TESTIMONY OF COMMISSIONER ISAAC C. HUNT, JR.

U.S. SECURITIES AND EXCHANGE COMMISSION

BEFORE THE COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
AND THE CURRENT ENERGY SITUATION IN CALIFORNIA
JUNE 20, 2001

Chairman Oxley, Ranking Member LaFalce, 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") about both the current energy problems being experienced in California and the Public Utility Holding Company Act of 1935 ("PUHCA"). As outlined below, because neither of the major California utilities is registered under the Act and because the Act is not an impediment to the construction of new generation facilities, the SEC's administration of PUHCA has not had any direct impact on the California situation. Nonetheless, because much of the regulation required by PUHCA is either duplicative of that done by other regulators or unnecessary in the current environment, the SEC continues to support repeal of PUHCA. As the SEC has testified in the past, however, we continue to believe that repeal should be accomplished in a manner that eliminates duplicative regulation while also preserving important protections for consumers of utility companies in multistate holding company systems. Short of repeal, the SEC believes that amending PUHCA to provide the agency with general exemptive authority would help ensure that the goals of PUHCA can be achieved while at the same time allowing the SEC to act in situations in which PUHCA may be an impediment to appropriate development of gas and electric markets.

I. INTRODUCTION

Before discussing the current problems in California and the SEC's position on repeal or amendment of PUHCA, it is useful to review both the history that led Congress to enact PUHCA in 1935 and the changes that have occurred in the electric industry since then. During the first quarter of the last century, misuse of the holding company structure led to serious problems in the electric and gas industry. These abuses included 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.[1] The Act also placed restrictions on the geographic scope of holding company systems and limited 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.

By the early 1980s, however, many aspects of the 1935 Act regulation had become redundant: 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. Changes in the accounting profession and the investment banking industry also had provided investors and consumers with a range of protections unforeseen in 1935. The SEC therefore concluded that the 1935 Act had accomplished its basic purpose and that many of its remaining provisions were either duplicative or

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

were no longer necessary to prevent 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 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 continuing changes in the utility industry during the early 1990s, and the accelerated pace of those changes, 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]

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[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, of which there were, at the time of the study, 19. 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 December 31, 2000, the 26 registered holding companies owned 214 electric and gas utility subsidiaries, with operations in 44 states, and in excess of 1500 nonutility subsidiaries. In financial terms, as of December 31, 2000, the 30 registered holding companies owned more than $404 billion of investor-owned electric and gas utility assets and received in excess of $160 billion in operating revenues. The 26 registered systems represent over 40% of the assets and revenues of

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. Some of these changes have been facilitated by Congress. Specifically, as a result of recently-created statutory exemptions, anyone, 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 telecommunication activities.[4] In addition, the SEC has implemented many of the administrative initiatives that were recommended in the Report.[5]

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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

II. PUHCA AND THE ENERGY SITUATION IN CALIFORNIA

The electricity shortages, price increases and rolling blackouts in California represent one of the most severe problems in the electric industry today. Specifically, in California, acute supply shortages, opposition and legal impediments to new power plant construction, and high natural gas prices have driven wholesale electricity prices to extraordinary levels. The two largest California utilities have been limited in their ability to pass wholesale price increases through to consumers and, as a result, are experiencing severe liquidity problems. One of the utilities has declared bankruptcy; the other has stated publicly that it may do so.

Neither PUHCA nor the Commission's administration of the Act has had any direct impact on the situation in California. First, although we have monitored the situation in California, the major public utilities in California are predominantly intrastate, and therefore are not registered under the Act. The Commission therefore does not directly regulate under PUHCA the two companies that have experienced the most severe financial problems.

Second, and perhaps more importantly, although a shortage of supply is undoubtedly a significant factor in the problems being experienced in California, PUHCA has not impeded the construction of new generation facilities in California or elsewhere in the United States. Prior to the passage of the Energy Policy Act of 1992, a company owning generation facilities would have been a public utility subject to PUHCA and thus its holding company would have been subject to the limitations imposed by the Act on the company's geographic scope and its other businesses. The Energy Policy Act

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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.

facilitated the entry of new companies, and hence new sources of capital, into the generating business by permitting any person (including registered holding companies) to acquire "exempt wholesale generators" ("EWGs"). Congress gave the Federal Energy Regulatory Commission ("FERC") responsibility to determine whether an entity may be classified as an EWG under the statute. A wholesale generator applies to the FERC to obtain EWG status.

An EWG is not considered an electric utility company under PUHCA, and, in fact, is exempt from all provisions of PUHCA. The only limitation that remains under PUHCA is one imposed by Congress on registered holding companies – 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."[6] In short, the Energy Policy 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.[7]

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6 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 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).

7 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").

III. REPEAL OR AMENDMENT OF PUHCA

1. Repeal of PUHCA

Although PUHCA has not played a significant role in the energy problems experienced in California, based on the findings in the Report as well as the continuing pace of change in the utility industry, the SEC continues to recommend that Congress repeal the 1935 Act subject to appropriate safeguards.[8] As the Report stated, regulation under the 1935 Act that affects the ability of holding company systems to issue securities, acquire other utilities, and acquire nonutility businesses is largely redundant in view of other existing regulation and controls imposed by the market. Repealing the Act is not, however, a magic solution to the current problems facing the U.S. utility industry. While 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[9] -- repeal of the Act will not directly affect the supply of electricity in the United States. Indeed, as discussed above, in 1992, as part of the Energy Policy Act, Congress amended the Act to remove most

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[8] As we have testified previously, however, there is a continuing need to protect consumers. 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. 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. In view of the sophistication of contemporary securities regulation, and analysis by the public and private sectors, the best means of guarding against cross-subsidization is likely to be audits of books and records and federal oversight of affiliate transactions. The SEC therefore continues to recommend the enactment of legislation to provide necessary authority to the FERC and the state public utility commissions relating to affiliate transactions, audits and access to books and records, for the continued protection of utility consumers. More broadly, repeal of the 1935 Act may be accomplished either separately or as part of a more comprehensive package of energy reform legislation. The SEC does not have a preference as to whether the Act is repealed on a stand-alone basis or as part of broader, energy-related legislation.

[9] 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").

restrictions on the ability of registered and exempt holding companies as well as nonutility companies to build, acquire and own generating facilities anywhere in the United States. Repeal of the Act would instead remove provisions 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.

2. Exemptive Authority as an Alternative to Repeal

If Congress does not repeal PUHCA, the SEC believes that the Act should be amended to give us more flexibility in its administration. In particular, in both the Report and in prior testimony, the SEC has suggested that if Congress chooses not to repeal the Act, it could grant the agency broad exemptive authority similar to that we currently have under the other Acts that we administer.[10] Although an expansion of the SEC's exemptive authority under the Act would not achieve the economic benefits of simplifying the federal regulatory structure and would continue to enmesh the SEC in difficult issues of energy policy, it would provide the SEC with a greater ability to respond quickly and appropriately to changes in the industry and the regulatory environment.

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[10] The SEC's current exemptive authority under the 1935 Act is considerably narrower than the exemptive authority under other securities laws. A model of broader exemptive authority is contained in section 6(c) of the Investment Company Act of 1940, 15 U.S.C. § 80a-6(c), which grants the SEC the authority by rule or order to exempt any person or transaction from any provision or rule if the exemption is necessary or appropriate in the public interest and consistent with the protection of investors. See also section 206A of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6a, and section 36 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78mm. Section 28 of the Securities Act of 1933, 15 U.S.C. § 77z-3, grants the Commission similar exemptive authority, but permits it to exercise it only by rule.

The flexibility afforded by broad exemptive authority would have numerous uses. For example, in recent months, questions have arisen about how the Act will impact the FERC's ability to implement its plans to restructure the control of transmission facilities in the United States.[11] 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."[12] 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.

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. Nonetheless, repeal of the Act would effectively resolve these issues. In the absence of repeal, however, amending the Act to give the SEC broad exemptive authority would permit the SEC more efficiently to deal with regulatory conflicts, unexpected industry problems, and other issues of this type.

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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 or amendment of the

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

[12] Order 2000, 65 FR at 811.

1935 Act, the SEC hopes to reduce unnecessary regulatory burdens on America's energy industry while providing adequate protections for energy consumers.