

HARVARD ELECTRICITY POLICY GROUP

SPECIAL SESSION

**THE FUTURE OF
THE PUBLIC UTILITY HOLDING COMPANY ACT
OF 1935**

**FROM THE VANTAGE POINT OF
THE REGISTERED HOLDING COMPANIES**

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My position on the future of the Public Utility Holding Company Act of 1935 ("PUHCA" or "Holding Company Act") has been consistent and clear. PUHCA should be repealed. This position reflects working on a daily basis with registered holding companies and PUHCA over a number of years. It is also the position developed by the counsel group representing the registered holding companies of which I have the privilege of being Chairman.

I was asked to testify last July during the Roundtable on the Holding Company Act sponsored by the Securities and Exchange Commission ("SEC"). The Roundtable led to the SEC's Concept Release on PUHCA which is currently under debate. Now almost 6 months later I feel very much the same way I did then. Simply stated, the Holding Company Act stands in the way of restructuring the electric utility industry and ought to be repealed or drastically reformed.

HOW do I reach this position? (1) increased regulatory oversight under other Federal and state securities and regulatory laws, (2) the efficient securities markets, (3) drastic changes in the utility business over the last 60 years, and (4) advances in technology all have rendered PUHCA anachronistic. This would be enough, in and of itself, to take a hard look at PUHCA. However, in addition to being archaic, PUHCA has caused unacceptable conflict. Recent events have highlighted the fact that the Federal Power Act and PUHCA often subject holding company systems, particularly registered systems, to duplicative, and potentially conflicting, federal regulation. Duplication has led to inefficiency and regulatory uncertainty. The goals of PUHCA reform should be to eliminate

unnecessary, duplicative regulation and to provide for a flexible regulatory framework to meet the changing utility business. Repeal, if not drastic revision, is required.

(1) Duplicative and Potentially Inconsistent Regulation - At the time of enactment of PUHCA in 1935, the Federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934, were in their infancy. The securities markets did not have access to current and accurate information for investors. The Federal Power Commission did not have jurisdiction over the nation's transmission facilities under the Federal Power Act or over public utility security issues, wholesale electric rates, electric utility mergers or utility accounting. Very few states had jurisdiction over, or resources to review, public utility security issues, affiliate transactions, or changes in control of utility companies. There was a basic exemption from the Federal antitrust laws for electric and gas utility companies.

I won't review the changes in all of these areas over the last 60 years producing efficient and knowledgeable securities markets for investors and regulatory protections at the wholesale and retail rate levels for consumers. They're well documented, including in the SEC's own position paper, in the 1980s, supporting repeal, and are, presumably, well known. However, I will highlight, by

example in the context of utility mergers and acquisitions, how duplicative, and potentially inconsistent, regulation has developed in recent years.

(a) Utility Merger and Acquisition Example - PUHCA gave the SEC primary jurisdiction over many electric company and gas distribution company mergers and acquisitions. Under Section 318 of the Federal Power Act the Federal Energy Regulatory Commission ("FERC") was ousted from jurisdiction if the SEC had jurisdiction under PUHCA. Congress in 1935 also assumed that, in the absence of state change in utility control statutes, a Federal agency should review utility mergers and acquisitions. By way of example, as late as 1971, when Middle South Utilities, Inc., a registered holding company, acquired Arkansas-Missouri Power Company, only the SEC and the Public Service Commission of Missouri approved the transaction. Regulation has now changed. When Entergy Corporation ("Entergy"), the successor to Middle South Utilities, Inc., in 1993, acquired Gulf States Utilities Company ("GSU"), various state commissions, the FERC and the SEC approved the merger. The states and the FERC imposed conditions on the merger. The SEC did not.

What happened to Section 318 of the Federal Power Act at the Federal level? In the late 1980s the FERC started taking the position that both the acquiror and the acquired needed to be part of a registered holding company

system before Section 318 removed FERC's jurisdiction. Since GSU was not part of such a registered system, GSU needed FERC approval to merge with the Entergy System. As a result both the FERC and the SEC issued orders. Is it necessary to have all these approvals for a utility merger? The time for such extra Federal review may, and usually does, extend the time for consummation of the merger, potentially to the detriment of investors and consumers and the ability of the combined operations to achieve early economies.

In the case of the GSU merger it's even more convoluted. The SEC in its merger orders has recently deferred to the FERC on operational issues. The SEC did just that in the GSU merger. Unfortunately, part of Entergy's open access transmission tariff, as approved by the FERC and included by reference in the FERC's GSU-Entergy merger order, was overturned by the Federal circuit courts. As a result, the SEC's GSU merger order, itself on appeal to the Federal circuit courts, has now been remanded back to the SEC pending developments at the FERC on the transmission tariff. Does all of this make sense? It is certainly not an efficient method of regulation and clearly is duplicative.

There is another aspect of this issue which also highlights the change in regulation.

The Holding Company Act resulted in 1935 from a report of the Federal Trade Commission ("FTC"). The FTC was, and continues to be, responsible primarily for restraints on trade and anti-competitive issues. Let me refer again to the exemption in 1935 for public utilities from the antitrust laws. The Holding Company Act was designed, in part, to fill this perceived regulatory gap. However, starting in the mid 1960s the courts eroded the public utility antitrust exemption. Now the FERC, the Department of Justice and the FTC all play a role in utility mergers in considering anti-competitive consequences. They played such a role in the Entergy-GSU merger. Does the SEC also need to administer the antitrust laws?

I believe the Entergy-GSU merger is a good example of the type of change in regulation which has rendered PUHCA unnecessary. Furthermore, the time and expense of an extra Federal regulatory proceeding, I believe, is unjustifiable under any cost/benefit analysis. PUHCA may even be obstructive. Please consider that, as I noted before, the state commissions and the FERC all imposed conditions on the Entergy-GSU merger. If one assumes the investors are protected by the efficient securities markets, what more can, or should, the SEC do to protect consumers? After all the SEC is the overseer primarily for investors and not consumers. If the SEC imposes its own conditions after the state

commissions and the FERC have crafted theirs, the likelihood for conflict among commission orders exists. This is not necessary or desirable.

My hypothesis in the previous paragraph over potential conflicts is not illusory. It is the concern caused by the Ohio Power Company case, among other decisions. If the SEC reaches one conclusion, that conclusion may trump the actions of other regulatory agencies over the same subject matter, including in rate-making. The SEC has never believed it was a rate-making body. Nor should it be.

(b) The case for repeal is compelling in my view. If one analyzes PUHCA section by section and considers other regulation, including antitrust laws, and the possible preemptive effect of SEC determinations on other regulatory bodies, the conclusion is that PUHCA is duplicative, costly (without countervailing benefit), and potentially obstructive. Given the extensive scope of PUHCA's regulation over the day to day business of registered holding companies, the issues of cost, duplication and potential obstruction are magnified many times over. These are grounds, in and of themselves, for repeal or drastic reform. However, there are other issues as well.

(2) A Changing Utility Business and Advances in Technology - Can one appropriately apply a 60 year old piece of legislation to a different utility

business? PUHCA was not designed to be flexible. PUHCA mandates a single geographically and operationally integrated structure, not well adapted to the system which is evolving as a result of Congressional and federal and state regulatory initiatives. PUHCA isolated electric and gas systems to small, discrete geographic areas. The requirement under PUHCA that registered holding companies maintain a single, integrated utility business has quickly become problematic. It will become acute if electric utilities are compelled, by regulatory or competitive forces, to "unbundle" utility functions and assets in an effort to restructure their businesses along product lines. Should PUHCA be the vehicle to control this "unbundling"? Is PUHCA necessary in this context? I believe the answer is no in both cases. Recent experience provides guidance. Already the "unbundling" has begun as a result of the Public Utility Regulatory Policies Act of 1978 ("PURPA") and the Energy Policy Act of 1992 ("Policy Act"). This "unbundling" has produced significant new players with geographically wide-spread utility properties. Since the new players under PURPA and the Policy Act are exempt from PUHCA, how can PUHCA's geographic integration requirements be significant and necessary to this changing industry?

Moreover, PUHCA was adopted in a world without computers, without reliable transmission systems, without regional power pools, without

reliable long-distance communication. Technology was one reason for PUHCA's geographic limits. Obviously, technology has passed PUHCA by.

What about other new players? The provisions of PUHCA are simply not crafted, in a changing utility business, to deal with other significant new entrants, such as power brokers or marketers. There will be others. What structure there is today will continue to evolve over a period of years with changing players and markets. In this environment any single structure, particularly of PUHCA's mandated type, will become quickly outmoded.

Let me give you a couple of other examples. Look at what the FERC is considering for GENCOs and TRANSCO, i.e., regional generating companies and regional transmission companies. Under PUHCA if a company owns 10% or more of the voting securities of one of these regional companies, it may be a holding company under PUHCA. But there may be no PUHCA exemption. On the one hand, FERC is considering regional GENCOs and TRANSCO. On the other hand, PUHCA may not let this occur. PUHCA should not be an impediment to evolving structural developments, whatever they may ultimately, and appropriately, be.

One final point should be made on PUHCA's integration requirements. Some would argue that PUHCA cannot be repealed in the absence of retail wheeling. PUHCA, as noted above, does not deal with utility operational issues.

PUHCA is only corporate and financial. Retail wheeling, if it is appropriate, can occur whether or not PUHCA exists. It is an independent and separate issue.

(3) PUHCA and Diversification - Jurisdiction over diversification is cited as one of the prime reasons for the need to have PUHCA survive. Is this a real or imaginary need? As I understand the arguments there is concern that in the absence of PUHCA, state commissions and the FERC will be unable to deal with the financial effects of unsuccessful diversification and cross-subsidization on consumers in multiple states served by the same holding company system. Let me address these issues.

(a) Unsuccessful diversification - To my knowledge, no electric or gas utility company which is part of a holding company system has suffered material financial harm as a result of diversification. The test I have used is whether, in its worse case, bankruptcy has resulted or whether the security ratings of the utility company have been downgraded due to unsuccessful diversification. The answer in both cases I believe is no. One utility system even wrote off nearly \$2 billion in unsuccessful diversified activities without bankruptcy or security ratings effect.

Where have the bankruptcies and downgradings occurred, or almost occurred? We all should be aware that the answer is as a result of the utility

business. Please consider Public Service of New Hampshire, El Paso Electric, Columbia Gas and EUA Power Corporation. Also please consider the financial difficulties of General Public Utilities Corporation as a result of Three Mile Island and Entergy Corporation as a result of Grand Gulf. In each case it's the utility business which has caused the financial set-back. Does PUHCA make a difference? The answer is no. Four of the six companies just named are part of registered holding company systems. Even for the registered holding companies, PUHCA does not save the companies from bankruptcy or financial distress.

Finally, most state utility commissions and the FERC have the ability in rate-making to take into effect any adverse effects of unsuccessful diversification. For instance, if, as is highly unlikely, a utility company's security ratings are downgraded as a result of failed affiliate company diversification, the rate commissions, at both the Federal and state level, generally have the authority, in rate-making, to adjust a utility's cost of capital or capital structure to remove perceived diversification effects.

(b) Cross-Subsidization - This is an interesting point. First, PUHCA basically has no jurisdiction over affiliate transactions and utility systems which are not part of registered holding companies. Obviously, repeal of PUHCA has no impact here. For the registered holding companies the SEC has traditionally

required that affiliate transactions involving goods or services be carried out "at cost". Now the SEC is questioning in its pending NOPR whether the standard should be the lower of cost or market. Cross-subsidization is in the eye of the beholder. If a utility in State A sells goods at the lower of cost or market to an affiliate utility in State B and actual market price is lower than cost, State A will argue cross-subsidization. State B would be pleased. Likewise under this new proposed SEC standard if a non-utility company purchases goods from an affiliated utility company all jurisdictions having rate authority over the utility company will argue cross-subsidization if market is lower than cost. These states would argue the same even under the current SEC cost standard if market were higher than cost. It's hard for me to understand how PUHCA protects against cross-subsidization under these circumstances. Again, in rate-making the regulatory bodies have, and do, exercise the authority to adjust rates based on perceived cross-subsidization. Ironically, under the Ohio Power Company case and preemption, they may lose this authority if the SEC approves the affiliate transaction. Using my examples, the SEC may approve, under PUHCA, an affiliate transaction which arguably involves cross-subsidization from the rate-maker's perspective. However, the rate regulators may be unable to adjust rates due to the potential preemptive effect of the SEC's determination. Therefore, PUHCA may be

an impediment, and not a benefit to, the ability of rate regulators to deal with cross-subsidization issues.

Let me make one final point about diversification and the utility business. There is clearly an analogy between multi-state electric utility systems and the regional bell telephone companies ("RBOCs"). Most of the RBOCs operate a utility business in multiple states with affiliates in closely related non-utility businesses. The parent companies are non-utility holding companies. The state commissions and the Federal Communications Commission ("FCC") have been able to deal with extremely complicated cross-subsidization and cost allocation issues for these companies. Please consider the multiple intrastate, interstate and non-utility uses of telephone lines. Please consider the sale of telephones by utility and non-utility affiliates using common administrative and technical support personnel. The state commissions and the FCC also have had to deal with RBOC diversification. This includes the sale of information services and the cellular telephone business, among others. These businesses are closely related to the telephone business with all the perceived attendant potential for cross-subsidization. In that sense, they are similar to the energy management and efficiency businesses of the electric and gas utility companies. Please consider, in similar fashion to the ownership of foreign electric and gas facilities by domestic

electric and gas utility companies, the ownership by the RBOCs of foreign telephone companies. Telephone utility personnel are transferred to run these foreign operations without detriment to the domestic telephone consumer. The parallels between these regulated industries are striking. In the RBOCs we have current examples of multi-state utility systems operating closely related non-utility businesses without apparent significant Federal or state regulatory gaps; and there is no PUHCA.

How do the state commissions and the FCC deal with these issues for the RBOCs? Traditional rate-making and audit authority is used.

For all of the above reasons, I restate my position that repeal or drastic reform of PUHCA is warranted and necessary in a changing utility world. The perceived gaps in regulation in the absence of PUHCA, in my view, are illusory.