempt holding company, there is no SEC jurisdiction over them.

And the third area would be sections 6 and 7 of the act which relate to the issuances of securities generally, which are reviewed not merely for accuracy but for prudence and reasonableness. A subsidiary or a holding company issuing debt, which is a registered holding company, would have had to satisfy the SEC's public interest criteria.

So, my position was that were registered status to have applied, which it would have applied had there not been the intrastate exemption, there would have been those three junctures at which review of the Enron situation would take place.

Senator WYDEN. I thank you and thank you, Mr. Chairman, because I want to follow up now with Mr. Hunt briefly with respect to what Mr. Hempling has said because this raises in my mind some serious questions about commission policy.

As you just heard, Commissioner Hunt, Mr. Hempling's answers raised some very serious questions that in 1997 the Securities and Exchange Commission allowed Enron to self-certify it was eligible for an exemption when it was not, and had the law been properly applied, Enron's collapse in his judgment could have been avoided. You all were at the commission at that point. The statute seems clear on its face that both the utility and the holding company have to be primarily in one State to qualify for the exemption.

Did the commission's review of Enron's certification that it was exempt from PUHCA as a predominantly intrastate company find that it was not a global concern?

Mr. HUNT. Well, sir, we do not think that Enron could have engaged in its core business of energy marketing if it had been registered as a registered holding company for some of the reasons that Mr. Hempling cited: the geographic area restrictions in the statute, the uniform, efficient operation of a company. We just do not think that if Enron had been registered as a registered holding company, they would ever have gone into the business that got them into trouble. They just, in our view, could not have done it as a registered public utility holding company.

In 1994, as I mentioned in my testimony, the staff did grant a no-action letter in which the staff agreed not to recommend enforcement action if they operated as a power marketing company because we and the staff, at that time, thought that the power marketing business was not a business that made them a public utility, generating and transmitting energy. So, in 1994, the staff issued a no-action letter.

And then in 1998, I think, not in 1997, when they acquired the Portland General Electric Company, they did claim the exemption under rule 2, and we did think at that time that, because of the incorporation of the holding company, the operation of the utility in the same State of incorporation, that it was entitled to the intrastate exemption insofar as it was a utility holding company, as opposed to its other operations. The core of its problems, the power marketing—again in 1994, we took the position that that did not make the company a registered utility holding company.

Senator WYDEN. The only thing that troubles me about that answer, Mr. Hunt, is energy marketing is a separate issue from the company that owned PGE. And what Mr. Hempling said is this does not come close. Does not come close. I asked him about whether the commission possibly abused its discretion in granting the exemption. He says it is not even a close call. He said the law is very clear. He said this is a global concern. It is not an intrastate concern. And you are talking about apples when the law specifically mentions oranges.

I would like to have a second round on this, Mr. Chairman. I know Senator Cantwell has questions she wants to raise.

Mr. HUNT. Mr. Chairman, could I respond to that?

Senator WYDEN. Yes, I would like that. I would like to know about what the process was for considering this.

The CHAIRMAN. Why don't you go ahead, Mr. Hunt, and respond, and then we will call on Senator Cantwell for a round of questions.

Mr. HUNT. Senator Wyden, in looking at the status of utility holding companies as to whether they are entitled to the intrastate exemption or any other exemption, we do not look at what we consider non-utility activities, and we did not think that the so-called global activities of Enron were activities we should look at in terms of determining its right to or non-right to the intrastate exemption. And since we did not consider its power marketing global activities utility activities, we did not look at those activities in coming to the conclusion that it was entitled to the intrastate exemption under rule 2. That is a longstanding position of the Commission.

Senator WYDEN. Well, Mr. Hunt, let me read the language Mr. Hempling is referring to. It says holding companies and all the subsidiaries have to be intrastate. I am looking right at the statute.

Mr. SOKOL. Senator, as a 3(a)(1) exempt company, can I try to respond to that? We have exactly the same exemption and we are a global company as well.

The language—and let me read it slowly—says, "such holding company, and every subsidiary company thereof which is a public-utility company"—that is a defined term under the act—"from which such holding company derives, directly or indirectly, any material part of its income are predominantly intrastate in character and carry on their business substantially in that single State in which such holding company and every subsidiary company thereof are organized."

I am not defending Enron, but Enron Corporation is incorporated in Oregon and its public utility, only public utility it owns, which is Portland General, is only in the State of Oregon. And by the way, we are the same. We have a utility that is predominantly in the State of Iowa, and we have global operations. I do not think there is any lack of discretion or appropriateness in the 3(a)(1) exemption for Enron.

Senator WYDEN. Can we just hear from Mr. Hempling on that? I just think the statute is very clear.

Mr. HEMPLING. I do not think there is any confusion here. I think that Commissioner Hunt described the policy of the SEC, as I have understood it, accurately. It is the policy of the SEC that, when looking at the holding company, as distinct from the public utility, when it looks at the holding company, it only looks at the holding company in its capacity as an owner of a public utility company, and if the holding company in its capacity as an owner of a public utility company is intrastate, then it will grant the exemption. As I have suggested, I see no discretion upon which one can give that answer because it simply says "such holding company."

Now, Justice Scalia once said when the legislative history is ambiguous, there is no prohibition in looking at the words of the statute.

[Laughter.]

Mr. HEMPLING. But even if one does look to the legislative history, one finds that the abuses which led to the enactment of the act had to do with the holding company and not merely the holding company in its capacity as the owner of a public utility company but the holding company as a form of doing business which controlled vast types of businesses and assets which had little or nothing to do with the public utility business. That is why the distinct phrase holding company, unlimited by the interpretation that the commission has been giving it, is in the statute.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Cantwell.

Senator CANTWELL. Thank you, Mr. Chairman, for holding this important hearing today on the Public Utility Holding Company Act and its effect on the energy markets and consumers.

I have a question for Ms. Marlette about some of your testimony as it relates to, obviously, the changes that you are recommending and oversight, but particularly as it related to your comments on FERC's authority to prescribe RTO's.

Let me first say I understand conceptually how RTO's provide benefits to consumers in some regions of the country. However, as you are probably aware, the Northwest situation is unique in the amount of power generated by Bonneville, which does not fall under the commission's jurisdiction. It already has a centralized grid and in some sense it owns 75 percent of the region's transmission system.

So, the question on the minds of many of our constituents is what kinds of benefits can an RTO provide to us in that Northwest parties are already engaged in the vigorous discussion of RTO's. So, I want to caution FERC in thinking that a one-size-fits-all RTO system would be a reasonable approach to this and get your comments on specifically the interrelation to this and PUHCA reform and to the Northwest.

Ms. MARLETTE. We are certainly well aware of the concerns of the Northwest with respect to RTO's, and as you probably already know, we are undertaking a cost-benefit analysis, which we hope to get back soon, to look at the benefits to the specific regions. Generally, the major benefits of an RTO—to me, the biggest benefit is eliminating undue discrimination in the access to and pricing of transmission, including eliminating pancaking of transmission rates, and also providing a forum for regional transmission planning so that States within a region can come together and the RTO can be a focal point for that planning.

But, as I said, we are looking at the specific cost benefits. It is a pending issue at the commission. When we issued Order 2000, we did a cost-benefit analysis, and that is being updated.

Senator CANTWELL. I think you can understand that given the Northwest's unique nature and then what has transpired, how crazy people would think that a west-wide RTO, given all the problems that have thus occurred, would be for the Northwest to participate in.

Ms. MARLETTE. The Commissioners are well aware of that and the concerns about not imposing a one-size-fits-all and particularly the concerns in the Western part of the country, in light of California.

Senator CANTWELL. I wanted to follow up too. This is somewhat of a follow-on to last week's hearing about the unregulated nature of energy markets and the link to get long-term power pricing. You may or may not know, but I am assuming you know since you are of counsel there, that I asked Chairman Wood about a 206 investigation. In fact, I think he said we will get an answer one way or another and we will commit to doing that for you. So, have you, in fact, opened up a 206 investigation?

Ms. MARLETTE. I have the letters on my desk, as do others, both yours and Senator Wyden's. To formally, officially open a 206 investigation, a majority of the Commission would need to vote to do that under the Federal Power Act. So, we have not issued any orders as yet.

The Commission is looking at trying to do some fact finding as we speak, to gather some information.

One point I should try to make clear is that under 206, the Commission's authority is to open investigations as to public utility contracts, the entities that we regulate. We do not directly regulate EnronOnLine. We have not asserted jurisdiction over it itself as a public utility. So, any 206's would be into the rates under the seller's long-term contracts. That would be where a 206 would come in.

However, having said that, the Commission can certainly, in fact-finding, gather information and we are going to do that with respect to the EnronOnLine activities.

Senator CANTWELL. Well, I just want to point out that we have been consistent about the investigation of long-term contracts, given that that was the price manipulation that the Northwest felt was going on last spring. So, we have been consistent in asking for an investigation and, when the price cap or price mitigation plan was put into place, that long-term contracts be looked at. So, I really believe that any hesitation by FERC will be viewed very negatively in not being cooperative in getting to what really has resulted in some parts of our State in 50 percent rate increases that now consumers will have to live up to for the next 3 or 4 years.

In fact, I am sure that probably what is happening is Enron is buying cheap power at $30 a megawatt from some source in my State, selling it to another utility for their long-term contract, which was probably like $130 a megawatt. And that is still going on today and consumers are going to have to continue to pay that 50 percent rate increase, and I believe that FERC needs to do its job to get that investigation underway immediately.

Ms. MARLETTE. Yes, Senator. I do not want to be perceived at all as the Commission hesitating, but what we are trying to do right now at the staff level is fact gathering so that we have enough to know how to go forward and whom to investigate and how to frame an investigation. So, we are seriously undertaking some fact-finding investigation.

Senator CANTWELL. We look forward to your update as soon as possible.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. Hempling, let me ask a couple of things. You have several suggestions for strengthening the language in S. 1766 as regards FERC's responsibilities. I think the way you put it, you believe that FERC needs more substantial affirmative authority. I think that was the phrase that I heard you use.

One of the suggestions there was that FERC should be obligated to assess the effect of the merger on retail competition, not just authorized to do so. Is that accurate?

Mr. HEMPLING. Yes, sir, that is correct. If I understand the present FERC policy today, it is set forth in what is called the FERC merger policy issued several years ago. It includes a recognition that the retail customer is a concern of FERC's even though retail ratemaking is not and the policy is that upon the request of a State commission, I believe in the context where a State commission has no jurisdiction over a merger, the FERC will look into it.

I find that approach to be spotty because we have a national infrastructure. Ultimately it is the retail customer who pays the bill, who finances the industry, and we have utilities whose very purposes for merging are to gain influence and dominance in retail markets. So, because of the national importance of the industry, I think relying on the episodic request from a State commission, the public admission by a State commission that it lacks jurisdiction, is a policy that is not sufficiently comprehensive to protect the consumer especially during a period where consolidation is occurring so rapidly.

The CHAIRMAN. Mr. Hemmingway, do you have a problem with that suggestion if we were to specify in Federal law that FERC is obligated, in looking at these mergers, to look at the effect the merger would have on retail competition?

Mr. HEMMINGWAY. I have no problem with that. Senator, that is exactly what we do in reviewing mergers under our statutes in Oregon.

The CHAIRMAN. There is also a suggestion in your testimony, Mr. Hempling, that the bill should codify FERC's recent policy of establishing that the right to charge market rates lasts only as long as the rates are just and reasonable. You think that needs to be specified.

Mr. HEMPLING. Yes, sir. Ms. Marlette can speak to this more authoritatively. It is my understanding that in the past, before approximately December, if FERC had authorized a company to charge what the market will bear and someone found out that the market is no longer competitive so that rates are now just and reasonable, that person or FERC could institute a complaint proceeding and refunds would be available prospectively. But a long period of time can go on between the time that the markets turn noncompetitive and that complaint gets filed.

And I believe FERC in December recognized this notion and intends to assign to all future authorizations of market-based rates the statement that at any point in time that this becomes unjust and unreasonable, even if we do not find out about it afterwards, we will grant refunds back to that date. And I think codifying that would remove the possibility that future commissions, like past commissions other than this commission, would miss the boat on protecting the consumer.

The CHAIRMAN. Ms. Marlette, do you have a problem with that suggestion?

Ms. MARLETTE. Well, just a couple of clarifications. What the Commission proposed to do—and we instituted a 206 investigation into all public utility tariffs, proposing to place into all existing tariffs and future tariffs a condition which says that if the seller is found to have engaged in anti-competitive conduct, then it will be subject to refunds. We could go back in time—those provisions have not taken effect yet. We have asked for comment on it. Actually I think the comments may be in by now. We do have a pending proceeding on that issue, so I do not feel it appropriate to discuss whether it ought to be legislated since I have not personally considered all the views on the issue.

The CHAIRMAN. Mr. Hemmingway, in your testimony I believe you have a statement that the books and records provisions that are in S. 1766 should be strengthened, but you do not specify in what way. Could you elaborate on that or tell us more specifically how you would like to see those strengthened?

Mr. HEMMINGWAY. Yes, Mr. Chairman. With respect to State commissions, it requires that there be an open proceeding before there can be a request for books and records. Many utility commissions do ongoing audit efforts with utilities without opening up a specific docket. We in Oregon tend to open dockets on everything, but many commissions do not. It would be fruitful, Mr. Chairman, if that provision could be broadened so that State utility commissions did not need to open a proceeding before requesting books and records.

The CHAIRMAN. One of the prohibitions that is in the Public Utility Holding Company Act is this prohibition against acquiring anything that is not part of an integrated public utility system, as I understand it. As I understand everyone's testimony, including yours, Mr. Hempling, everyone has agreed that that does not make sense in the current economic circumstance that we live in, that that prohibition that says you can only acquire an asset or a business that is part of an integrated public utility system—that that requirement is obsolete at this point. Let me ask Mr. Hempling if you agree with that.

Mr. HEMPLING. Making the concern a requirement is the error. The concern itself is not. The distant collection of monopoly assets based on inquisitiveness or market dominance is still a concern. It is because of the possibilities brought by an investor like Mr. Buffett, who seems to run a good business, that I have suggested that that concern should not be translated anymore into a prohibition. So, I think there is complete agreement, as you pointed out, on that. The fundamental difference has to do with whether the acquisition is going to be reviewed sufficiently.

The CHAIRMAN. Let me go ahead and defer to Senator Wyden for another round.

Senator WYDEN. Thank you, Mr. Chairman. I just want to note for the record that no one could ever question your commitment to energy conservation because it is so cold on this side of the dais.

[Laughter.]

Senator WYDEN. You are doing more than your share.

I appreciate having another round.

The CHAIRMAN. We appreciate that rousing endorsement.

[Laughter.]

Senator WYDEN. Commissioner Hunt, let me go back to something you said in response to my earlier question. You said in response to my earlier question that the SEC's decision to issue the no-action letter in 1994 allowing Enron to engage in energy trading without having to register under PUHCA, your view was that Enron would not have been able to get into the business of energy trading had it not been a registered holding company.

Mr. HUNT. I think my statement, Senator, was I do not think they would have been able to get into the business of energy trading if they were a registered public utility holding company because it is global in nature and their business would have violated many of the restrictive aspects of the 1935 act.

Senator WYDEN. Is it the principal job of the SEC to help companies like Enron get into the energy trading business?

Mr. HUNT. No, sir. I think our principal job is to regulate the securities markets of the United States and to provide for the easy raising of capital for American industry and to protect investors.

Senator WYDEN. Well, my read is it is SEC's job to enforce the letter and the spirit of the law rather than help folks get into the energy trading business.

Mr. HUNT. Senator, we gave this kind of relief to 20 companies after we gave the relief to Enron. We also incorporated it into our rule 58, defining energy marketing as a permitted non-utility business in 1997 after notice to the general public. And of course, the rulemaking was a public proceeding. In our rule 58, we said that the brokering and marketing of energy commodities, including but not limited to electricity, natural or manufactured gas and other combustible fuels, was a permitted non-utility activity of utility holding companies.

Now, people would have had a right to object to that rule when we proposed it, but we defined energy marketing as a non-utility activity for purposes of the 1935 act in 1997.

Senator WYDEN. Well, again, what you are saying sure seems to be different than what we have heard from Mr. Hempling. Mr. Hempling described something that the public got no notice about.

Mr. HEMPLING. Sir, if I may clarify.

Senator WYDEN. Why do you not?

Mr. HEMPLING. Yes, sir, because I think there is nothing about which Commissioner Hunt is saying that is not 100 percent accurate. I want to make sure the record is clear.

When I talked about the absence of advanced public notice, I was referring to the process by which the intrastate exemption under section 3(a)(1) is granted. Commissioner Hunt is, of course, correct that with respect to the declaration that marketing, brokering, and other activities are determined to be permitted for registered holding companies, that was certainly done pursuant to the traditional notice and comment rulemaking that the SEC and all agencies engage in. There were no procedural defects associated with the rule 58.

Senator WYDEN. Nobody is saying that.

I just want to go back to the issue that I have been concerned about, that my constituents are concerned about: there was not any public process with respect to this self-certification.

Now, Mr. Hunt, during the time you served on the SEC, were there ever any questions about the self-certification process?

Mr. HUNT. Certainly none that came to my attention, Senator. I do not think so.

Senator WYDEN. Now, in 1997, around the same time—this would be a question again for you, Mr. Hunt—that Enron was self-certifying it was exempt from PUHCA, Enron also sought another exemption from the SEC. This was under the Investment Company Act. Now, in seeking that exemption, Enron certainly did not hide the fact that it wanted to expand its overseas operation. Enron specifically requested an exemption from the investment company statute to engage in foreign infrastructure projects, and the SEC granted that exemption.

Mr. HUNT. Yes, sir.

Senator WYDEN. Given that the SEC was on notice that Enron was going to engage in overseas operations, that it was going to be a global company, did anyone at the SEC compare that filing with Enron's self-certification that it was exempt from PUHCA because it was saying the company was primarily in business in one State?

My reason for asking this I think is obvious. How can you be a global company in one respect under one act the SEC enforces, the Investment Company Act, and then be classified as operating primarily in one State under another act the SEC enforces which is PUHCA?

Mr. HUNT. Easy, sir. The Investment Company Act is designed to get at companies that essentially hold investment securities in other companies. What Enron was doing was engaging in infrastructure, bridge, railroad, dam, projects around the world. In many countries, the legal regimes of those countries prohibit a foreign corporation from holding a majority interest in any kind of corporation whether it is constructing infrastructure items or other things. Therefore, Enron found itself holding minority interests in companies around the world in infrastructure engagements. But for an exemption from the Investment Company Act of 1940, Enron would have, therefore, been deemed to be an investment company because it may have had over 45 percent of its assets invested in this way and perhaps would have had more than 45 percent of its income derived from these infrastructure engagements.

It was the Division of Investment Management's view that this was not the sort of activity that the Investment Company Act was meant to regulate, that the Investment Company Act was meant to regulate such investments as are engaged in by mutual funds or other investment companies, and that, under these circumstances, given the business in which Enron was engaged and going to be engaged, its security holders did not need the protection under the Investment Company Act of 1940.

Senator WYDEN. Mr. Chairman, I know my time is expired. I want to wrap up by asking that an article from the *Wall Street Journal* be entered into the record. It is entitled "Enron's Rise and Fall Mirrors Collapse of Middle West Utilities 70 Years Ago." Just in wrapping up, I quote from the article. It says, "In rapid order in 1934 and 1935, Congress passed the Securities and Exchange Act, the Public Utility Holding Company Act, and the Federal Power Act. These laws sought to break up the power trusts and guarantee investors the information they need to make informed decisions. More than a half century later, Enron would figure out ways around part of those same laws."

I think what we have heard today—and again, these are very complicated issues and you have been very gracious in terms of letting us look at these issues—raises some very troubling questions. I am not reaching any judgments at this point, but certainly what we have heard—and particularly when Mr. Hempling says it is not a close call here, there was not any abuse of discretion, that the SEC in his judgment did not follow the law on this issue, I think we ought to be digging further. I am anxious to work cooperatively with you in this regard.

The CHAIRMAN. Thank you.

Senator Carper, I had another few questions. Would you like to go ahead first with your questions?

Senator CARPER. I would like to hear your questions.

The CHAIRMAN. Well, I am glad to ask them and you can then ask yours.

Senator CARPER. Thank you.

The CHAIRMAN. Let me ask a general question. One of the things the Public Utility Holding Company Act was intended to accomplish was to prevent this cross-subsidization that we worry about so that you do not wind up with ratepayers having to subsidize other businesses that they have had no involvement in. Mr. Hemmingway, you testified that you try to regulate there in Oregon each company, each utility, as a stand-alone business so that you work hard to be sure that there is no cross-subsidization.

PUHCA, as I understand it, has a prohibition against it in the sense that it says if you get into a business that is an affiliated business, you have got to do business with that business on a cost basis. So, one example would be if you buy a lumber company to make electric poles, you cannot enrich your lumber company by charging an unduly high price for those electric poles and making the utility customer pay that price. You have got to sell them at cost. Now, that is my understanding of one thing PUHCA is trying to do.

Does the language we have in this S. 1766 adequately ensure that that cross-subsidization will not be there once this responsibility is transferred, if it is, if this legislation goes through and the responsibility is going to be with the State commissions and is going to be with FERC—does the language we have here ensure against that cross-subsidization as effectively as PUHCA has?

Mr. Hemmingway.

Mr. HEMMINGWAY. Mr. Chairman, cross-subsidization is an issue for any utility regulator because utilities often have enterprises which are not regulated. They may do everything from—we have had airplane leasing to real estate development to coal development. And whether they are registered or come under any purview of the Holding Company Act whatsoever. So, any regulator is accustomed to having to separate out these enterprises and to ensure that there is not any cross-subsidization from regulated enterprises to non-regulated enterprises. And the key there is being able to have access to the books and records of the company to be able to audit them and to make sure that that is not happening.

Now, when PUHCA is repealed, as is contemplated in S. 1766, there is a provision with respect to the way that registered holding companies are regulated that requires the allocation of costs from an affiliated company to be done at cost, and it may happen that it may suit regulators to look at market prices in a situation where market prices, for instance, are well below cost. It may well happen, for instance, that a utility has developed real estate and the real estate market has dropped and the question then comes before the regulator, must you allow the cost of that real estate in the rates or can you look at market. With the repeal of PUHCA, we would not be facing that situation of having the SEC do that allocation of cost, but we could actually look at market alone.

To sum up, the key to us is being able to have access to the books and records of whatever corporate structure results, whether it is a holding company or not, and if we have access, we think we can effectively regulate.

The CHAIRMAN. Good.

Mr. Hempling.

Mr. HEMPLING. Yes, sir. It certainly is correct to outlaw the types of transactions that lead to cross-subsidies, and the bill does that appropriately. But the history of regulation and the present of regulation is that there is a distinction between transaction and structure. If one has the type of corporate structure and market structure where there is an incentive and opportunity to cross-subsidize, then all one is doing is making far more work for the regulator at the other end and creating far more uncertainty.

When I looked at the form filed by the Enron Corp. asking for its intrastate exemption, I looked for the list of subsidiaries that it had around the world, and it said, see appendix 1. And when I went to appendix 1, it said, not filed pursuant to regulation 202 of the SEC's S-T. And I asked a colleague of mine who is in corporate law, what does that mean, and he said, it is so voluminous that they asked for an exemption from having to do it electronically because they would have had to put too many things through a scanner.

The point is that one can have staff, one can be committed to the policing of cross-subsidies. But I make most of my money working within State commissions, and I am not aware of any State commissions where there is surplus staff to review for the cross-subsidies based on the increasing complexity transactionally that will arise once the Holding Company Act is repealed.

The CHAIRMAN. But now, what is your solution? Is your solution that we say, if a company does have extensive other holdings, like Berkshire Hathaway does, that we should not let them in the utility business? Is that your solution?

Mr. HEMPLING. No, sir, not at all. My solution is simply what the act does now, with the exception of the prohibition. What the act does now is create an advance review. So, let the Federal regulators, as well as the State regulators, look at the corporate structure that is being proposed before the acquisition and ask the simple question, are we going to have the authority, the resources, the technical ability to trace the cross-subsidies, at what cost? Is our legislative body going to continue to fund us at the level necessary to incur those costs? And if so, have at it.

The CHAIRMAN. So, you are saying if FERC has the ability to do a prior review before Berkshire Hathaway could come in and buy a utility or anybody else could come in and buy a utility, and if the State commission involved has the ability to do a prior review and say, okay, you can do it, then that satisfies your concern.

Mr. HEMPLING. Yes, sir, if the reviewing agencies are required to conduct a review and that they are required to conduct it pursuant to the traditional public interest criteria.

Now, I want to be clear. I am not talking about the 12-month delay. I understand what competitive entry is. I run a law practice where I compete. I do not want to get 6 months of delay before I decide whether to bid on a job. But these are the types of structural reviews that can be done concisely in advance upon the proper filings of things, and then someone who passes——

The CHAIRMAN. So, someone could come in and make a bid to purchase a utility, and it would be conditioned upon approval by the appropriate commissions, and that would be the end.

Mr. HEMPLING. Yes, sir. Again, what we would be doing is retaining what is good about the act and eliminating the obstructions that are in the act.

The CHAIRMAN. Mr. Sokol.

Mr. SOKOL. Senator, I would just make two comments. First of all, that is exactly what happens today and your bill will only enhance that. I would ask the chairman of the Oregon Commission whether he would allow—the thing I would disagree with, Mr. Hempling, is it is not enough to just review it up front because corporations change. The State regulators have got to have the right to review it every time they want to review it and have the access to information.

The CHAIRMAN. Do you agree with his point that both the State regulators and FERC should have ongoing access to books and records?

Mr. SOKOL. As they require it, yes.

Mr. HUNT. Senator, if I may. We would not dictate the rules, but FERC should have rulemaking authority to prohibit those kinds of affiliated transactions that they find to inherently have a conflict of interest.

The CHAIRMAN. Senator Carper, I have asked my questions.

Senator CARPER. Well, good. Thank you, sir, for allowing me to ask a few myself.

I apologize for being late. I serve on three committees that are meeting this morning and I am trying to go from one to the other and cover them all. The Senate is in session, and I have been presiding for a while and speaking on the Senate floor. So, I am just glad to be here. I am glad that you all are still here.

I will be real honest with you. I have not had a chance to read your testimony. I understand the basic reason we are having this hearing is to try to get your input as to whether or not some of the events that are involved around the Enron bankruptcy raise concerns among some people that the regulation of energy companies might be insufficient if we repeal PUHCA.

What I really would most appreciate is just for each of you to take a minute and answer that question for me, and if there is anything else that you want me to take out of this hearing that you think, by golly, you have missed most of this, pal, but there are one or two things you ought to know and here they are. Just take a minute apiece and answer the basic question for me.

Mr. HUNT. Senator, my name is Isaac Hunt. I am with the Securities and Exchange Commission. We, fortunately or unfortunately, administer PUHCA now.

[Laughter.]

Mr. HUNT. It is our position and has been for 20 years that PUHCA is outdated, that most of the evils that PUHCA was meant to remedy have been remedied, that more authority should be given to FERC, the principal utility regulator, and to the States to have complete access to the books and records of utility companies so that they can guard against these cross-affiliate transactions that we were just talking about with the chairman.

We think that the State regulation has improved. We think that FERC is clearly the agency that the Congress intends to be principal utility regulator at the Federal level, and we think we should be out of this business.

Senator CARPER. Thank you for that direct response.

Others, please.

Mr. HEMMINGWAY. I am Roy Hemmingway, the chairman of the Oregon Public Utility Commission.

Senator CARPER. Welcome.

Mr. HEMMINGWAY. Thank you.

The Public Utility Holding Company Act is basically the constitution by which the electric and natural gas retail utility industry is structured today. We have hundreds of relatively small enterprises serving retail consumers around the country.

If PUHCA is repealed, we expect that there will be considerably greater acceleration of consolidation in this industry, and you can have your own opinion whether that is a good thing or a bad thing. I think in many respects it would be a good thing.

The concern, though, that we have as State regulators is that that consolidation makes regulation more difficult and more complicated and shifts some of that jurisdiction to the Federal Government. We think that we can accommodate that change if we have ability to investigate books and records and if FERC has additional authority to approve mergers. But we think that the Congress and the Federal agencies will need to maintain vigilance because it is somewhat unpredictable as to what kind of industry structure will result from repeal of PUHCA and there may be abuses in the future that we cannot anticipate at this time.

Senator CARPER. Thank you.

Ms. MARLETTE. I am here as a staff witness.

Senator CARPER. Are you with FERC?

Ms. MARLETTE. I am the General Counsel of the FERC.

Our Commission witnesses have consistently for the last, I think, 5 to 6 years testified that PUHCA does need to be repealed or reformed. We think it is inconsistent with competitive markets right now. It encourages geographic concentrations of generation, which actually can increase market power, and it can serve as a disincentive to investments in RTO's, regional transmission organizations.

There are certain areas of PUHCA which have actually impeded our Commission's ability to protect the ratepayers served by registered holding companies from affiliate cross-subsidization, the issue that Senator Bingaman was talking about a few minutes ago. I think that Senator Bingaman's bill, the repeal, that would add access to books and records by both State and Federal regulators of all members of the holding company system would significantly enhance our ability to monitor against market power and cross-subsidization, and it would cure the problem that is in the act right now in that regard.

Senator CARPER. Thanks very much.

Mr. SOKOL. Senator, David Sokol, CEO of MidAmerican Energy. Our largest shareholder is Berkshire Hathaway.

I think we need to separate the issues. S. 1766 is a very good bill, particularly the portions about PUHCA reform. We must protect the access to books and records, affiliate transactions, et cetera, and we must give the State and FERC more authority there. We also have to get rid of those parts of PUHCA that stop companies like Berkshire Hathaway from investing in this sector so that we have high quality investors moving industry forward.

Enron is a red herring in this sense. Enron had two PUHCA exemptions: the 3(a)(1) which was appropriate, and the market trading which was appropriate as well. Enron did not go bankrupt because it bought Portland General Electric. In fact, as the commissioner has stated, Portland General's consumers were not harmed by Enron's bankruptcy. PUHCA is actually inhibiting their ability to sell it to a credit worthy company.

Enron was not harmed because it was in the marketing business of energy. Enron went bankrupt because of arrogance, accounting fraud, and mismanagement. Those are the issues of Enron. PUHCA did not stop it. In some ways, PUHCA may have helped Enron do what they were doing, but again it was an illegal activity based operation and it went bankrupt, as it should, as other companies have in the past.

We cannot not move forward with energy modernization over the excitement of Enron. We need to put executives in jail when they break the law, and we need to hold auditors accountable. But PUHCA has to be reformed if, in fact, we want to move forward with the energy sector because right now we are on the 50-yard line. The Congress deregulated wholesale electricity in 1992, but we still do not have rule clarification throughout the sector, and that is a serious mistake and frankly a recipe for serious problems in the future if we do not fix it.

Senator CARPER. So, we are on the 50-yard line. Who has the ball?

Mr. SOKOL. You all do.

[Laughter.]

Senator CARPER. Is it a first down?

Mr. SOKOL. First down.

Senator CARPER. Before we turn to Mr. Hempling for a closing word, you said there are three reasons why Enron went down. Just say those again. I thought that was nicely put.

Mr. SOKOL. Arrogance, accounting fraud, and mismanagement.

Senator CARPER. Mr. Hempling.

Mr. HEMPLING. Thank you, Senator. The Holding Company Act uses structural limits to protect consumers in an industry where competition is ineffective and regulators are outmatched. Those are the preconditions for repealing the Holding Company Act. If wholesale competition works, if retail regulation works, then the limitations imposed on entry by the Holding Company Act are appropriate, but the record is that wholesale competition is a work in progress. Many tasks lie ahead from understanding regional transmission policy to learning how to measure the competitiveness of wholesale markets. We have about the best FERC we have had in years. It is struggling determinedly with these issues, but it would be the last to say that it could predict when these matters will be resolved.

We should adjust the Holding Company Act so that new companies who can bring real benefits, real savings, real competition to the market enter, but we have to make sure those entries are procompetitive. We have to do that by assuring that the Federal Energy Regulatory Commission has the appropriate tools to do so. The position that says repeal the Holding Company Act and we will see how things work does not take into account the realities of wholesale competition today.

Senator CARPER. Well, my thanks to each of you. That was very helpful for me. I am sure, Mr. Chairman, this is repetition for you, and I apologize for that. But this has been a good, helpful exchange. And we thank each of you for your contributions and your presence.

The CHAIRMAN. I think that is a very good summary of the testimony we heard. Thank you all very much. I think this is very useful testimony.

[Whereupon, at 11:50 p.m., the hearing was adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Questions

FEDERAL ENERGY REGULATORY COMMISSION,
Washington, DC, February 15, 2002.

Hon. JEFF BINGAMAN,
Chairman, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR CHAIRMAN BINGAMAN: Thank you for your letter of February 8 enclosing questions from Senator Richard C. Shelby and Senator Maria Cantwell for the record of your Committee's February 6 hearing.

I have enclosed my responses to Senator Shelby's and Senator Cantwell's questions. If you need additional information, please do not hesitate to let me know.

Sincerely,

CYNTHIA A. MARLETTE,
General Counsel.

[Enclosures]

RESPONSES TO QUESTIONS FROM SENATOR SHELBY

Question 1. Mr. Hempling has stated that the SEC did not apply PUHCA in an appropriate manner when considering Enron's request for a no-action letter with respect to engaging in power marketing activities. In his statement, Commissioner Hunt said that if Congress chooses to not repeal PUHCA it should be given to the FERC. If this were to happen, could you please describe for us how FERC would apply PUHCA to energy marketing activities like those engaged in by Enron?

Answer. My understanding is that Enron sought a no-action letter for its power marketing activities on the basis that these activities did not entail ownership or operation of generation, transmission or distribution "facilities" under the definition of an electric utility company under PUHCA. The SEC staff issued a no-action letter. It is not clear whether FERC could interpret "facilities" in PUHCA differently than the SEC Staff. However, the FERC has held that "facilities" under the Federal Power Act includes books, records and contracts, and it has exercised jurisdiction over power marketers on this basis. If the FERC were given authority to administer PUHCA, I do not know whether a court would affirm an interpretation of PUHCA consistent with the FERC's interpretation of the same term under the Federal Power Act.

Question 2. Commissioner Hunt stated that the SEC took into consideration Enron's ability to get "into the business" of power marketing without a no-action letter. Would the FERC disagree with the SEC's consideration of the importance of power marketing to competitive electricity markets?

Answer. I agree that power marketing is important to competitive electricity markets. Power marketing allows market participants a greater array of possible transactions, in which the marketer takes electrical supply from a number of generators and repackages it in the quantities and with the terms desired by buyers. In short, power marketing can produce greater efficiencies in the markets.

RESPONSES TO QUESTIONS FROM SENATOR CANTWELL

Question 1. While I understand, conceptually, how RTOs may provide benefits to consumers in some regions of the country, you are probably aware that the Pacific

Northwest's situation is quite unique in this regard, because of the presence of the Bonneville Power Administration (BPA). BPA is already a centralized grid operator in the sense its owns about 75 percent of our region's high-voltage transmission system. Nevertheless, Northwest parties are engaged in vigorous discussion and working on an RTO proposal that would meet the needs of our region's consumers. However, I just want to caution FERC that it cannot prescribe a one-size-fits-all approach to RTOs, and that we need to see measurable benefits in the Northwest. I believe the Northwest must be given time to craft an RTO that meets our singular needs—in contrast to the timeline and concepts outlined in various FERC orders and staff papers. Do you agree, however, that FERC lacks the authority to direct a Power Marketing Administration such as BPA to participate in an RTO?

Answer. Yes, I agree that the FERC has no direct authority to require a PMA such as BPA to participate in an RTO. With respect to BPA specifically, BPA is overseen by the Department of Energy, and is not within the Commission's direct jurisdiction under sections 205-206 of the FPA.

Question 2. With regard to the unregulated nature of forward energy markets discussed at the Jan. 30 Energy Committee hearing, there are some of us who are taking a close look at legislative proposals to close this loophole, which some believe may have allowed Enron—through its Internet-based trading platform, EnronOnline—to manipulate prices in the West. What type of jurisdiction and resources do you believe FERC would need to patrol these markets and apply the same just and reasonable standard it is currently charged with upholding in other wholesale market transactions?

Answer. If the Congress finds it appropriate to expand the FERC's jurisdiction in the way you describe, the legislative language should give FERC explicit jurisdiction over: (1) derivatives transactions based on, or reflecting, the prices of or for natural gas or electric energy; (2) persons making such transactions; and (3) any entity that operates an electronic facility in which persons make such transactions. Exceptions from this jurisdiction should apply for any transactions within the exclusive jurisdiction of the CFTC or the exclusive jurisdiction of a State over retail sales of natural gas or electricity. If FERC's responsibilities were expanded in this way, FERC would likely need significant additional resources.

Question 3. In the wake of Enron's collapse, many merchant generating companies seem to be in shaky financial condition and, therefore, are potential buy-out targets. In fact, at least three proposed power plants in Washington—needed to meet the West's growing energy demand—have already been put on hold because of this uncertainty. The weak financial condition of some of these companies raises concerns. Given that consolidation within the generation sector is at odds with increased competition, how high should we set the bar for utility mergers and acquisitions, in order to prevent undue market power? Shouldn't mergers be deemed "in the public interest" before they are allowed to proceed?

Answer. Mergers involving merchant generation companies generally require FERC approval under FPA Section 203. (The exception would be a merger involving only generation facilities and not transmission facilities or wholesale contracts, a circumstance that occurs infrequently, if ever.) Under Section 203, proposed mergers must be "consistent with the public interest" in order to be approved. Under existing court precedent, "consistent with the public interest" does not require a showing of positive benefit to the public, but rather a showing of no detriment to the status quo. The Commission considers the effect on competition of proposed mergers involving jurisdictional facilities under the FPA. If the Commission finds that a merger is likely to harm competition, the Commission may impose conditions on the merger to prevent such harm. The Commission has used this authority in past cases to require such procompetitive measures as the filing of an open access tariff. The Commission also considers the effect of the merger on rates and on regulation and may impose conditions in these areas as well. If the Congress were to change the standard under FPA section 203 to require mergers to be "in the public interest," this arguably would give the Commission the discretion to require merger applicants to demonstrate that the merger would increase competition or result in other positive benefits.

Question 4. S. 1766, the Senate energy bill, relies on FERC access to books and records to prevent abusive transactions among a utility holding company's affiliates. Enron reportedly had 5,800 affiliates—including 281 located off-shore. Given these potentially complex corporate structures, is access to books and records sufficient to prevent abusive transactions? Does FERC have the resources to comb through this massive amount of information?

Answer. Under section 301 of the FPA, the Commission currently has extensive access to books and records of public utilities and their affiliates. Increased access to books and records of all members of a holding company system would provide additional regulatory protection and sufficient authority to prevent inappropriate affiliate cross-subsidization. However, FERC may need additional resources to properly audit books and records. Currently, few FERC personnel have the experience and training needed to examine and fully analyze the extremely complex corporate structures and affiliate transactions used by companies such as Enron. The amount of any additional resources needed might vary based on any guidance or instructions Congress gives the Commission along with such new authority. For example, if Congress requires annual comprehensive reviews of the books and records of all large utilities, the additional resources needed would be quite extensive.

U.S. SECURITIES AND EXCHANGE COMMISSION,
Washington, DC, February 20, 2002.

Hon. JEFF BINGAMAN,
Committee on Energy and Natural Resources, U.S. Senate, Dirksen Senate Office Building, Washington, DC.

DEAR CHAIRMAN BINGAMAN: Thank you for your letter of February 6th regarding my testimony before the Committee on Energy and Natural Resources and transmitting follow-up questions from members of the Committee. I appreciate the opportunity to respond to the concerns of Committee members. I ask that you include my responses to these questions, which follow on the attached pages, in the hearing record.

Please do not hesitate to let me know if I can be of further assistance.

Sincerely yours,

ISAAC C. HUNT, JR.,
Commissioner.

RESPONSES TO QUESTIONS FROM SENATOR SHELBY

Question. Commissioner Hunt, could you please detail for us again, why the SEC issued a no-action letter with respect to Enron's power marketing activities? What factors were taken into consideration and why?

Answer. The no-action letter that Enron Power Marketing, Inc. ("EPMI") received stated that the staff would not recommend enforcement action against the company if it engaged in certain types of power marketing activities. As a general matter, in a no-enforcement no-action letter, the staff—not the Commission—agrees not to recommend enforcement action to the Commission. Typically, as occurred in this case, the party seeking the letter makes detailed representations to the staff about the proposed transaction or activity in question. While the staff usually will not agree or disagree with the legal analysis set forth by the party, the staff, in issuing the no-action letter, will base its determinations on those representations.

In a 1994 no-action letter to EPMI, the SEC staff stated that it would not recommend an enforcement action under section 2(a)(3) of the Public Utility Holding Company Act of 1935 ("PUHCA") in the event that EPMI, an indirect subsidiary of Enron Corp., entered into contracts for the purchase and resale of electric power or for transmission capacity in connection with its power marketing activities. EPMI did not own any generating plants, transmission lines or electric distribution systems. EPMI argued in its incoming request that under PUHCA, the contracts and books and records underlying its power marketing activities were not "facilities" used for the "generation, transmission or distribution of electric energy for sale" and that its power marketing subsidiary therefore was not, for purposes of PUHCA, an electric utility company subject to the Act. EPMI also indicated that other companies were engaging in similar power marketing activities without registering under the Act.

Based on these representations, the staff gave EPMI the requested no-action assurance.[1] Although the staff's letter clearly stated that the staff did not necessarily agree or disagree with EPMI's legal analysis, the staff would have considered

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[1] In the past, the staff has noted the potential breadth of the term "facility." Specifically, in a 1974 no-action letter issued to Unilease No. 10, Inc., the staff noted that the term could "include[] anything which aids or makes easier the performance of the business in which the company is engaged." In that letter, however, the staff also noted that "the Act generally distinguishes between the business of a public utility company and businesses which are nonutilities in function and character." On this basis, the staff concluded that the "business of fuel procurement, storage and delivery" was non-utility in character, and that a company engaged in those activities was not necessarily a utility company. Therefore, even though the 1974 letter notes the potential breadth of the term "facility," the result the staff reached in the EPMI letter is not inconsistent with the result it reached over 20 years earlier.

whether, in its view, EPMI was engaging in activities that were subject to the PUHCA. In deciding to issue the letter, the staff likely concluded that power marketing was not a utility activity. Since issuing the no-action letter to EPMI, the staff has issued approximately 20 analogous letters to other power marketers. The Commission itself has issued several orders and promulgated a rule (Rule 58) allowing registered holding companies to engage in power marketing as a non-utility activity, evidencing its agreement that power marketing is not a utility activity.[2]

Question. Could the SEC explain in a more fulsome manner the import, rationale, and precedent for the order issued in 1997 (Release No. IC-22560; March 13, 1997) that exempted Enron Corp. from regulation under the Investment Company Act of 1940? Does this rationale conflict with that utilized in the 1994 and 1997 no-action letters issued to Enron under PUHCA? If not, then why not? A brief description of similar 40 Act orders to other energy-related companies would be helpful also.

Answer. As outlined below, the issues underlying the 1997 exemptive order and the 1994 and 1997 no-action letters were different, and thus there was no conflict between them. The 1997 exemptive order addressed whether Enron's participation in foreign infrastructure projects could lead to it falling within the definition of "investment company" in the Investment Company Act. In contrast, the two no-action letters dealt with whether a subsidiary engaged in power marketing fell within the definition of "utility" for purposes of PUHCA.

The 1997 exemptive order dealt with Enron's interests in foreign infrastructure projects in which it believed that it could not acquire a majority interest for reasons such as restrictions imposed by local law. The Investment Company Act defines an investment company, among other things, as any issuer that holds "investment securities" in excess of 40% of its total assets on an unconsolidated basis (exclusive of cash and U.S. government securities). To the extent Enron's minority interests in foreign infrastructure projects were "investment securities," they limited the extent to which Enron could participate in foreign infrastructure projects without coming within the definition of "investment company."

According to Enron's application for the 1997 SEC exemption ("Application"), Enron viewed many of its interests in foreign infrastructure projects as outside the definition of "investment security," but wanted the SEC exemption to eliminate any uncertainty. Enron further noted that the Investment Company Act was not intended to regulate industrial foreign infrastructure activity.[3]

Prior to issuing the Enron order, the Commission had granted orders under section 3(b)(2) of the Act to other companies engaged in foreign infrastructure projects.[4] The Enron order extended those orders somewhat by including within the scope of the exemption smaller, non-controlling equity stakes in foreign infrastructure projects. Nonetheless, given the unique limitations sometimes imposed on the ability of U.S. companies to own large equity stakes in foreign infrastructure projects, the relief granted Enron was consistent in principle with the prior orders. In addition, the 1997 order was consistent with the legislative history of the National Securities Markets Improvement Act of 1996.[5] Since that time, the Commission has issued analogous orders under section 6(c) to four companies, each of which is involved in foreign infrastructure projects in the telecommunications area.[6] Although no other company engaged in energy-related foreign infrastructure projects has applied for this type of order, there does not seem to be any reason to distinguish between en-

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[2] Rule 58, 17 C.F.R. § 250.58, permits a registered holding company system to engage in various non-utility activities, including "[t]he brokering and marketing of energy commodities, including but not limited to electricity, natural or manufactured gas and other combustible fuels." Rule 58(b)(1)(v), 17 C.F.R. § 250.58(b)(1)(v).

[3] In its June 17, 1996 report on the Securities Amendments of 1996 (the National Securities Markets Improvement Act of 1996), the House Committee on Commerce stated that it "expects the Commission to take administrative action expeditiously, either on a case-by-case basis through exemptive orders or through rulemaking, to exempt from regulation as investment companies U.S. companies that own substantial interests in foreign infrastructure companies and that are directly or through affiliates actively involved in foreign infrastructure projects."

[4] See *CITIC Pacific Limited*, Investment Company Act Release Nos. 21282 (Aug. 15, 1995) (notice) and 21375 (Sept. 12, 1995) (order); *Consolidated TVX Mining Corporation*, Investment Company Act Release Nos. 17853 (Nov. 13, 1990) (notice) and 17902 (Dec. 11, 1990) (order).

[5] *See supra* note 3.

[6] *See e.g., Propel, Inc.*, Investment Company Act Release Nos. 24633 (Sep. 6, 2000) (notice) and 24673 (Oct. 3, 2000) (order); *Telesystem International Wireless Inc.*, Investment Company Act Release Nos. 23618 (Dec. 22, 1998) (notice) and 23658 (Jan. 20, 1999) (order); *Formus Communications*, Investment Company Act Release Nos. 23486 (Oct. 14, 1998) (notice) and 23530 (Nov. 10, 1998) (order); *Tele-Communications International, Inc.*, Investment Company Act Release Nos. 22797 (Aug. 22, 1997) (notice) and 22825 (Sep. 17, 1997) (order).

ergy-related and telecommunications-related infrastructure projects for purposes of the Investment Company Act.

Based on the representations in Enron's application, it does not appear that Enron would have registered under the Investment Company Act even absent the 1997 SEC exemption. According to the Application, if the SEC did not grant the requested exemption, Enron would have structured or limited its participation in foreign infrastructure projects so as not to come under the definition of investment company in the Investment Company Act. An operating company typically finds the requirements of the Investment Company Act incompatible with its business needs. It is therefore not uncommon for an operating company to structure its operations and holdings to avoid falling within the scope of the Investment Company Act.

Finally, the relief granted Enron under the Investment Company Act does not conflict with any relief Enron received under PUHCA. First, there is no relationship between the Investment Company Act relief and the no-action relief that Enron received from the staff with respect to its power marketing activities. Second, as I discussed in my testimony, Enron's global business as portrayed in its exemptive application does not conflict with Enron's claim of the intrastate exemption under PUHCA. In administering the intrastate exemption, the Commission has always looked to the place of incorporation of the holding company, the place of incorporation of the holding company's utility subsidiaries, and the states in which those subsidiaries conducted their utility business. As long as the holding company and material utility subsidiaries are all incorporated in the same state and the utility activities are conducted in that state, the holding company is entitled to the intrastate exemption. The Commission has traditionally held that the scope and geographic extent of the holding company's non-utility activities (such as Enron's foreign infrastructure projects) are not to be considered as part of this analysis. In order to aid the Committee's understanding of this issue, I have attached to this response a memorandum prepared by the Division of Investment Management addressing how the Commission has administered the intrastate exemption since the enactment of PUHCA.

MEMORANDUM

To: Commissioner Isaac C. Hunt, Jr.

From: Paul F. Roye, *Director*, Division of Investment Management

Re: The Commission's Historic Approach to the Section 3(a)(1) "Intrastate" Exemption

During your February 6, 2002 testimony before the Senate Committee on Energy and Natural Resources, you were asked a number of questions about the Commission's approach to the "intrastate" exemption provided by section 3(a)(1) of the Public Utility Holding Company Act of 1935 ("PUHCA"). These questions may have been related to the claims of Scott Hempling, another witness, who testified that because Enron was a global company,, it "clearly did not meet the requirements of Section 3(a)(1)." [1] Senator Wyden, in particular, expressed interest in this issue. We have prepared this memorandum to clarify the Commission's historic approach of under which a holding company's non-utility activities are not considered in analyzing whether it qualifies for the intrastate exemption.

Enron has been an exempt holding company since it acquired Portland General Electric in 1997. Immediately following its acquisition of Portland General, Enron was incorporated in Oregon, as was Portland General, Enron's only "public utility" subsidiary. Portland General's utility operations were conducted almost exclusively within Oregon. Although Enron engaged in substantial non-utility activities through other subsidiaries across the United States and internationally, it claimed exemption under PUHCA rule 2 as an intrastate holding company.

Section 3(a)(1) requires the Commission, "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers" to exempt any holding company if:

> Such holding company, and every subsidiary company thereof which is a public-utility company from which such holding company derives, directly or indirectly, any material part of its income, are predominantly intrastate in char-

[1] Written Testimony of Scott Hempling before the Senate Committee on Energy and Natural Resources on "The Public Utility Holding Company Act of 1935 and S. 1766" (Feb. 6, 2002) at 31.

> acter and carry on their business substantially in a single State in which such holding company and every such subsidiary company are organized.[2]

Under longstanding Commission precedent, holding companies exempt under section 3(a)(1) have a virtually unlimited ability to diversify into non-utility activities without any limitation on the geographical scope of those activities. The leading treatise on the regulation of utility holding companies states that "nonutility subsidiaries may be organized anywhere and . . . the holding company may itself engage in nonutility activities anywhere."[3]

This precedent goes back to the earliest days of the Commission's administration of the Act. Some of these early cases address whether a holding company's sale of a manufactured product in interstate commerce puts its exemption at risk. For example, in 1936, the Commission concluded that a company incorporated in South Carolina with a single utility subsidiary incorporated and operating in South Carolina did not lose its entitlement to the exemption because it engaged in interstate sales of textiles it manufactured through another subsidiary.[4] The Commission reached virtually identical conclusions in granting exemptions to the International Pulp Company[5] and the Copper Range Company.[6]

The early cases extend beyond the interstate sales of non-utility subsidiaries incorporated in the same state as the holding company and make clear that a holding company that owns non-utility subsidiaries that are incorporated in and operate in different states than the holding company may also claim an exemption under section 3(a)(1). Most notably, in 1937, the Commission granted an exemption to the Southeastern Indiana Corporation.[7] The company, which was incorporated in Indiana, owned a single public utility subsidiary, which was also incorporated in and operating exclusively in Indiana. The company also owned a number of non-utility subsidiaries incorporated in Indiana and Ohio that variously provided bus and telephone service in Indiana, Ohio and Kentucky. In granting the company's request for an intrastate exemption, the Commission stated that:

> [S]uch non-public utility (as defined in Section 2(a)(5)) activities of the applicant do not deprive it of its intrastate character so far as the public utility aspect of its business is concerned, and that so long as all of its public utility subsidiaries are organized under the laws of Indiana and confine their public utility business to that State, it will be entitled to the exemption provided by Section 3(a)(1).[8]

The *Southeastern Indiana* decision thus made it clear that utility holding companies could engage in non-utility activities through subsidiaries incorporated in any state without losing their intrastate exemption. During the 1940s and 1950s, the Commission granted intrastate exemptions to companies that engaged in substantial nonutility activities in other states. For example, in 1945, the Commission granted an intrastate exemption to a Kansas corporation that owned two public utility subsidiaries that operated in Kansas and non-utility subsidiaries that, among other things, were incorporated in and provided telephone service in Arkansas, Kansas, Indiana, Missouri, New Jersey, Ohio and Pennsylvania.[9] The non-utility subsidiaries represented most of the company's business. The Commission apparently found it clear "that such non-utility activities do not deprive [the applicant] of its intrastate character so far as the public utility aspects of its business are con-

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[2] PUHCA § 3(a)(1), 15 U.S.C. § 79c(a)(1).

[3] Douglas W. Hawes, Utility Holding Companies at 3-12 (1984 and Supp. 1987).

[4] *In the Matter of Monarch Mills*, 1 S.E.C. 822 (1936). The Commission noted that "[t]he only interstate activities of the applicant are in connection with the sale of the textile products of its South Carolina plants. These sales are effected through New York commission merchants." *Id.* at 823. The Commission then rejected the notion that this "should prevent it from obtaining the exemption under Section 3(a)(1) to which it would otherwise be entitled." *Id.*

[5] *In the Matter of International Pulp Co.*, 1 S.E.C. 906 (1936).

[6] *In the Matter of Copper Range Co.*, 2 S.E.C. 61 (1937). In *Copper Range*, the Commission definitively stated that "this Commission has indicated in numerous cases that it does not deem that interstate activities in such non-public utility phases of its business should prevent the applicant from obtaining the exemption under Section 3(a)(1) to which it otherwise would be entitled." *Id.* at 62.

[7] *In the Matter of Southeastern Indiana Corp.*, 2 S.E.C. 156 (1937).

[8] *Id.* at 157.

[9] *See In the Matter of United Utilities, Inc.*, Holding Co. Act Release No. 6045 (Sept. 14, 1945) (order approving the sale of certain utility assets in Colorado that might have caused the company to lose its entitlement to the intrastate exemption) ("Sale Order") and *In the Matter of United Utilities, Inc.*, Holding Co. Act Release No. 6162 (Oct. 25, 1945) (order granting exemption under section 3(a)(1)). The Sale Order makes clear that United Utilities' telephone operations produced over 75% of the holding company's gross revenues.

cerned."[10] Likewise, in 1955, the Commission granted an intrastate exemption to a Massachusetts corporation that owned a single public utility subsidiary in Massachusetts but also owned subsidiaries, some incorporated in other states, that engaged in substantial coal mining operations (including activities related to the transportation and distribution of coal, and the conversion of the coal into gas and other products) throughout the eastern United States.[11] Neither the notice nor the order contain any substantial legal analysis of the claim for exemption, suggesting that both the Commission and the applicant thought granting the exemption to be noncontroversial in spite of the applicant's substantial interstate, non-utility activities.

Given the language of section 3(a)(1), it might well have been within the Commission's discretion to decide these cases in a way other than it did, and confine the non-utility activities of exempt intrastate holding companies to the same state in which the holding company and its utility subsidiaries were incorporated. Indeed, there are a few aberrational decisions in which the Commission relected exemptions that seem to fall within this line of precedent.[12] However, the policy of not looking at the non-utility activities of a holding company when analyzing its claim to the intrastate exemption clearly goes back to the earliest days of the Commission's administration of PUHCA—a time when the individual commissioners who considered and decided these matters likely were familiar with the specific details surrounding the enactment of PUHCA and the goals that Congress was seeking to achieve through the Act.[13] In this context, to argue that the Commission is not just abusing its discretion, but is acting far outside the discretion permitted it, in allowing companies with substantial interstate non-utility activities to claim exemption under section 3(a)(1) fails to take into consideration the fact that the Commission has interpreted the intrastate exemption this way for over 65 years in a manner consistent with the underlying policy goals of PUHCA.

One of the overriding concerns of PUHCA is to give federal regulators jurisdiction over multistate holding companies that no single state can effectively regulate. In particular, PUHCA is meant to ensure that if a state does not have jurisdiction over both the holding company and the utility that does business in its state—a situation that will occur if the holding company is incorporated in a state different than that in which the utility subsidiary is incorporated—a federal regulator with access to all the holding company's books and records can step in to monitor and police affiliate transactions.[14] In general, the Commission has concluded that where the holding company and all its utility subsidiaries are incorporated in the same state, this concern does not arise, and an exemption from PUHCA is warranted.[15]

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[10] Sale Order, *supra* (citing *Southeastern Indiana Corp.*).

[11] *See In the Matter of Eastern Gas & Fuel Associates*, Holding Co. Act Release No. 12786 (Jan. 25, 1955) (notice of application for an exemption under section 3(a)(1)) and Holding Co. Act Release No. 12807 (Feb. 28, 1955) (order granting exemption under section 3(a)(1)). According to the notice, the company owned subsidiaries in Massachusetts, Delaware, Virginia, Connecticut, Pennsylvania, West Virginia, New Jersey and, perhaps surprisingly, a collier incorporated in Liberia.

[12] *See Houston Natural Gas Corp.*, 3 S.E.C. 664 (1938). In *Houston Gas*, the Commission appropriately denied the applicant an exemption under section 3(a)(1) because, although all the applicant holding company's subsidiaries were incorporated in and operated exclusively in Texas, the holding company itself was incorporated in Delaware. *Id.* at 667. However, the decision includes a lengthy discussion in which the Commission opined that because the company sold its securities in numerous states and sent interstate mail and made interstate telephone calls, it was not entitled to the intrastate exemption. *Id.* at 667-68. Literally applied, this analysis would deny the section 3(a)(1) exemption to virtually all companies—it is hard to comprehend how any company could conduct its business, whether today or in 1938, without engaging in some interstate administrative activities. The discussion in *Houston Natural Gas* is therefore better understood either as unpersuasive dicta or as an attempt by the Commission to explain why it mattered, for purposes of the statute, that the holding company and its utility subsidiaries were incorporated in different states.

[13] Commissioners during this period included William O. Douglas, George Matthews, and Robert Healy. James Landis was Chairman of the Commission from September 1935 through September 1937, the period during which the earliest of the cases establishing this precedent under section 3(a)(1) were decided.

[14] "It is plain, therefore, that Congress directed the exemption under Section 3(a)(1) solely to holding companies organized in the same state as its subsidiaries; it purposely withheld that exemption from holding companies which control operating utilities in states other than its domicile . . . in order to assure necessary regulation not otherwise forthcoming." *In the Matter of Houston Natural Gas Corp.*, 3 S.E.C. 664, 667 (1938).

[15] The Commission retains the authority under section 3 and rules 2 and 6 to revoke an otherwise-warranted intrastate exemption if doing so is necessary to protect the public interest or the interests of investors or consumers.

RESPONSE TO QUESTION FROM SENATOR WYDEN

Question. I am requesting all records of communications between Enron Corp. or its subsidiaries or affiliates ("collectively referred to as "Enron") or any representative of Enron and the U.S. Securities and Exchange Commission (SEC) concerning the Public Utility Holding Company Act of 1935 or the Investment Company Act of 1940, including any written, oral, electronic or telephone communication.

Answer. Included with this response are documents responsive to this request. These documents include applications filed by Enron under both acts, other materials supplied by Enron to the Commission and its staff, orders and notices that the Commission has issued with respect to Enron, Enron's no-action requests and the staff's responses, comment letters from SEC staff to counsel for Enron, and correspondence from counsel for Enron to SEC staff. Consistent with our usual practice, we are not including internal memoranda, handwritten notes, and other nonpublic materials that reflect the SEC's deliberations. We also have not included certain routine filings made by Enron related to its claim of exemption under rule 2 and notifying the Commission of the status of certain of its subsidiaries as foreign utility companies or exempt wholesale generators under sections 32 and 33 of PUHCA. As always, we would be pleased to answer any further questions Senator Wyden or other members of the Committee may have with respect to these materials. I also note that Enron requested confidential treatment under the Freedom of Information Act for some of the documents that I am including with my response under separate cover.

RESPONSES TO QUESTIONS FROM SENATOR CANTWELL

Question. PUHCA Sec. 12(h) prohibits certain political and campaign contributions by registered holding companies. Has the SEC reviewed the campaign contributions of registered holding companies and ensured that no improper contributions are being made? If so, please provide me with that information. If not, please explain why the SEC has not adhered to this statutory requirement.

Answer. As you point out, section 12(h) of PUHCA prohibits a registered holding company from "mak[ing] any contribution whatsoever in connection with candidacy, nomination, election or appointment of any person for or to any office or position" in federal or state government. It also prohibits a registered holding company from mak[ing] any contribution to or in support of any political party or any committee or agency thereof."

This provision applies only to registered holding companies. Exempt holding companies such as Enron are not subject to this prohibition.[7] With respect to registered holding companies, the Federal Election Campaign Act clarified section 12(h) to permit the "establishment, administration and solicitation of contributions to a separate segregated fund to be utilized by the corporation for political purposes."[8] Based upon this amendment, many registered holding companies have set up PACs to which their employees contribute so that the corporation can advance its political goals.

Commission staff regularly examine registered holding companies to monitor their overall compliance with the Act. Our examinations are primarily directed at the core abuses that led to passage of the Act, particularly the provisions governing allocation of costs among system companies and affiliate transactions between system companies. While examining for compliance with section 12(h) is not one of our primary areas of focus, no violations of the section have come to our attention in recent years. However, as part of the examination program, we do analyze how the costs of administering PACs are allocated among companies in the holding company system. This tends to ensure that the costs of administering PACs are not unfairly allocated to the holding company's utility subsidiaries. We would obviously take seriously any allegation that a registered holding company is violating section 12(h).

[7] Exempt holding companies, like all corporations, appear to be prohibited by the Federal Election Campaign Act from "mak[ing] a contribution or expenditure in connection with any election at which presidential and vice presidential electors or a Senator or Representative . . . are to be voted for, or in connection with any primary election or political convention or caucus held to select candidates for any of the foregoing offices . . . ." 2 U.S.C. § 441b(a). The SEC, however, does not administer this statute.

[8] 2 U.S.C. § 441 b(b)(2) ("For purposes of this section and section 12(h) of the Public Utility Holding Company Act . . . the term 'contribution or expenditure' . . . shall not include . . . (C) the establishment, administration, and solicitation of contributions to a separate segregated fund to be utilized for political purposes by a corporation, labor organization, membership organization, cooperative, or corporation without capital stock.")

APPENDIX II

Additional Material Submitted for the Record

STATEMENT OF THE AMERICAN FOREST & PAPER ASSOCIATION

The American Forest & Paper Association (AF&PA) appreciates the opportunity to submit testimony for the hearing record related to the repeal of the Public Utility Holding Company Act. AF&PA is the national trade association representing more than 240 member companies and related associations that engage in or represent the manufacturers of pulp, paper, paperboard and wood products. America's forest and paper industry ranges from state-of-the-art paper mills to small, family-owned sawmills and some nine million individual woodlot owners.

The forest products industry is a major energy producer and consumer, producing nearly 60 percent of its own power, largely though the use of biomass. At some paper and wood manufacturing facilities, self-generated electricity goes beyond serving onsite production needs by providing supplemental electricity to the surrounding electric power grid.

We support comprehensive electricity legislation that promotes competition in the energy markets. However, until there is a truly competitive marketplace, we have concerns about the vacuum that may exist if PUHCA is repealed without adequate safeguards put in its place. Therefore, we offer the following suggestions as possible ways to ensure that a competitive market can take hold in the context of efforts such as S. 1766 to promote competition in the electricity marketplace.

PUHCA AND RELATED MARKET POWER ISSUES

PUHCA was originally designed to break up "the unconstrained and excessively large trusts that then controlled the Nation's electric and gas distribution networks." It was intended to be an effective safeguard against market power abuses by utilities and their affiliates that evaded regulatory oversight through complex holding company arrangements.

The current enforcement under PUHCA is not effective. The Securities and Exchange Commission has openly admitted that it has done a poor job at enforcing provisions of PUHCA. But market power issues are still extremely important, particularly in states that have no retail competition. The development of a fully functioning competitive electricity market (wholesale and retail) cannot take place if utilities, whether they be investor-owned, federal, municipal or cooperative, are allowed significant government-sanctioned advantages over their competitors.

PUHCA should not be repealed before the establishment of a fully functioning competitive market (wholesale and retail) for electricity throughout the nation. However, should the Congress decide to proceed with PUHCA repeal legislation, then steps need to be taken to ensure that implementation of such legislation coincides with the effective operation of truly competitive electricity markets. At a bare minimum, the repeal date of PUHCA for a utility should be linked to the date that the FERC certifies that markets served by that utility are open and competitive. The relevant market should be defined as a large area, such as that covered by an RTO.

AF&PA would support the repeal of PUHCA under the following conditions that would apply to both public and private power:

- Legislation is enacted requiring participation in Regional Transmission Organizations (RTOs) by all transmission entities. This legislation must set a firm deadline for RTO participation, give the FERC adequate authority to implement RTOs, and be effective only upon the full and efficient functioning of the RTOs.
- Markets administered by RTOs are fully functional and workably competitive.
- Legislation is enacted that (i) requires FERC to act on a complaint regarding the abuse of market power within 90 days of the filing of the complaint, (ii) failing timely action by FERC, allows the complainant to seek redress from the

Federal Trade Commission, and (iii) allows such complaints to be initiated by consumers and other market participants.

- Legislation is enacted that provides explicit criteria (e.g., market concentration, scale, etc.) for the merger or acquisition of regulated entities, and requires clear and significant economic benefits to ratepayers as a condition of approval.
- Legislation is enacted that (1) provides access to the books and records of holding companies by state commissions and (ii) limits the pass-through to captive retail ratepayers by regulated utilities of costs incurred by their marketing affiliates only to those costs that serve the ratepayers and that are either cost-based or shown to be competitive in a fully functioning competitive market.
- Absent a nationwide, fully functioning competitive retail electricity market, implementation of PUHCA repeal only upon certification by the FERC that the markets served by the utility are fully functioning and competitive.

We appreciate the opportunity to submit these suggestions related to PUHCA repeal and look forward to working with the Committee and the full Senate as this issue moves through the legislative process.

Statement of the Executive Intelligence Review

ENRON: THE CONVERGENCE OF ENERGY AND FINANCIAL DEREGULATION, AND THE END OF THE OFF-BALANCE-SHEET ERA

With every day that passes, it becomes more obvious that Enron was a thoroughly corrupt corporation, which cooked its books through a variety of schemes, including the use of special purpose entities and off-balance-sheet partnerships. As a result of these machinations, Enron presented a completely false face to the public—it was a financial scam, masquerading as an energy company.

At this point, few would argue that Enron was out of control, operating well outside the bounds of ethics and apparently outside the law, and few would argue that those officers and directors of Enron, as well as its accountants and lawyers, should be held accountable for their actions, or the lack thereof.

There is another group which should be held accountable, and that group includes the policymakers who have systematically stripped away the body of protections which had been written into State and Federal laws and regulations, in order to keep the Enrons of the world in check.

Lyndon LaRouche, the founding editor of EIR News Service, has both through this news service and through his role as a pre-candidate for the 2004 Presidential election, led the mobilization against energy deregulation, focusing the attention of California, the nation and the international community on the destructive nature of deregulation, and the key role Enron has played in that process. LaRouche has also led the fight against the out-of-control speculation in the derivatives markets, where Enron also played.

The Enron debacle now gives Congress, and this Committee, the opportunity to re-visit the nation's approach to deregulation, to confront and correct the errors which are destroying out nation's economy. It is an opportunity which should not be wasted.

Beyond the Culture of Corruption

The "culture of corruption" which thrived at Enron is nothing new; history is replete with similar examples of untrammeled greed, and of the need to protect populations from that greed. The strength of our nation is based in part on the creativity of our people, and for that creativity to flourish, the public must be protected from exploitation. Creativity is the rising tide which lifts all boats, but those boats must also be protected from pirates.

In its investigation of the Enron affair, the Congress must look not just at the company, but at the environment in which the company operated. In this case, that means looking at how deregulation created the conditions under which Enron's activities became possible.

One of the founding principles of the United States, is that the Government has not just the right, but the duty, to advance and protect the General Welfare of the People. In the wake of the Great Depression, a number of laws were passed to protect the People from abuses; prominent among them the Glass-Steagall Act, which was designed to prevent financial insiders from profiting at the expense of the general public, and the Public Utilities Holding Company Act, which was designed to protect the People from the machinations of the giant Morgan and Insull electricity cartels, whose holding company structures were in many respects the equivalents of today's off-balance-sheet structures. Congress passed these laws because events proved them necessary—they were necessary then, and they are necessary today.

Over the years, most of the protections implemented during the Roosevelt era have been stripped away. Glass-Steagall was gutted, then repealed, and an already weakened PUHCA is facing a similar fate unless wiser minds prevail. The combination of energy deregulation and the surge in mergers among regulated utility holding companies has created an environment in which the electricity market is increasingly coming to resemble the casino mondiale financial markets.

Enron, in many respects, reflects the deadly convergence of financial and energy deregulation. In its S.E.C. filings, Enron described itself as an investment bank, and testimony before this Congress has detailed the extent to which Enron was a derivatives trading firm rather than an energy company. What Enron was doing was applying to the deregulated energy markets, the same kinds of speculative derivatives trading that the big investment and commercial banks—a distinction which is fast disappearing—have long applied to the deregulated financial markets.

In its off-balance-sheet activities, Enron was following a trend which began in the banking world. Until recently, every issue of the Federal Deposit Insurance Corporation's Quarterly Banking Profile contained a line item for "off-balance-sheet derivatives," The F.D.I.C. has discretely dropped the "off-balance-sheet" portion of the designation, but the derivatives remain, $51.7 trillion of them, backed by $6.6 trillion in assets and $586 billion in equity capital. A loss equivalent to just 1.1% of the total derivatives portfolio would be sufficient to wipe out the entire equity capital of the U.S. banking system.

The most egregious example of derivatives speculation is J.P. Morgan Chase & Co., which by itself has a $24 trillion derivatives portfolio, roughly half of the total derivatives held by all U.S. bank holding companies. That figure is as of the third quarter, at which point Morgan Chase reported assets of $799 billion and equity capital of $42.7 billion. meaning that a loss equivalent to less than 0.2% of is derivatives portfolio would wipe out its equity base. At Citigroup and Bank of America, which between them have another $18 trillion in derivatives, it would take only 0.5%.

These aren't banks any more than Enron was an energy company. Enron's reported $200 billion derivatives portfolio pales by comparison to the holdings of the big banks, but Enron was just getting started. The big banks were already involved in energy trading, and with Enron's demise have strengthened their position in the market.

The extraordinary danger presented by such derivatives speculation is clear in the Enron case, where derivatives were used to hide the company's condition, but again, this is just a case of Enron following the example of its banking peers, as investigations by the Japanese Government have brought to light numerous examples where Wall Street firms employed derivatives to help Japanese companies hide losses. Derivatives were also at the root of the 1998 failure of Long-Term Capital Management, and the wave of derivatives losses which swept the country in the early 1990s. The shocking $105 billion drop in assets at Morgan Chase during the fourth quarter suggests that the derivatives losses have not gone away, but are just better hidden in a complex of off-balance-sheet structures of the type we see in the Enron case.

Had Congress and the States not dismantled the nations regulatory protections, there would be no need for these hearings. This hearing provides the Senate with the opportunity to return to a policy of sound regulation in the public interest. PUHCA must be strengthened, not weakened, as the first step in rolling back deregulation. Congress must choose between servicing the casino at the expense of the population, and protecting the General Welfare by rebuilding the protections which have been stripped away.

The Energy Committee, in particular, has the responsibility of "picking up the pieces" from the "Enronomics" era so that the nation may begin to reverse the damage done by deregulation. As LaRouche outlines in his forthcoming special report "*At the End of a Delusion*," we can build our way out of this deepening global depression, if we chose to do so, but it requires the courage to admit that we must abandon the policies which have created this disaster.

LaRouche outlined the measures which are required in the energy realm in an international Webcast on Jan. 24, 2002, in an exchange with State Sen. Joe Neal (D-Las Vegas), a senior Nevada lawmaker, who successfully led the fight against deregulation, and against Enron, in his state, and also in other states and in Mexico.

In response to Neal's question about the reasons for the collapse of Enron and what it means for the country, LaRouche responded:

I would go backwards, and go from the end-result of the crash of Enron, rather than trying to, say, re-write the history of what Enron's history should have been.

First of all, we face a major energy crisis in the United States. The severity of this crisis is hidden by the fact of the collapse of our industries. If we were to rev up the economy overnight, we couldn't support it.

People don't realize that we have been exporting our industries, in shutting down whole sections of the functions of our economy, we have lowered the requirement of energy! If we were to try to restore the economy, to what it was at, say, 1980 or earlier, we would have to have a large amount of new energy.

So, therefore, we have the need for a national energy recovery program, which would cover, inclusively, the problems which are illustrated by and posed by Enron, and similar institutions. That means that we have to repeal deregulation; go back to the system of regulation, we used to have: I think we'd just go back to that; that's adequate, because it would work: There're are precedents; the machinery is all understood—it would work; just do it.

But, set, also, into motion—See President Bush is trying to find out ways of stimulating the economy, and he doesn't know how to do it. Well, this is one of the ways of doing it. If you take Federal money, and use it, not just as Federal printed money, but Federal credit; and you put it into a national energy program, which is going to fix the national energy grid system, to make it more usable and to improve its performance: That, in itself, is a good way to make the economy grow. And, it's typical of the various measures, which government can take, which are largely in the area of infrastructure and special projects; not in the private sector, as such, but in those areas alone, which will cause the economy to grow.

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