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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Request for Comments on Modernization of the Regulation of Public Utility Holding Companies	)	Docket No. S7-3294

COMMENTS OF CENTRAL AND SOUTH WEST CORPORATION

Central and South West Corporation ("CSW") submits these comments and other evidence in response to the Commission's concept release and request for comments, dated November 2, 1994 ("Notice").

INTRODUCTION AND SUMMARY

CSW applauds the Commission's announcement (Notice at 2) that it intends to undertake a "thorough evaluation" of the Public Utility Holding Company Act of 1935 ("PUHCA" or "the Act"). As the Commission recognizes, the intervening sixty years have seen "fundamental changes in the industry, as well as significant legal and regulatory developments" which, at the very least, call into question PUHCA's continued propriety. Id. In fact, the industry has changed so much in the last sixty years that PUHCA has become not only outmoded, but counterproductive. Moreover, the pace of change in the industry has been accelerating in recent years, making PUHCA's "myriad requirements" (Notice at 7) all the more obsolete.

In light of these and other changes described below, the appropriate outcome of this proceeding is a recommendation to Congress that PUHCA be repealed outright. Such a proposal would not be extreme or even unprecedented: the Commission unanimously recommended repeal in 1982.

PUHCA should be repealed for three overarching reasons. First, many of PUHCA's specific restrictions have become counterproductive and inappropriate to today's vastly different utility industry. In recent years, competition has developed in many parts of the industry, especially at the wholesale level. Competition will only continue to grow and, indeed, to spread to the retail level. Competition requires ever more efficiency in the production and distribution of energy. Yet PUHCA's restrictions on utility mergers, diversification into related non-utility markets, and the burdensome procedures for pre-approval of financings and inter-affiliate transactions all work to hinder the ability of registered companies to adapt to this new competitive environment and to deploy their utility assets in the most efficient manner.

Indeed, these features of the current PUHCA regime have enormous adverse, concrete effects on the customers, potential customers, and investors of registered companies. As currently interpreted by the Commission, PUHCA effectively prevents registered companies from meaningful participation in other businesses -- including telecommunications and cable television -- that would be natural extensions of their existing electricity businesses. The current PUHCA regime therefore deprives

consumers of the benefits of increased competition, and deprives shareholders of the additional revenues that registered companies could earn in those markets. PUHCA regulations also deny consumers and investors the benefits of substantial economies that could be achieved if registered holding companies had the same flexibility as their non-registered counterparts to acquire utilities located in other regions and utilities operating other utility businesses. Those regulations likewise deny consumers and investors the benefits of more efficient financing opportunities, and of efficient intrasystem transactions. All told, the social costs of PUHCA -- including primarily these foregone economic benefits -- amount to approximately $__ to $__ billion annually. <u>See</u> Cost Study, attached as Exhibit ___.

Second, PUHCA is no longer necessary to achieve its original purposes. In the sixty years since PUHCA was enacted, state and federal regulation of utility holding companies pursuant to other statutes has matured to the point where PUHCA has simply become duplicative of those efforts. For example, as the Commission correctly notes, "[t]he need for adequate disclosure for investors has largely been addressed by developments in the federal securities laws and in the securities markets themselves." <u>Notice</u> at 18. And, as the Commission elsewhere observes, "there has been a significant increase in the reach of state utility regulation." <u>Id.</u> at 19. Today the FERC, the state commissions, and the Commission itself under other securities laws exercise ample oversight over the holding companies' activities.

Third, PUHCA is all the more inequitable because it applies only to a small, almost random, subset of the industry. Today, there are only fourteen registered holding companies, representing only about twenty percent of the industry, that are fully subject to PUHCA's many restrictions and prohibitions. Their non-registered and exempt rivals, however, are largely free to engage in the beneficial, efficiency-enhancing activities that PUHCA denies to the registered companies, such as diversification into other utility and non-utility markets. The registered companies' inability to engage in these activities stems not from any sound economic or policy reason, but solely from the historical accident of being an interstate holding company, rather than an intrastate one.

PUHCA's obsolescence has been exacerbated by the Commission's unnecessarily harsh administration of the Act. At several important turns, the Commission has taken an overly restrictive interpretation of the Act, which has had the effect of preventing a wide range of activities that PUHCA itself would permit.

Accordingly, until PUHCA is repealed, the Commission should exercise its discretion under the Act to allow the registered companies greater freedom to respond to the challenges presented in this changing industry. As demonstrated in the

accompanying legal memorandum,[1] the Commission has the authority to take the following concrete steps:

- Allow greater diversification into non-utility businesses by

  (1) adopting a broad "economically appropriate" test in lieu of the current "functional relationship" test; and

  (2) abolishing the so-called "50 percent rule" altogether;

- Allow greater expansion into other utility businesses by

  (1) treating two utilities as part of a single integrated system, for purposes of the geographic restrictions in Section 11(b)(1), even when they are not contiguous or directly connected to each other; and

  (2) allowing registered companies to acquire additional integrated systems (including both gas and electric systems), whether or not they are geographically contiguous to the primary system, and without showing that the acquisition is necessary to avoid "serious impairment" of the additional system;

- Eliminate the regulation of financings by holding company subsidiaries, and scale back the regulation of financings by holding companies themselves; and

- Eliminate or scale back regulation of inter-affiliate transactions.

Each of these changes would greatly reduce the economic inefficiencies created by PUHCA, and would do so without harming consumers or investors. Therefore, regardless of the legislative proposal the Commission ultimately makes, CSW strongly urges the Commission to take this opportunity to promulgate a series of rules implementing each of these changes. Suggested regulatory language appears at Exhibit ___.

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[1] An earlier version of this memorandum as well as statements by Professor Eugene F. Brigham ("Brigham Statement") and Professors William J. Baumol and Robert D. Willig ("Baumol-Willig Statement") were previously submitted as attachments to CSW's Post-Round Table Comments. These attachments are reproduced here for the Commission's convenience.

In the remainder of these comments, CSW addresses in more detail each of the four major areas in which PUHCA reform is most urgently needed, and on which the Commission has specifically requested comment: (1) diversification into non-utility businesses; (2) entry into other utility businesses; (3) financings; and (4) inter-affiliate transactions.[2] For each of these areas, the comments explain why the existing PUHCA restrictions are no longer needed to protect consumers and investors and how the restrictions hurt registered companies, their customers (and potential customers) and shareholders. Each section also explains in detail what the Commission can and should do to eliminate or mitigate these effects and thereby bring the regulation of registered utility companies into the modern age.

I. THE COMMISSION SHOULD WORK TO ELIMINATE THE RESTRICTIONS ON ENTRY INTO NON-UTILITY MARKETS CREATED BY THE CURRENT PUHCA REGIME.

The Commission has asked for comment on a number of issues relating to the desirability of continuing the current restrictions on the registered companies' ability to diversify into non-utility businesses. See Notice at 32-33. Briefly stated, PUHCA requires that registered holding companies and their subsidiaries obtain prior approval from the Commission for all acquisitions of other businesses.[3] Under Section 11(b)(1) of

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[2] CSW takes no position on the Commission's questions regarding exemptions (Questions 31-32) or investment company issues (Question 36).

[3] 15 U.S.C. §§ 79i and 79j.

the Act, the Commission can approve an acquisition of a non-utility business only if that business is "reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system."[4]

Although the statute is worded in broad terms, the Commission has interpreted these provisions narrowly to require that a non-utility business be "functionally related" to the utility operations of a registered system -- a phrase that does not appear in the statute. See Central and South West Corp., Holding Co. Release No. 35-26061, 1994 SEC LEXIS 1729 (June 3, 1994).[5] In addition, the Commission has imposed a nonstatutory "50 percent rule" gloss on top of the nonstatutory "functionally

[4] 15 U.S.C. § 79k(b)(1). Section 11 later states that the Commission:

> may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

15 U.S.C. § 79k(b)(1).

[5] Contrary to the Commission's suggestion (Notice at 32), no judicial decision requires a "functional relationship" between a nonutility business and the utility operations of a registered holding company system. Michigan Consolidated Gas Co. v. SEC, 444 F.2d 913 (D.C. Cir. 1971), reached no holding on the validity of the Commission's functional relationship test. As explained in the attached Legal Memorandum (at 5-6), the issue there was not whether Section 11(b)(1) of the Act requires a functional relationship, but whether that provision imposes a "public interest" requirement in addition to the requirement that the non-utility business be "reasonably incidental, or economically necessary or appropriate to the operations" of the utility business.

related" test. Under the "50 percent rule," even if a non-utility business is functionally related, and thus permissible, no more than half of the non-utility activities can come from outside the utility operations of the holding company system. See, e.g., CSW Credit, Inc., Holding Co. Release No. 25995, 1994 SEC LEXIS 557 (March 2, 1994); Jersey Central Power and Light Co., Holding Co. Release No. 35-24348, 1987 SEC LEXIS 2339 (March 18, 1987). Together these two restrictions effectively prevent registered companies from entering a whole range of non-utility businesses to which they are well adapted.

On this topic, the fundamental issue is that posed by the Commission in Question 26, i.e., whether there should be any "limits on diversification by registered holding companies" under PUHCA. Notice at 33. As explained below, these restrictions should be abolished. To begin with, they are no longer necessary because investors and consumers are adequately protected under other laws; the existing restrictions therefore provide no incremental benefits to consumers or investors (see id. (Question 27)), and the abolition of those restrictions would pose no meaningful risks to consumers or investors. See id. at 32-33 (Questions 25, 26, 28).

On the other hand, the existing restrictions have become counterproductive because they deny to both consumers and investors the substantial benefits of increased diversification. From the investor's standpoint, those restrictions clearly prevent registered holding companies from offsetting the low earnings growth in their core utility businesses with higher

earnings in other businesses. See id. at 33 (Question 25). But that is not the "primary justification" (id.) for relaxing those restrictions: What is more important is that those restrictions also prevent registered companies from making full use of their assets and thereby from achieving economies of scale and scope that would further enhance shareholder returns. In the aggregate, these lost economies are estimated to be in the range of $__-__ billion each year. See Questions 24, 25; Cost Study at ___.

Most important of all, the existing restrictions deprive consumers of the substantial benefits of diversification, including the development of new services as well as increased competition for such services as telephone and cable television. See Question 24. For these reasons, the Commission should recommend that these provisions be repealed, and in the interim should exercise its rulemaking authority to permit more non-utility diversification.

A. The Diversification Restrictions Are No Longer Necessary To Protect Investors Or Consumers (Questions 25-30).

Since 1935, there have been dramatic changes both in the industry and in the effectiveness of other forms of regulation that have undermined the need for PUHCA's diversification restrictions. As explained below, in the absence of PUHCA both investors and consumers would be fully protected by other laws.

1. __These restrictions no longer provide any incremental protection to investors.__

Although diversification into non-utility businesses "was not a major concern when the 1935 Act was passed" (see SEC Statement at 592), Congress generally believed that, under the conditions prevailing in 1935, "the growth and extension of holding companies" often "[bore] no relation to economy of management and operation," and therefore investors might be harmed by a registered company's acquisition of a risky new business. 15 U.S.C. § 79a(b)(4). Since 1935, however, there have been dramatic changes in the scope and effectiveness of regulation under the other securities laws, and therefore PUHCA's additional diversification restrictions have become unnecessary.

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 require substantial disclosure and reporting that are fully adequate to protect the registered companies' investors. See Questions 25, 27. Many of these requirements would not have applied to the registered companies in 1935. For example, as originally enacted, the reporting requirements of the Securities Exchange Act applied only to securities listed on a national exchange -- which would have excluded all of the registered companies. Only later did the Commission extend these (and other) requirements to a broader set of securities. Moreover, the Commission's regulation of the securities industry was in its infancy in 1935; virtually all aspects of its regulation have been expanded and refined over time. In addition, since 1935 the Commission, FERC, and the accounting

profession, through the Financial Accounting Standards Board, have all developed uniform accounting standards that govern the industry independent of PUHCA.

All of these developments are more than sufficient to provide investors with the information they need to make intelligent investment decisions. As the Commission puts it in the Notice, "[t]he need for adequate disclosure for investors has largely been addressed by developments in the federal securities laws and in the securities markets themselves." Notice at 18. See also Baumol-Willig Statement at __ ("[t]he current regulatory treatment of public corporations and financial markets, the competitiveness of the marketplace, and the rights of stockholders to pressure or even change corporate managements are deemed to be sufficient protection of investors."). With today's highly developed regulatory structure of disclosure and protection of shareholder rights, there is no longer any need for a layer of special "protection" for the investors of registered companies by means of prophylactic (and intrusive) limitations on the kinds of businesses the registered companies can enter.

In all events, the available evidence suggests that diversified utility companies are not riskier investments, as a general matter, than non-diversified registered holding companies. See Question 27. One study found no statistical correlation between the percentage of non-utility assets held by a utility and that utility's return on common equity. See Edison Electric Institute, Nonutility Business Activities of Investor-Owned Electric Utilities (1994) ("Nonutility Business Activities

of IOUs") at 16 (Attachment C to Baumol-Willig Statement). The same study also found that diversification had no effect on a utility company's stock beta. To be sure, individual companies have lost money from time to time on particular non-utility investments, as the Commission suggests, just as some have been very successful.[6] However, systematic comparisons show that diversified utility companies as a class do not pose unique risks to the investing public, and therefore PUHCA's special restrictions on diversification are no longer justified.

2. **These restrictions no longer provide any incremental protection to consumers.**

PUHCA's diversification restrictions are also no longer necessary to protect ratepayers. As the Commission recognizes, the principal risk of diversification, as it relates to ratepayers, is the possibility that the registered company could overcharge ratepayers in order to recoup losses from non-utility investments. See Notice at 33 (Question 28). Since 1935, however, both the states and FERC have gained adequate authority to ensure that this does not happen.

To the extent that a registered company expands into non-utility businesses through a utility subsidiary, state

[6] See Notice at 33 (citing Studness, Earnings from Utility Diversification Ventures, 130 Pub. Util. Fort. 28 (1992)). Notably, Studness makes no systematic comparison between registered and nonregistered companies. Moreover, of the twenty companies surveyed, Studness concedes that twelve earned positive returns from their diversified businesses, four sustained modest losses, and four others sustained more severe losses. See Studness at 29. Indeed, the two more celebrated cases of Pinnacle West and Public Service Company of New Mexico should not obscure the fact that most of the twenty utilities' investments were at least modestly successful.

commissions have the ability, through their power to regulate retail rates, to determine the value of the assets to be included in the rate base and to disallow any costs associated with non-utility investments. See National Association of Regulatory Utility Commissioners, Utility Regulatory Policy In The United States And Canada, 1993-1994 (August 15, 1994) ("NARUC Compilation") at 51.[7] Indeed, the scope and effectiveness of such regulation has dramatically improved since 1935. See Energy Information Administration, The Changing Structure of the Electric Power Industry 1970-1991 (Mar. 1993) at 29.

Where a holding company chooses instead to diversify through non-utility subsidiaries, state commissions and FERC have ample authority to determine the utility's cost of capital apart from the cost of capital for the system as a whole. As Professor Eugene Brigham explains in the accompanying statement, regulators (and even private firms) estimate the cost of capital for separate subsidiaries all the time. Brigham Statement at 2. If regulators believe that a holding company system's cost of capital is higher than that of the regulated utility subsidiary, the regulators can simply assign to the utility an "imputed" cost of capital that more closely reflects the utility's actual cost of capital. Id. at 3. This is often done by using a

[7] For example, each of the four states in which CSW conducts business has more than adequate authority to protect ratepayers. See Texas Public Utility Regulatory Act §§ 39, 41, Tex. Rev. Civ. Stat. Ann. art. 1446 (Vernon Supp. 1995) (only allows recovery of expenditures that are reasonable and necessary to the provision of utility service); La. R.S. 45:1176 (authority to disallow costs if designed to subsidize affiliate); [confirm OK and AK].

hypothetical capital structure more appropriate to the utility's operations and then calculating the costs of debt and equity that would have prevailed at those levels. Thus, ratepayers would still be protected from having to fund changes in the overall riskiness of the holding company.[8]

Here again, now that the states and FERC have adequate means to protect ratepayers from the potential risks of diversified utility companies, there is no longer any need for PUHCA's prophylactic restrictions on diversification.[9]

B. By Allowing Efficient Deployment Of Utility Assets, Elimination Of The Diversification Restrictions Would Confer Enormous Benefits Upon Consumers And Investors (Questions 24-25).

The Commission also seeks comment on the possible benefits of diversification to investors and consumers. See

[8] Indeed, there are many examples of regulators making such decisions. As FERC said in one such case: "When the risk profile of the parent and subsidiary are significantly different, we see no alternative to postulating a hypothetical capital structure for the subsidiary by referring to the average capital structure for comparable independent firms . . . where the subsidiary's capital structure is atypical we must impute a capital structure to the subsidiary." Kentucky West Virginia Gas Co., 2 FERC ¶ 61,139, ¶ 61,326-7 (Feb. 16, 1978). See also San Diego Gas and Electric Co. v. Alamito Co., 46 FERC ¶ 61,363, ¶ 62,115 (April 13, 1989); Re Southwest Gas Corp., 146 PUR4th 54, 72 (1993); Consumers Gas Company, No. 85-0089, 1985 Ill. PUC LEXIS 1; In the Matter of the Application of Contel of California, Decision No. 90-06-015, 1990 Cal. PUC LEXIS 323, *14 ("In setting returns, we have traditionally imputed a capital structure where we believe a utility's actual equity ratio is too high or too low.").

[9] The Commission also seeks comment on whether there should be different limitations on foreign and domestic diversification. See Notice at 33 (Question 29). Here again, the FERC and the state commissions have adequate authority to protect consumers and investors from the potential risks from foreign diversification, and indeed these agencies regulate foreign diversification today by companies outside the scope of PUHCA.

Notice at 32-33. The principal, overarching benefit is that greater diversification would allow the registered companies to make joint use of utility, management, and other assets to achieve economies of scale and scope, which would benefit both investors and consumers. Relaxation of these restrictions would do this in three distinct ways.

First, it would allow registered holding companies to enter a number of businesses to which those companies are economically well suited, but from which they are today completely barred. The Commission's "functional relationship" test bars entry into many such industries, principally cable television service.

Indeed, these restrictions often lead to paradoxical results, because these lost opportunities often fall to exempt holding companies. For example, an exempt company such as Houston Industries can enter the cable television business in CSW's service area, whereas CSW is prohibited from providing such services in either its own or Houston Lighting's service area. In each of these areas, consumers and investors are losing the benefits of economies that would lead to cost reductions, lower prices, and more vigorous competition.

Second, relaxation of the diversification restrictions would allow registered companies to expand existing businesses which have already been deemed "functionally related" to the companies' core utility business. Today, the Commission's "50 percent rule" effectively bars any meaningful entry into such businesses as telecommunications, credit factoring, waste

management, and other businesses which are in fact natural areas of expansion for the registered companies. Indeed, registered holding companies today are often uniquely positioned to enter non-utility markets where competition has historically been underdeveloped or nonexistent.

Telecommunications is a good example. Many utilities already own a range of assets that could be used for telecommunications services, but the "50 percent rule" often arbitrarily precludes the registered companies from making full use of these assets. See, e.g., Central and South West Corp., 1994 SEC LEXIS 1729 (applying 50 percent rule to CSW's limited-purpose communications subsidiary).

Utility credit factoring is another natural area of expansion and, indeed, CSW operates such a business itself. CSW Credit buys accounts receivable from utilities, giving them a cash infusion and saving them the cost of processing the accounts. The Commission, however, has invoked the "50 percent rule" to prevent CSW Credit from expanding to meet the growing demand for its services. CSW Credit, Inc., 1994 SEC LEXIS 557 (March 2, 1994).

That decision was striking for its arbitrariness: The Commission did not question the economic benefit of expanding CSW Credit's operations. To the contrary, the Commission observed that the expansion "arguably would permit CSW to benefit from economies of scale in the factoring business, which in turn (assuming profitable operations and an adequate return on capital) would benefit CSW's consumers and investors; moreover,

the consumers and investors of non-affiliates served by CSW Credit presumably also would stand to benefit to some degree from the lower factoring costs." CSW Credit, 1994 SEC LEXIS 557, *7. Instead, the Commission's decision to block CSW Credit's growth simply means that CSW's potential factoring customers will have to turn for such services to other firms -- which, ironically, may include exempt holding companies or other nonregistered utility companies.

Third, relaxing the diversification restrictions would benefit registered companies and their investors by allowing them to offset low earnings in the utility industry with higher earnings in other businesses. As noted above, this is certainly not "the primary justification for further diversification" (Notice at 33), but it is important to registered companies: Increasing competition in the wholesale market (and, inevitably, in retail markets as well) is putting pressure on the registered companies to find additional avenues for growth.

The more important fact, however, is that PUHCA's restrictions are preventing the registered companies from making acquisitions and expanding existing lines of business in ways that would make both consumers and investors better off, regardless of whether the registered companies are experiencing low earnings growth in their core businesses. The attached Cost Study estimates the net social costs of these restrictions at $___-__ billion per year. Those costs would be transformed into benefits -- for consumers as well as registered companies -- if the existing diversification restrictions were relaxed.

C. The Commission Should Recommend Repeal Of The Diversification Restrictions, And In The Interim Promulgate Rules To Permit Greater Diversification (Questions 24, 26).

For the reasons explained above, the answer to the Commission's question whether there should be "limits on diversification by registered holding companies" (Question 26) is a resounding no. PUHCA's diversification restrictions no longer serve any beneficial purpose, because both investors and consumers would receive adequate protection under other laws if PUHCA were repealed. Moreover, PUHCA's prophylactic restrictions on the kinds of businesses registered companies can enter have become affirmatively harmful, because they prevent the companies from realizing economies that would produce net gains for society as a whole. Therefore, the Commission should recommend the repeal of PUHCA's diversification provisions, particularly Section 11(b).

The Commission also asks, in Question 24, whether the "applicable standards can be made more flexible while retaining appropriate consumer protections." As explained in the accompanying legal memorandum, the Commission has substantial authority to permit a much greater degree of diversification by rulemaking. <u>See</u> Legal Memo. at ___. Thus, until Congress acts, the Commission should adopt a number of changes in the standards it currently employs.

Specifically, neither the "functional relationship" test nor the Commission's "50 percent rule" is required by the statute. On the contrary, the statute permits diversification into non-utility businesses that are "reasonably incidental" <u>or</u>

"economically necessary or appropriate." The Commission therefore should promulgate a new rule replacing its current "functional relationship" test with a new standard allowing "economically appropriate" acquisitions -- i.e., acquisitions where a registered company could achieve genuine economies of scale or scope. In addition, the Commission should simply abolish the onerous "50 percent rule."

Indeed, the Commission correctly indicated in its recent decision in Southern Company, Holding Co. Act Rel. No. 35-26211 (December 30, 1994), that the proper inquiry is whether the proposed transaction falls "within the plain meaning of the statute, viz., the proposed [] activities are permitted as 'reasonably incidental or economically necessary or appropriate' on a finding that they are 'necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental' to the functioning of the integrated public-utility system." See id. at 15-16 (quoting Section 11(b)). Moreover, the Commission properly recognized that an acquisition should not be barred merely because "a majority of the revenues may ultimately come from [nonaffiliated] customers." Id. at 15. The Commission should take this opportunity to promulgate a new rule adopting these principles and formally abolishing the old standards embodied in such cases as CSW Credit. See Legal Memo. at ___; Exhibit __ (suggested regulatory language).

II. THERE IS NO LONGER ANY JUSTIFICATION FOR PUHCA'S RESTRICTIONS ON UTILITY ACQUISITIONS, AND THE COMMISSION SHOULD DO EVERYTHING POSSIBLE TO ELIMINATE THOSE RESTRICTIONS.

In Questions 15 through 23, the Commission has asked a series of questions relating to the special restrictions PUHCA places on the acquisition of utilities.[10] As previously (and erroneously) interpreted by the Commission, these restrictions prevent the acquisition of utilities that are not directly interconnected with the registered company's existing, "integrated" system.[11] The Commission has also strictly interpreted the conditions under which a registered company can own more than one integrated system, in effect barring all such acquisitions unless the purchase will save the acquired system from economic ruin.[12] This unwarranted interpretation of the Act has the effect of prohibiting broader geographic diversification

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[10] Sections 10 and 11 of the Act together require that, except in certain circumstances, registered holding companies can control only one "integrated" utility system. Section 2(a)(29) defines an "integrated" system, when applied to electric utilities, 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 physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.

15 U.S.C. § 79b(a)(29)(A).

[11] See UNITIL Corp., Holding Co. Release No. 35-25524, 1992 SEC LEXIS 1016 (Apr. 24, 1992).

[12] See SEC v. New England Electric Sys., 384 U.S. 176 (1966).

as well as, in most cases, prohibiting the simultaneous ownership of both gas and electric utilities.[13]

Like the restrictions on diversification into non-utility businesses, the restrictions on acquisitions have outlived their usefulness and should be repealed. The FERC, the state commissions, and the antitrust authorities have ample authority to review the acquisition of other utility companies, thus fully protecting both consumers and investors. See Questions 15 and 16. Moreover, the factual assumptions on which these acquisition restrictions are based have been completely undermined by the technological transformations that have occurred in the industry since 1935. See Question 18. Today, developments such as wheeling and power pools make the efficient operation of dispersed utility systems possible and even desirable. See Question 17. Therefore, PUHCA's restrictions are now depriving consumers of the benefits of more efficient energy supplies. See id.

[13] The Notice incorrectly cites SEC v. New England Elec. System (NEES I), 384 U.S. 176 (1966), for the proposition that "the courts have previously interpreted section 11 of the Holding Company Act to prohibit a registered holding company from owning both gas and electric facilities." Notice at 29 & n. 83. In fact, as explained in the accompanying Legal Memorandum (at 10-11), NEES I merely held that the Commission's interpretation was "within the permissible range" of possible interpretations. 384 U.S. at 185. The Court did not hold that this was the only reasonable interpretation, and thereby left open the option that the Commission might adopt a different interpretation. Further, as the Commission notes (Notice at 29), the Commission's interpretation is at odds with Section 8 of the Act, "which appears to contemplate the combination of gas and electric properties."

Similarly, the Commission's ban on combination gas-electric systems is no longer necessary. The advent of competition in the gas markets (and increasing competition in the electric markets) have obviated the risks of cross-ownership, and the FERC and state commission routinely regulate gas-electric combinations today. See Question 20. Here again, such combinations would create efficiencies that would benefit consumers through lower energy prices. Id.

Therefore, each of these restrictions should be repealed and, in the interim, reinterpreted by the Commission to permit greater utility flexibility. See Question 19.

A. The Restrictions On Utility Acquisitions No Longer Serve Any Beneficial Purpose (Questions 15-18, 20).

As the Commission recognizes, the fundamental question with respect to these restrictions is whether they "still serve the interest of investors and consumers." Question 17; see also Question 20. They clearly do not, in part because they no longer provide any meaningful protection to these groups. PUHCA's acquisition restrictions were originally designed to prevent two things: anticompetitive behavior and inefficiency arising from long-distance management and operations. See SEC Statement at ___. However, dramatic changes in the utility industry since 1935 have eliminated the latter concern and (at least partially) eliminated concerns about anticompetitive behavior. Moreover, increased regulation by the states and the FERC (not to mention the Department of Justice) have eliminated any remaining risk that an acquisition will be anticompetitive.

1. Technological and market changes have substantially obviated the need for these restrictions.

In Question 18, the Commission correctly observes that "[o]ne of the assumptions underlying the Act was that utilities were essentially local institutions that should be locally controlled and owned," and then asks whether this premise is still valid. Notice at 28. It plainly is not.

The utility industry has undergone radical changes since 1935. When PUHCA was passed, electric utilities were few and far between. Power plants were concentrated in the cities. They were relatively small and isolated, and there existed no economical way to transport power over any great distance.[14] Indeed, in 1935 only about ten percent of all farms in the United states received central station electric service.[15] As the Commission has recognized, "[i]n 1935, an electric utility system generally included local generation, transmission and distribution, little long-distance transmission, no joint ownership of generation and distribution facilities, and no power pools."[16]

It is therefore hardly surprising that utilities were viewed as "essentially local institutions" and that, as the Commission put it (Question 17), "geographic proximity" was viewed as important to "a utility's efficiency of operation."

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[14] Edwin Vennard, The Electric Power Business 42 (2d ed. 1970).

[15] [cite]

[16] UNITIL Corp., 51 SEC Docket 562, 566 n.33 (1992).

Notice at 28. But that is no longer true. With the development of such practices as wheeling and power pools, holding companies now have a greatly expanded ability to "interconnect" utilities to one another, and to do so efficiently.[17]

Moreover, as the Commission notes, the utility markets are experiencing increasing competition -- particularly at the wholesale level -- which makes it unwise and, indeed, inefficient for utilities to limit their operations to a single location. In short, lack of geographic proximity no longer has any adverse effects "on a utility's efficiency of operation, particularly in view of open access transmission policies." Question 17.

Likewise, the original rationale for the ban on gas-electric systems has been undermined by increased competition. The prohibition is predicated on the assumption that both the gas and electric utility markets are monopolies.[18] Today, however, sweeping regulatory changes have introduced competition into the gas service market.[19] Therefore, there is now little reason to fear that holding companies could "favor" their own electric utilities by curtailing the availability or increasing the price of gas service to other utilities.[20] See Question 20 (seeking comment on the "perceived risks" of cross-ownership).

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17 [cite statistics on extent of power pooling arrangements]

18 See SEC v. New England Elec. Sys., 384 U.S. 176, 183 (1966).

19 [cite evidence, statistics]

20 See NEES, 384 U.S. at 183.

Finally, one other market development is also relevant to the continued soundness of the Commission's restrictions on acquisitions: the fact that those restrictions now apply to only ten electric utility systems representing only about twenty percent of the industry. See Question 17; supra, pp. ___. The uneven application of the acquisition rules now creates severe competitive imbalances, because the registered companies' competitors have much greater freedom to acquire other utility assets. This is especially true of cross-ownership of both gas and electric utilities: As with geographic diversification (infra, __-__), gas-electric combinations are common,[21] and there is no evidence that such combinations harm investors or consumers.[22] See Questions 17 and 20. Therefore, the

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[21] Exempt holding companies that own both electric and gas utilities include: CILCORP Inc. (Central Illinois Light Co.), CMS Energy (Consumers Power Co.), DPL Inc. (Dayton Power and Light), LG&E Energy Corp. (Louisville Gas & Electric), MDU Resources Group, Inc. (Montana-Dakota Utilities), Midwest Resources Inc. (Midwest Power Systems), Minnesota Power (Minnesota Power, Superior Water, Light & Power Co.), NIPSCO Industries, Inc. (Northern Indiana Public Service Co.), Public Service Company of Colorado (Cheyenne Light, Fuel & Power Co., Western Gas Supply Co.), SCANA Corp. (South Carolina Electric & Gas Co.) and the Wisconsin Energy Corporation (Wisconsin Electric Power Co., Wisconsin Natural Gas Co.). EEI, Non-utility Business Activities of IOUs.

Non-registered utility companies that control both electric and gas utilities include: Central Hudson Gas & Electric, Iowa-Illinois Gas and Electric Co., the Montana Power Co., Niagara Mohawk Power Corp., Oklahoma Gas & Electric Co., Pacific Gas and Electric Co., Public Service Co. of New Mexico and UtiliCorp United Inc. Id.

[22] For example, Pacific Gas & Electric, an electric/gas utility based in San Francisco, was named *Electric Light & Power's* 1993 Utility of the Year. PG&E's financial performance ranks it among the best electric utilities for returns on investment from 1990-

(continued...)

acquisition restrictions have simply become arbitrary and unnecessary.

2. Changes in regulation have eliminated any remaining need for PUHCA regulation as a means of preventing anticompetitive acquisitions.

Any residual concerns about competition are fully addressed through means other than PUHCA. Indeed, the Commission observes that its review of utility mergers generally "may duplicate the efforts of other regulators" (Notice at 27) and acknowlegdes that there may be "adequate protections against potential anticompetitive effects of . . . combination systems." Id. at __.

The scope and effectiveness of regulation outside the purview of PUHCA have increased dramatically since 1935, and even since 1982, when the Commission last recommended repeal of PUHCA. See Questions 15 and 16. First, under Section 203 of the Federal Power Act, FERC exercises authority over transfers of jurisdictional assets, including transfers involving holding

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[22] (...continued)
1993. Mark T. Hoske and Wayne Beaty, "PG&E: 1993 EL&P Utility of the Year," *Electric Light & Power* (Dec. 1993). Similarly, Oklahoma Gas & Electric, despite a flat service area economy, managed to increase revenue and dividends for nine of ten years from 1983 to 1993. The natural gas subsidiary, Enogex, contributed 9% of 1992 company revenue and 12% of earnings while saving customers $55 million since 1983. Mark T. Hoske, "25th Utility of the Year Anniversary," *Electric Light & Power* (Dec. 1993). And SCANA (South Carolina Electric & Gas), an exempt holding company with gas and electric utilities and 11 non-utility subsidiaries, has reduced its residential rates over the 10 last years. EEI, Non-utility Business Activities of IOUs.

companies.[23] In assessing such acquisitions, FERC considers many of the same factors the Commission considers under PUHCA, including the reasonableness of the purchase price, the effect on competition, the impact on the effectiveness of state and federal regulation, and the existence of cost savings or other merger benefits.[24] Second, the states also regulate utility acquisitions to ensure that such transfers are in the public interest and do not adversely affect either ratepayers, competition, or the financial stability of the utilities.[25] Third, the antitrust authorities (i.e., the Department of Justice and the Federal Trade Commission) routinely review utility mergers to ensure that they are not anticompetitive.[26]

Clearly, then, the additional layer of PUHCA regulation has been "largely superseded" by the efforts of others (see Question 15), because both consumers and investors are adequately protected by other statutes. This is dramatically illustrated by the fact that the Commission has not held a hearing in a merger case in years. Indeed, the Commission recently approved the $3.5

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[23] See Illinois Power Co., 67 FERC ¶ 61,136 (1994). Until recently, FERC had declined to exercise its jurisdiction over pure holding company mergers, but has since changed its position in the Illinois Power case.

[24] See, e.g., FERC Order on Merger Application and Rate Filing in El Paso Electric Co. and Central and South West, Services, Inc., 68 FERC ¶ 61,181 at 61,901-02 (Aug. 1, 1994).

[25] For example, each of the four states in which CSW is located fully regulates utility acquisitions. See Ark. Code § 23-3-31-(1)-(5); Okla. Stat. Ann. tit. 17, § 158.53; Louisiana Commission General Order, dated June 7, 1968; Texas Rev. Stat. Ann. Art. 1446(c), § 63.

[26] [cite statistics on DOJ review, if available]

billion CINergy merger without a hearing, after the merger was approved by FERC and state regulators, and relying in large part on the record before those other agencies.[27]

B. Eliminating The Restrictions On Acquisitions Would Confer Enormous Benefits Upon Consumers and Investors (Questions 17 & 20).

Not only are the Commission's acquisition restrictions unnecessary to protect consumers and investors, but, like the restrictions on diversification, these restrictions affirmatively disserve consumer and investor interests by impeding the efficient use of utility capital. Certainly, the acquisition restrictions have "hindered the development of creative solutions to the production and delivery of energy." See Question 17. More generally, registered companies could realize significant economies of scale and scope from acquisitions of other utilities. Restrictions on these acquisitions therefore deprive consumers the benefits of lower energy prices and investors the benefits of owning a stronger company.

The abolition of PUHCA's restrictions on entry into other utility markets would produce three specific benefits. First, permitting the acquisition of other utility companies would allow holding companies to realize substantial economies of scale and scope. These economies include not only administrative savings, which would be significant, but also more flexibility in operations and a more efficient generation mix that would both

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[27] See also Entergy Corp., 55 SEC Docket 2035, 2041-42, 2046 (1993) (relying on the findings of FERC and the state regulators); Notice at 27 (acknowledging Commission reliance on some of the FERC's analysis in merger cases).

reduce production costs and allow capital savings by delaying the need for new construction. Indeed, Edward Tirello, Senior Vice President and utilities analyst with Shearson Lehman Hutton Inc., estimated in 1989 that 50 percent of cost savings in mergers came from the economical use of plants in low-demand periods; only 25 percent came from savings in administrative costs and salaries. "Cooperatives Urged to Merge to Face Takeover in 'Meaner, Tougher' World," *Electric Utility Week* (June 12, 1989).[28] These cost savings, of course, would inevitably be passed on to energy consumers in the form of lower energy prices.

As with the restrictions on geographic diversification, the flat ban on gas-electric systems likewise prevents registered companies from realizing "economies such as consolidation of purchasing and other economies of scope." See Baumol-Willig Statement at 11; see also Question 20 (seeking comment on the benefits of cross-ownership). These economies would also confer substantial benefits on consumers through lower energy prices.

Second, abolition of the restrictions on acquisitions would allow registered holding companies to build a more varied customer mix, and thereby protect them from economic swings. For example, PacifiCorp is a geographically diversified Western transmission and wholesale utility with an interest in six of the

[28] To take a real-world example, in 1990 Cleveland Electric Illuminating Co. and Toledo Edison Co. officially merged to create the parent exempt holding company, Centerior Energy Corporation. By allowing the two utilities to combine their generating and dispatching systems and consolidate administrative costs, the merger saved Centerior some $90 million a year. "Electric Utility Executives' Forum: Industry Consolidation," *Public Utilities Fortnightly* (May 24, 1990).

20 lowest-cost U.S. thermal plants, and with an average system cost that is 36 percent below the industry average. It has interconnections with more than 50 utilities, allowing favorable power exchanges and seasonal diversity. Mark T. Hoske, "25th Utility of the Year Anniversary: A Look at the Winners," *Electric Light & Power* (Dec. 1993). In part as a result of this diversity, PacifiCorp's average return on equity for the last five years has been 12.14 percent, one of the highest in the industry. EEI, Nonutility Business Activities of IOUs at 20.

Third, removal of PUHCA's geographic diversification restrictions would even the playing field in the industry by allowing holding companies (including both registered and exempt companies) to compete with non-holding companies that are permitted to expand the geographic scope of their operations. Indeed, apart from holding companies, geographic diversification in the industry is both legal and common.[29] For example,

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[29] Many investor-owned utilities not organized in a holding company structure serve customers in more than one state: Black Hills Corporation (Montana, South Dakota, Wyoming); Carolina Power & Light (North Carolina, South Carolina); Citizens Utilities Co. (Arizona, Hawaii, Vermont); Delmarva Power & Light Co. (Delaware, Maryland, Virginia); El Paso Electric Co. (New Mexico, Texas); Empire District Electric Co. (Arkansas, Kansas, Missouri, Oklahoma); Idaho Power Co. (Idaho, Nevada, Oregon); Interstate Power Co. (Iowa, Illinois, Minnesota); Iowa-Illinois Gas & Electric Co. (Iowa, Illinois); Montana Power Co. (Montana, Wyoming); MDU Resources Group Inc. (Montana, North Dakota, South Dakota, Wyoming); Northwestern Wisconsin Electric Co. (Minnesota, Wisconsin); Otter Tail Power Co. (Minnesota, North Dakota, South Dakota); PacifiCorp (California, Idaho, Oregon, Utah, Washington, Wyoming); Potomac Electric Power Co. (District of Columbia, Maryland); Southwestern Public Service Co. (Kansas, New Mexico, Oklahoma, Texas); UtiliCorp United Inc. (Colorado, Kansas, Missouri, West Virginia); Washington Water Power Co. (Idaho, Montana, Washington). Energy Information Administration,
(continued...)

Citizens Utilities operates utilities in states as geographically diverse as Vermont, Colorado, and Hawaii, and yet was rated the top utility company in the nation in a 1990 United Shareholders Association study measuring economic performance and adherence to shareholders' rights. Charles Studness, "'Shareholder 1000' Rankings Announced," *Public Utilities Fortnightly* (April 26, 1990).

Together, these benefits are substantial. As discussed in the attached Cost Study, the economic savings from relaxing the current "integration" restrictions could range from $__ to $__ billion per year, while the savings from relaxing the ban on combination systems could range from $__ to $__ billion annually, for a total savings of $___ to $___ billion. See Cost Study at ___.

C. The Commission Should Recommend Repeal Of The Existing Restrictions On Utility Acquisitions, And In The Interim It Should Promulgate Rules To Allow Greater Flexibility. (Questions 19-23).

For all of these reasons, the Commission should recommend repeal of the restrictions on diversification into other utility markets. In the interim, the Commission should quickly relax the existing restrictions: As the Commission recognizes, PUHCA gives the Commission administrative "flexibility to respond to technological advances and other changes in the industry" and to accommodate "nontraditional"

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[29] (...continued)
Financial Statistics of Major U.S. Investor-Owned Utilities, 1992 (Dec. 1993) at 548-50.

systems. <u>Notice</u> at 28-29; <u>see</u> Question 19. The Commission should exercise its rulemaking authority to take three significant steps.

First, the Commission can and should recognize by rulemaking that the statutory phrase "physically interconnected or capable of physical interconnection" properly encompasses such modern-day advances as wheeling and power pool arrangements. This recognition would permit registered companies to engage in broader geographic diversification without sacrificing any of the benefits of "integration and coordination of related operating properties" that Congress sought by requiring "interconnection." <u>See</u> Legal Memo. at 8-10.

Second, the Commission should abolish the onerous "serious impairment" test for determining when a registered company can acquire additional integrated systems. Section 11(b) merely requires that the acquisition provide "substantial economies," which the Commission can and should interpret to mean simply a significant (or non-trivial) amount of money, as determined under a business judgment rule. Such a change would open the way for registered companies to make beneficial acquisitions of other integrated systems. <u>See</u> Legal Memorandum at 10-13.

Third, consistent with the foregoing, the Commission should specifically acknowledge that PUHCA allows registered companies to own both gas and electric utilities. <u>See</u> <u>id.</u> at 9-

11.[30] As explained in the accompanying legal memorandum, the Act does not compel a flat prohibition on gas-electric combinations. Indeed, as the Commission recognizes, "[t]here is a tension between this [prohibition] and section 8 of the Act, which appears to contemplate the combination of gas and electric properties." See Notice at 29 (footnote omitted).

III. THE COMMISSION SHOULD RECOMMEND THE ELIMINATION OF PUHCA'S RESTRICTIONS ON CHANGES IN FINANCIAL STRUCTURE AND ON THE ISSUANCE AND SALE OF SECURITIES.

The Commission also requests comment on several matters involving its regulation of holding company financings under PUHCA. See Notice at 20-24. Registered holding companies and their subsidiaries are required by Sections 6 and 7 of PUHCA to secure Commission approval before issuing or selling securities, or changing the rights of any security holders.[31] The Commission may decline to allow the issuance of a security that is not reasonably adapted to the issuer's capital structure and that of

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[30] The Commission also seeks comment on whether there should be restrictions on the ability of foreign companies to own U.S. utilities. Notice at 30-32 (Questions 21-23). While CSW takes no position on this question **[CSW: should we?]**, it should be emphasized that this question is entirely different from the question whether U.S. holding companies should be permitted to acquire foreign companies. See supra, pp. ___. Foreign ownership of U.S. utilities raises questions of national security, and therefore should be weighed carefully in light of those very different concerns.

[31] 15 U.S.C. §§ 79f-g. Section 7 states that "[a] registered holding company or subsidiary company thereof may file a declaration with the Commission . . . ." 15 U.S.C. § 79g(a). Section 6 states that, "[e]xcept in accordance with a declaration . . . and with the order . . . permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof . . . to issue or sell any security of such company . . . ." 15 U.S.C. § 79f(a).

other companies in the same holding company system, or that is "not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest," or where the terms of the issuance or sale are "detrimental to the public interest."[32] Under the Act, registered holding companies must also obtain Commission approval for certain intrasystem financings, such as loans from parent to subsidiary.[33]

The basic issue in this area is whether "the protections provided by such review [are] still necessary in view of developments in state and federal regulation." Notice at 21 (Question 1). In fact, such oversight of holding company financing transactions has become unnecessary because of major developments since 1935 in both state and federal regulation and in industry practice. PUHCA's restrictions on financing duplicate other regulations, and impose needless costs on registered holding companies without any corresponding benefit (Question 2). Accordingly, the Commission should recommend eliminating its regulation of financings by holding company subsidiaries and scale back its regulation of financing by the holding companies themselves.

[32] 15 U.S.C. § 79g(d).

[33] 15 U.S.C. § 79l.

A. If PUHCA's Financing Restrictions Are Repealed, Other Regulatory Safeguards Will Amply Satisfy Their Purposes (Question 1).

When PUHCA was enacted in 1935, Congress sought to remedy various alleged abuses of public utilities which were not then subject to effective regulation; these abuses were facilitated by inadequate financial disclosure by utility holding companies and their subsidiaries. See 15 U.S.C. § 79a(b). Sections 6 and 7 of PUHCA allowed the Commission to monitor the holding company systems' capital structure, and examine how the companies utilized the proceeds from their security issuances. PUHCA effected a fundamental restructuring of the industry, with Sections 6 and 7 serving to supervise the holding company systems.

With this reorganization long complete, several factors have rendered Commission review in this area unnecessary for the protection of consumers or investors. A wide range of safeguards -- including federal and state laws and regulations as well as industry developments -- ensures adequate disclosure to investors and consumers of important financial data.

1. If PUHCA is repealed, investors will still possess full financial information about utility holding companies.

Even without PUHCA, investors in public utility holding companies will have access to abundant public information about those companies. The Commission itself declared in 1982 that, "[i]f the 1935 Act were repealed now, investors in public utility holding companies would still have available from other sources essentially the same information . . . ." SEC Statement at 571.

The primary reason that investors are so well informed is the Commission's current requirement of full financial disclosure from all public companies under the Securities Act of 1933 and the Securities Exchange Act of 1934 ("Securities Acts"). See, e.g., Securities Act, § 19(a) (1933); Securities Exchange Act, § 13(b) (1934). When offering securities to the public, registered holding companies and their subsidiaries must file a detailed registration statement, including specific financial information, and must furnish potential investors with a prospectus. All holding companies must file an annual Form 10-K and a quarterly Form 10-Q, and must further report on certain events on a Form 8-K. Investors, analysts, and rating agencies thus have access to specific financial information about holding company systems. As the Commission recognizes, "investors today have far greater access to information concerning their investment decisions" than in 1935, and "[t]he need for adequate disclosure for investors has largely been addressed by developments in the federal securities laws and in the securities markets themselves." Notice at 16, 18.

The Commission has been increasingly exacting in its enforcement of the Securities Acts disclosure requirements. It has, for instance, shown an intensified interest in management's discussion and analysis, required by Regulation S-K Item 303, which "provid[es] the marketplace with appropriate information concerning the registrant's financial condition, changes in

financial condition and results of operations."[34] The Commission has also shown a willingness to use its enforcement mechanisms, pursuing actions against registrants who have failed to fulfill their disclosure obligations.[35] Securities laws also prompt underwriters of holding company securities, and persons controlling a utility, to undertake a due diligence investigation of the utility as securities issuer in order to develop a due diligence defense under Section 11 of the Securities Act.

The FERC, too, requires financial disclosure from public utilities. Federal Power Act § 304. FERC compels all electric utilities (i.e., ten out of the thirteen utility systems now subject to PUHCA) to submit detailed information on utility financing in connection with securities issuances over which it has jurisdiction. 18 C.F.R. §§ 34.3-34.10.

Additionally, the regulations and reporting requirements of the Trust Indenture Act (TIA), which provide additional disclosure and investor safeguards, come into play when a utility company issues most kinds of registered debt securities. 15 U.S.C. §§ 77aaa-77bbbb. Under TIA, most utilities and other issuers must file a trust indenture with the Commission, and obtain its approval, before distributing the debt securities.

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[34] Securities Act Rel. No. 6835, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,436 (May 18, 1989).

[35] See, e.g., id. at 62,145; In re Caterpillar Inc., Exchange Act Re. No. 30532, 7 Fed. Sec. L. Rep. (CCH) ¶ 73,830 (Mar. 31, 1992).

Further, since PUHCA's enactment, nearly all states have passed legislation giving them the authority to regulate utilities' securities issuance. E.g., Cal. Pub. Util. § 822 (West Supp. 1992); Fla. Stat. Ann. § 366.04 (West Supp. 1991); La. R.S. 45:1168; N.Y. Pub. Serv. L. § 69 (McKinney 1989); 17 O.S. § 182. State agencies, far more financially sophisticated than in 1935, can use their regulatory supervision of public utility subsidiaries to obviate problems with holding company financings. Indeed, the Commission may now exempt the issuance and sale of securities from PUHCA's approval requirements when they have been expressly approved by a state regulatory commission. 15 U.S.C. § 79f(b).

Other developments since 1935 contribute to the redundancy of PUHCA's financing regulations. The advent of uniform accounting standards has made financial information far more accessible because of its standardized format. The Commission requires standardized accounting information in registration statements, and the FERC and all states but Nebraska also have authority to dictate uniform accounting standards. NARUC Compilation at 97. Further, analysts and investors are now quite sophisticated at evaluating securities, and rating services have emerged as well to scrutinize those securities. Finally, the investment banking industry is now regulated to prevent the self-dealing that led it to contribute to pre-PUHCA abuses. SEC Statement at 575-76.

In short, the perceived problems that brought about regulation of utility holding company financings "have long since

been removed through the surveillance of the commissions, the reorganization of electric and gas holding companies under [PUHCA], and refinements in the art of accounting and auditing." Charles F. Phillips, Jr., The Regulation of Public Utilities (1988) at 218-19. The above listed developments clearly suffice to protect those who invest in the nonregistered and exempt utility companies. Such protections will also enable investors in the registered holding companies to make informed decisions after the repeal of Sections 6 and 7 of PUHCA.

2. **Consumers will remain sufficiently protected by state and federal ratemaking authorities if PUHCA is repealed.**

Consumers too will be more than adequately protected by other means if PUHCA is repealed. Sections 6 and 7 of the Act were intended to protect consumers by allowing regulatory commissions to monitor the companies' actual financial positions, which would enable the commissions to establish appropriate rates. SEC Statement at 550-51. In addition, those Sections restricted the issuance of excessive capital at the holding company level, which states at that time did not regulate. The lack of control over the level of holding company debt also indirectly increased rates charged to consumers by utility operating companies.

Today, FERC and state regulatory schemes combine to protect consumer interests sufficiently, and financing restrictions under PUHCA are therefore unnecessary. (Question 1) First, FERC, as the federal regulator of wholesale rates for electric and gas utilities, aggressively protects ratepayers. It

must set rates that are "just and reasonable," and can order refunds for rates it finds exceed that standard. Federal Power Act, § 205(a). It may also suspend any electric rate increase for as long as five months. Currently, FERC does not regulate securities issuances by regulated holding companies, as that falls to the Commission under PUHCA, but FERC retains authority under Section 204 of the Federal Power Act to do so if PUHCA is repealed or if the Commission relaxes its own regulation.

FERC must also coordinate its regulatory efforts with those of the states, by, for example, making available to state commissions any helpful reports or information. Federal Power Act § 209(c). If PUHCA is repealed, FERC would remain authorized to work with the state commissions to protect ratepayers. The agency is also authorized to investigate and determine production and transmission costs for energy from facilities under its jurisdiction "upon the request of any State commission" where FERC does not have ratemaking power. Federal Power Act § 206(b). Further, FERC may ensure the adequacy of any public utility's interstate service "upon complaint of a State commission, after notice to each State commission . . . affected." Federal Power Act § 207. The Federal Power Act also authorizes the FERC to confer with any state commission about the relationship between rate structures, costs, accounts, charges, practices, classifications, and regulations of public utilities subject to FERC and state jurisdiction, and to hold joint hearings with any state commission in connection with any matter within the FERC's jurisdiction. Federal Power Act § 209(b).

The Natural Gas Act contains similar provisions authorizing FERC to establish joint boards for the determination of any matter arising under that Act, to confer with state commissions regarding rate structures, costs, and other matters, and to hold joint hearings with state commissions, and requiring the FERC to make information and reports available to state commissions. Natural Gas Act §§ 17(a), 17(b), 17(c). These provisions clearly enhance the effectiveness of state regulation. Regulation of interstate utility systems will remain effective without PUHCA.

Second, state agencies extensively regulate utilities' financial structure, both directly through approval of reorganization and affiliate transactions, and indirectly through rate regulation. As the Commission notes, "[m]ost state commissions . . . have authority . . . to regulate the issuance of securities." Notice at 15. Every state public utility commission has ultimate ratemaking authority for utilities within its jurisdiction, NARUC Compilation at 51-68, and regulates which costs of a utility subsidiary, including cost of capital based on an actual or hypothetical capital structure, should be recovered in utility rates. Brigham Statement at 1. Consumer advocacy agencies assist state commissions in performing their duties, and help ensure aggressive advocacy for consumer interests in rate proceedings and other matters.

In short, the Commission appears to draw the wrong conclusion when it states that, "[w]ith respect to consumer interests, it appears that retail distribution will continue to

be a monopoly for at least the next decade, thus justifying the continued protection of captive consumers." Notice at 18. While consumers may require protection through rate regulation, FERC and the state commissions are well equipped to provide that protection. PUHCA's regulatory scheme is not necessary for additional protection of consumers' interest in reasonable utility rates.

B. Relaxing PUHCA's Burdensome Financing Restrictions Would Give Holding Companies Greater Business Flexibility And Also Benefit Investors (Question 2).

In addition to being unnecessary for the protection of consumers or investors, PUHCA's financing restrictions harm both groups. Obviously, those restrictions require the dedication of staff resources, which by itself needlessly increases costs and thus rates to consumers.[36] But the biggest problem, as the Commission apparently recognizes (Notice at 4), is the needless "delay inherent in the current administration" of these restrictions -- delay that clearly stands as "an obstacle to desirable financing opportunities." Id. at 21 (Question 2).

The reason is that timing plays a very "critical" role in financial decisions. Id. Bond yields and interest rates change daily, such that a financing opportunity that appears attractive today likely will not be available tomorrow.[37] Similarly, many investment opportunities (which may need to be

[36] For example, Form U5S, required by PUHCA to be filed annually, substantially parallels the information required by Form 10-K under federal securities laws.

[37] [Examples from CSW's experience?]

financed by bonds or other debt) must be seized quickly or they are lost forever.[38]

Constrained as they are by the existing regulatory approval process, however, registered companies simply cannot act quickly on market opportunities. Before proceeding with any financing (regardless of its purpose), a registered company must first apply to issue new securities, after which the Commission places a notice in the Federal Register for a public hearing on the proposed securities issuance. Under existing regulations, it is only then that the Commission may authorize the sale of the securities. As a result, a registered company may have to wait months to obtain final Commission approval for its financing.

The resultant regulatory delay severely curtails access to capital markets by limiting companies' ability to respond to market developments. And even when the company is not denied access altogether, the delay deprives customers and investors of the benefits of efficient financing, including the company's opportunity to sell debt when interest rates are low and offer equity when market yields are low.[39]

This differential treatment creates large inequities between registered and exempt companies. As Professors Baumol and Willig state, "Disparities in regulatory treatment are always

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38 [Examples?]

39 Baumol-Willig Statement at 14; see also Executive Summary Submitted by Morgan Stanley & Co., Financing and Intrasystem Transaction, Roundtable Meeting (July 1994) at 1 (PUHCA review of financing transactions "unduly limits the ability of holding companies to respond to developments in the capital markets today.").

the cause of some inefficiency because they raise the relative prices that must be charged by firms that are not exempt, and consequently restrict their outputs relative to the outputs of suppliers not subject to the regulatory constraints." Baumol-Willig Statement at 1. Consumers and investors will surely benefit when these disparities are eradicated.

Indeed, the CSW's Social Cost Study estimates the total costs of PUHCA's financing restrictions at $___ -___ million annually, including approximately $___ million in compliance costs, and $___ million in increased capital costs associated with existing regulatory delays.

C. In Addition To Recommending Repeal Of Sections 6 And 7, The Commission Should Take Certain Administrative Steps To Mitigate The Burden Created By PUHCA's Financing Restrictions (Questions 3-8).

In sum, review under PUHCA of holding company financing imposes substantial costs with no accompanying benefit. The Commission, therefore, should recommend that Congress repeal Sections 6 and 7.

In the interim, the Commission should also take certain administrative steps now to mitigate the costs created by current regulations. First, the Commission should expand existing safe harbors for certain financings. See Questions 3, 5, 6. Specifically, in order to meet registered companies' needs for greater flexibility and less regulatory delay, the Commission should create a safe harbor by streamlining the process of making its Section 7(d) findings. Section 7 of the Act delineates specific requirements for securities transactions by registered

holding companies or their subsidiaries.[40] Instead of making such findings on a case-by-case basis, the Commission could find, in a rulemaking context, that financings presumptively satisfy the criteria of Section 7(d) if they satisfy the objective standards of Section 7(c) and conform to the other federal securities laws. The Commission would "watchfully defer" to approvals under the Securities Act of 1933 where the transaction complies with Section 7(c).[41]

Indeed, rather than outlining more limited safe harbors based on, for instance, specific minimum capitalization levels or dividend payout ratios, the Commission should create a safe harbor encompassing <u>all</u> financing transactions that satisfy Section 7(c) and the federal securities laws. Compliance with the Securities Acts would ensure that investors are fully informed, and ratepayers would still be protected by the FERC and

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[40] Section 7(c) provides that the Commission "shall not" allow a security to be sold or issued unless it finds that.

> (1) such security is (A) a common stock . . . ; (B) a bond . . . ; (C) a guaranty of . . . a security of another company; or (D) a receiver's or trustee's certificate . . . or (2) such security is to be issued or sold solely (A) for the purpose of refunding, extending, exchanging, or discharging an outstanding security . . . or for the purpose of effecting a merger, consolidation, or other reorganization; (B) for the purpose of financing the business . . . as a public-utility company; (C) for the purpose of financing the business . . . when the declarant is neither a holding company nor a public-utility company; and/or (D) for necessary and urgent corporate purposes. . . .

15 U.S.C. § 79g(c).

[41] <u>See</u> <u>City of Holyoke Gas & Elec. Dept.</u> v. <u>SEC</u>, 972 F.2d 358, 363 (D.C. Cir. 1992), quoting <u>Wisconsin's Environmental Decade</u> v. <u>SEC</u>, 882 F.2d 523, 527 (D.C. Cir. 1989).

state commissions. Such an action would reduce the onerous delay of individual review of holding company financings.[42]

Second, the Commission should utilize its broad exemption power under Section 3(d) of PUHCA to exempt subsidiaries -- though not holding companies -- from the requirements of Sections 6 and 7. The Commission must only find this exemption to be "necessary or appropriate in the public interest or for the protection of investors or consumers and not contrary to the purposes of this chapter." 15 U.S.C. § 79c(d). These criteria surely give the Commission authority to allow utility subsidiaries to issue and sell registered securities without the further procedures it currently requires.

Third, the Commission should maintain and continue to expand the exemption contained in Rule 52 (17 C.F.R. sec. 250.52). That rule, which exempts certain securities transactions from the requirement of an effective declaration under Section 6(a) of PUHCA, has already proven to be quite effective in reducing delay in financing transactions. See Question 6.

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[42] The Commission could also reduce delay by altering the process by which it makes findings under Section 7. Through a rulemaking proceeding, it should eliminate the time-consuming requirement of publishing a notice in the Federal Register for public hearing on financings. This requirement is not prescribed by PUHCA, and it merely delays financing transactions further.

The Commission recently rescinded Rule 50, a rule requiring competitive bidding as a precondition to the issuance and sale of securities, 59 Fed. Reg. 21,925 (1994), and should continue to promulgate rules that similarly ease the burden on registered holding companies.

When it adopted Rule 52, the Commission stated that its "streamlined procedure is consistent with the Congressional purpose in enacting subsection 6(b) 'to exempt the issue of securities by subsidiary companies in cases where holding company abuses are unlikely to exist,'" and that the rule "is an appropriate measure to ease the regulatory burden on registered holding-company systems."[43] The Commission subsequently revised Rule 52 to further lessen the regulatory burden, expanding the exemptions based upon the opinion that "the registered holding-company systems should have greater ability to engage in routine financing without the regulatory burden of prior Commission authorization."[44] This exemption should be retained and, indeed, expanded further.[45]

Fourth, the Commission should ease financing standards to allow registered companies to issue a broader range of securities. See Question 4. Standard and Poor's Ratings Group, for example, favors allowing utility holding companies and their subsidiaries more flexibility to issue junior debt or newer types of preferred stock.[46] In fact, the SEC has in the past approved the issuance of high yield debt, or "junk bonds." SEC Release

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[43] Holding Co. Act Release No. 25058, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,517 (Mar. 19, 1990).

[44] Holding Co. Act Release No. 25574, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,007 (July 7, 1992).

[45] [Describe how, if at all, this exemption could be expanded further.]

[46] Executive Summary Submitted by Standard and Poor's Rating Group, Roundtable Meeting (July 1994), at 3.

No. 35-24245 (Nov. 21, 1986); Douglas W. Hawes, Utility Holding Companies § 3.07, at 3-51 to -52 (1987). Potential risks in this area would be mitigated by the fact that most public utility holding company investors are sophisticated, institutional investors or mutual funds. They are well informed about their investments, and the requirements of Sections 6 and 7 give them no benefit.

Fifth, the Commission should relax the limitations currently imposed on registered holding companies' ability to declare and pay dividends. See Question 8. The Commission's regulations currently require it to approve any payment of dividends by a registered holding company. 17 C.F.R. § 250.46. These limitations are unnecessary and burdensome. Such restrictive regulation of holding company dividends is not compelled by PUHCA, and there is no principled reason to treat registered public utility holding companies differently than other industries in this regard.

Sixth, the Commission should eliminate the requirement that intrasystem financings mirror the terms of a system's external financings. See Question 7. This regulatory gloss on PUHCA is no longer needed, even for non-utility financings. Other protections exist for the system's operating companies, ensuring the holding company does not profit from intrasystem transactions. See infra __-__.[47]

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[47] [Perhaps we also need to take a position here on whether the Commission, if it decides not to repeal PUHCA, should "pursue a regulatory approach that would utilize NRSRO credit ratings of utility companies" in a registered system. (Question 9)]

In short, PUHCA's framework of financing regulation no longer performs a useful function, and it forces registered holding companies and their subsidiaries to bear unnecessary costs. Sections 6 and 7 of PUHCA should be repealed, and in the interim, the Commission should take the above administrative steps to ease this severe regulatory burden.

IV. THE COMMISSION SHOULD RECOMMEND THE ELIMINATION OF PUHCA'S RESTRICTIONS ON INTRASYSTEM TRANSACTIONS, AND TAKE ADMINISTRATIVE STEPS NOW TO EASE THOSE RESTRICTIONS.

The Commission also seeks comment on several issues regarding its regulation of intrasystem, or inter-affiliate, transactions. See Notice at 24-26. Under Sections 12 and 13 of PUHCA, the Commission currently regulates public utility holding company intrasystem transactions, including loans, contracts for services, and purchase and sale of assets.[48] Some transactions

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[48] Section 12 states:

> It shall be unlawful for any registered holding company . . . to borrow, or to receive any extension of credit or indemnity, from any public-utility company in the same holding-company system or from any subsidiary company of such holding company . . . . It shall be unlawful for any registered holding company or subsidiary company thereof . . . to lend or in any manner extend its credit to or indemnify any company in the same holding-company system in contravention of such rules . . . as the Commission deems necessary or appropriate in the public interest or for the protection of investors or consumers . . . .

15 U.S.C. § 79*l*(a)-(b). Section 13(a) states:

> [I]t shall be unlawful for any registered holding company . . . to enter into . . . any service, sales, or construction contract by which such company undertakes to perform services or construction work for, or sell goods to, any associate company thereof which is a public-utility . . . company.

(continued...)

between affiliates are entirely prohibited, while others must be pre-approved by the Commission.[49] In the Notice, the Commission asks commenters to describe specifically the extent to which the federal government should regulate inter-affiliate transactions. See Question 10.

The simple answer is that all federal regulation should be left to the FERC. Extensive regulation by state regulatory commissions and FERC has made any supervision by the Commission superfluous. Further, this unnecessary layer of regulation under PUHCA burdens registered holding companies, resulting in inefficient operations and extra administrative costs which are ultimately paid by ratepayers. Inasmuch as one of the Commission's stated objectives is to "minimize regulatory overlap," Notice at 4, the Commission should recommend repeal of

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[48] (...continued)

15 U.S.C. § 79m(a).

[49] The Commission substantively reviews transactions between subsidiaries and their affiliates. 17 C.F.R. §§ 250.90-250.92. Under these regulations, a registered company must file a declaration of a potential inter-affiliate transaction under Sections 12(b), 12(c), 12(d), or 12(f). The Commission then makes certain findings under the statute and publishes a notice in the Federal Register. See 17 C.F.R. § 250.23.

The Commission has also promulgated other rules which, consistent with Section 13(b), require that sales of goods and services from affiliates to utilities of a registered holding company be made at cost. 17 C.F.R. § 250.90-250.92. Other transactions are subject to Commission regulation, including loans made by the parent holding company to the utility. The Commission can also regulate service, sales, and construction contracts between a holding company and its associate utility companies.

PUHCA's intrasystem transaction limitations, and take specific administrative steps now to reduce their cost.

A. The Added Layer Of PUHCA's Restrictions On Intrasystem Transactions Is Unnecessary For The Benefit Of Investors Or Consumers (Questions 10, 13, 14).

When PUHCA was enacted in 1935, Congress was concerned about possible conflicts of interest in intrasystem transactions. It believed that certain service companies charged their affiliates inflated amounts for goods and services, and that those costs were passed on to consumers through excessive rates. Moreover, no state or federal regulator had the authority or resources, individually or collectively, to police intrasystem transactions effectively.[50] Two subsequent developments, however, have made Sections 12 and 13 unnecessary to protect consumers or investors: (1) the increased ability of state commissions to police such transactions, and (2) FERC's increased ability to review such transactions at the federal level.

As for the role of the state commissions (see Question 13), they now have ample authority and resources to protect consumers from any unreasonable inter-affiliate contracts through direct regulation as well as through ratemaking. Most state commissions have explicit authority to evaluate the propriety of those transactions, and to disapprove them if a utility pays more than a reasonable amount (which could either be cost or market value), if the affiliate receives an excessive rate of return, or

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[50] See, e.g., Statement of Floyd C. Lewis, Repeal of the Public Utility Holding Company Act, 1982: Hearings on S. 1977 (1982) at 268.

if the arrangement is otherwise unreasonable.[51] Indeed, twenty-nine states' utility commissions -- including almost all of the 25 states that currently include a holding company registered under PUHCA -- have explicit authority to investigate such transactions and approve or disapprove them.[52] Most of the remaining states, moreover, have express authority to investigate inter-affiliate contracts, with implicit authority to disapprove objectionable contracts.[53]

Further, state commission pre-approval may also be required for loans or financial contracts between a public utility company and its affiliates.[54] And some states have taken steps to prevent inappropriate self-dealing in competitive

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[51] SEC Statement at 588; NARUC Compilation at 152-53; see, e.g., Ala. Code § 37-4-26; Alaska Stat. § 42.05.501; Ark. Stat. § 23-18-103; Haw. Rev. Stat. § 269-19.5; Iowa Code Ann. § 476.74; Mass. Laws Ann. ch. 164 § 85A; Minn. Stat. Ann. § 216B.48; Miss. Code Ann. § 77-3-10; N.H. Rev. Stat. Ann. § 366:3; N.Y. Pub. Serv. Law § 110; N.C. Gen. Stat. § 62-153; 66 Pa. Cons. Stat. Ann. § 2102; R.I. Gen. Laws § 39-3-28; Tex. Rev. Civ. Stat. Ann. art. 1446(c) § 28; Va. Code Ann. § 56-77; Wis. Stat. Ann. § 196.52.

[52] Edison Electric Institute, State Regulation of Utility Diversification (August 1994) at i-vii.

[53] Id.; NARUC Compilation at 152-53. State regulators may need additional access to relevant books and records (see Question 13), though many states now have quite broad access. E.g., Ark. Code Ann. § 23-2-309; 17 O.S. § 14-17; [cite others]. If current access is insufficient, state legislatures can act to enhance state commissions' ability to obtain these materials once PUHCA's restrictions are eliminated.

[54] E.g., Kans. Stat. Ann. § 66-1213; Me. Rev. Stat. Ann. tit. 35A, § 707; N.H. Rev. Stat. Ann. § 374:33; Va. Code Ann. § 56-82; Wis. Stat. Ann. § 196.525.

bidding situations.[55] Finally, to the extent any state commissions do not have sufficient authority to supervise inter-affiliate contracts directly, the legislatures of those states can clearly give them that authority.

State commissions also have enormous indirect control over inter-affiliate transactions through their ratemaking authority, and authority that state commissions can and do exercise to protect ratepayers from unreasonable costs, including those resulting from inter-affiliate transactions. As the Commission recognizes, state regulatory commissions "generally have the power to require prior authorization of rate changes, to suspend proposed rate changes, to prescribe interim rates and to initiate rate investigations." Notice at 15. Each state's regulatory commission has power to control end users' retail rates as well as the power to require approval before utilities make rate changes.[56]

This extensive monitoring eliminates utilities' incentives to engage in inappropriate self-dealing.[57] Utilities

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[55] Phillip S. Cross, "All-Source Bidding: The Purchased Power Market in Flux," Fortnightly (April 15, 1993) at 55.

[56] NARUC Compilation at 24-5, 35-6. In Texas, for example, payments by a utility to its affiliates may only be included in the utility's cost of service in a rate case upon a finding by the Texas Public Utility Commission that the payments are reasonable and necessary. Tex. Rev. Civ. Stat. Ann. art. 1446, § 41(c)(1) (Vernon Supp. 1995).

[57] Indeed, state regulators have frequently used their authority to examine utilities' proposed rates to protect ratepayers from costs resulting from self-dealing affiliate transactions. For example, the California Public Utility Commission has penalized Southern California Edison for its "disregard for the appearance
(continued...)

know at the outset they will be unable to recover costs from an abusive transaction, and will instead face the possibility that regulators will deny the costs associated with those transactions.[58]

At the federal level, FERC can use its authority under the Federal Power Act to work with the state commissions to protect ratepayers from unreasonable costs due to improper inter-affiliate transactions,[59] and is much better able to do so than its predecessor, the Federal Power Commission. FERC has ample authority to establish and adjust rates for wholesale sales and transmissions, Federal Power Act § 205, and has jurisdiction over

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[57] (...continued)
of self-dealing" arising from a inter-affiliate contract. Southern California Edison Co., Application No. 88-02-016, Decision No. 90-09-88 (CPUC Sept. 25, 1990), at 3. The Michigan Public Service Commission similarly criticized Consumers Power when it concluded that its contract with an affiliate "did not result from arm's-length negotiations." Midland Cogeneration Venture Limited Partnership, Case No. U-8871 et al., (MPSC Jan. 31, 1989), at 99. See also Re Arkansas Western Gas and Associated Natural Gas Division of Arkansas Western Gas Company, Docket No. 92-028-U, Order No. 41 (APSC Nov. 29, 1993, slip op.) ("[T]he presence of an affiliate relationship does give cause for intense regulatory scrutiny to assure that ratepayers are not detrimentally affected by the relationship.").

[58] Regulatory lag also reduces incentives to engage in inappropriate inter-affiliate transactions. If a utility enters into an inefficient contract or makes an inefficient purchase from an affiliate, it cannot immediately recover the resulting costs from ratepayers. The utility must instead wait for the next rate case, and even then must face the prospect that the regulators will deny the costs associated with the transaction.

[59] As the Commission states in its Notice, the Federal Power Act, now administered by the FERC, "represented a response to the gap in state regulation of utility rates and services." Notice at 12 n.35. FERC is required by statute to coordinate its regulatory efforts with the state commissions, by, for example, making available to them helpful reports or information. Federal Power Act § 209(c).

inter-affiliate wholesale sales and power transmissions as well as sales of jurisdictional utility assets. Public utilities must file with the FERC all contracts which affect or relate to rates and charges for any transmission or sale that is subject to FERC's jurisdiction. Federal Power Act § 205(c). FERC can also consider the effect of inter-affiliate pricing for services, sales, and construction in setting wholesale power rates, and can disallow costs from inter-affiliate transactions that it finds to be improper. Federal Power Act, § 205. Furthermore, to the extent a federal regulator is needed to ensure consistency in the treatment of a utility's costs, FERC can serve that function as well as anyone. <u>See</u> Question 12.

Investors, as well as ratepayers, will similarly remain protected if PUHCA's regulation of inter-affiliate transactions is repealed. Extensive financial disclosure under the Securities Acts and uniform accounting standards used in utilities' financial reporting give investors substantial access to an accurate financial picture of the holding company systems. Finally, investors may bring a shareholder derivative suit if the utility enters into an improper inter-affiliate contract that benefits the parent while over-charging the utility itself.

Finally, there is no reason to treat transactions between utilities in a holding company system any differently than intrasystem transactions between a utility and a nonutility company. <u>See</u> Question 14. State commissions and FERC, with their ratemaking authority, can oversee transactions between a utility and a non-utility company in a holding company system as

well as they can supervise transactions between utilities in a holding company system. Forty-four states grant utility commissions the authority to investigate contracts and agreements between utilities and their affiliated non-utilities. State Regulation of Utility Diversification, Edison Electric Institute, August 1994, at i-vii. PUHCA is not needed to check potential abuses in either situation.

In sum, if Sections 12 and 13 were repealed, or if the SEC declined to exercise its authority over these matters, state and FERC regulation would amply protect ratepayers from improper inter-affiliate contracts. Indeed, the superfluous nature of these provisions is demonstrated by the fact that the SEC does not ordinarily conduct its own fact-finding in this area; instead, it ordinarily relies upon determinations made by the states and FERC.[60]

B. Relaxation of Existing Restrictions On Intrasystem Transactions Will Benefit Both Consumers And Investors By Enabling Registered Holding Company Systems To Achieve Greater Efficiency In Production And Distribution (Question 10).

The Commission's existing regulation of intrasystem transactions not only is unnecessary in light of state and FERC regulation, but it also "imposes significant administrative and regulatory costs on regulated affiliates, with virtually no incremental benefits." Baumol-Willig Statement at 15. These costs are of three types.

60 [cites, examples]

First, there are significant administrative costs that result from the current three-tiered system of regulatory oversight, even if the reviewing entities agree with one another. Indeed, the Notice recognizes (at 25) that "affiliate transactions may be subject to multiple regulatory reviews" which inevitably lead to duplication and redundancy.

Second, as the Commission also recognizes (Notice at 25, Question 11), oversight by two federal agencies creates a distinct "possibility of inconsistent determinations by the various regulators," particularly in light of the Ohio Power decision.[61] This not only exacerbates the administrative costs associated with inter-affiliate transactions, but also undermines "the ability of the FERC, as well as state and local regulators, to protect consumers through traditional ratemaking proceedings." Id.

Third and perhaps most important, the existing regulatory scheme has a tendency to deter efficient inter-affiliate transactions, resulting in significant lost efficiencies. Consolidating certain intrasystem activities would save the public money by allowing companies to take advantage of economies of scale, and some of these activities must be combined for practicality, including pooled operations, coordinated economic dispatch, and shared reserves.[62] State commission

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[61] Ohio Power Co. v. FERC, 954 F.2d 779 (D.C. Cir.), cert. denied, 113 S.Ct. 483 (1992).

[62] See Comments Submitted by Jim Sullivan, President of the Alabama Public Service Commission, Roundtable Meeting (July 1994) at 3.

review of these operations could allow efficient, appropriate transactions to occur without the additional layer of PUHCA regulation, and allow better business flexibility for registered holding companies.

The total social costs associated with PUHCA regulation of inter-affiliate transactions are therefore quite significant. Indeed, CSW's Cost Study estimates that investors and consumers lose $__ to $__ million annually from lost efficiencies, and that the total annual social costs of PUHCA's regulation of inter-affiliate transactions is in the range of $__ to $__ million annually. That is the amount by which consumers and investors would benefit if the restrictions were repealed.

C. In Addition To Recommending Repeal Of Sections 12 And 13, The Commission Should Take Certain Administrative Steps To Ease The Burden Of PUHCA's Restrictions On Intrasystem Transactions (Questions 11-13).

Because PUHCA's oversight of intrasystem transactions imposes considerable costs without any corresponding benefit, the Commission should recommend the repeal of Sections 12 and 13. This would have the salutary effect of consolidating federal review of inter-affiliate transactions in the SEC. See Question 12; supra __-__. In the interim, the Commission should take other steps to reduce the costs created by this portion of the PUHCA regulatory regime.

Ideally, the Commission would simply use its broad discretion under Section 3(d) of PUHCA to exempt holding company affiliates and subsidiaries from its restrictions on inter-affiliate transactions. See Legal Memo. at __-__. That action

would be amply justified by the major economic and regulatory changes that have taken place since 1935.

Alternatively, the Commission could invoke its authority to exempt certain classes of transactions under Section 13(b) as involving "special or unusual circumstances" or as being "not in the ordinary course of business." The Commission could use its rulemaking power to exempt transactions that are specifically subject to state regulation. See Legal Memorandum at 16-17.

In all events, the Commission can and should streamline its procedure for determining whether a transaction satisfies Section 13(b)'s "at cost" requirement. Indeed, the Commission could establish through rulemaking a rebuttable presumption that inter-affiliate transactions are conducted "at cost" under Section 13(b). See id. The Commission would still place a notice of hearing in the Federal Register, but the transactions would be completed without substantial regulatory delay.