The Regulation of Public-Utility Holding Companies

Division of Investment Management
United States Securities and Exchange Commission

June 1995

This is a report of the Division of Investment Management. The Commission has expressed no view regarding the analysis, findings, or conclusions herein.

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 20, 1995

In addition to its responsibility for administering the other federal securities laws, the Securities and Exchange Commission was charged by Congress in 1935 with the regulation of public-utility holding companies, to address widespread abuses and protect both investors and consumers.

As one scholar described it, the Public Utility Holding Company Act of 1935 "gave the SEC power to refashion the structure and the business practices of an entire industry. Except in wartime, the federal government never before assumed such total control over any industry."

Today, this comprehensive control has become something of an anachronism. As a result of prudent administration of the Public Utility Holding Company Act, and the development of comprehensive federal securities regulation, the conduct that gave rise to the Act has all but disappeared. Indeed, critics of the Act charge that is has become a barrier to innovation and competition in the utility industry.

Last year, in keeping with Vice President Gore's mandate to reinvent government, I asked the staff to conduct a study of the Act, soliciting the views of all interested parties. The goal of the study was to develop a series of recommendations that addressed congressional concerns, past and present, as well as the needs of those affected by our regulation. To provide Commission guidance, I asked my colleague Rick Roberts to lend a hand. From chairing the Commission's "roundtable" conference last July to meeting with interested parties outside the agency, Commissioner Roberts has been a willing listener and a strong advocate of dynamic and practical solutions. I thank him and the staff for their tireless efforts in this year-long endeavor.

This study draws on 60 years of practical experience since the Public Utility Holding Company Act was signed into law. In addition to legislative proposals, it contains a number of administrative reforms that, by themselves, could remove nearly two-thirds of the industry's regulatory burden while continuing to provide for the protection of investors and utility consumers. It is my sincere hope that this report will provide a blueprint for regulatory reform.

Arthur Levitt

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

June 20, 1995

Dear Mr. Chairman:

I am pleased to submit the Division of Investment Management's report on public-utility holding company regulation. Last year, with the approach of the sixtieth anniversary of the Public Utility Holding Company Act of 1935, you asked the Division to take a fresh look at the regulation of public-utility holding companies to determine how best to protect the public interest and the interest of investors and consumers, while affording the companies the flexibility needed to compete in a rapidly changing environment.

The Division's Office of Public Utility Regulation has devoted considerable effort to the report. Virtually everyone in the Office contributed. I especially would like to note the indispensable role of William C. Weeden, whose leadership has guided the study from its inception. Special commendation should also go to Joanne Rutkowski, staff coordinator of the study, for her expert draftsmanship of the report. We received substantial assistance from staff members of other Commission offices, in particular, C. Hunter Jones of the Office of the General Counsel, Robert Comment of the Office of Economic Analysis, John H. Walsh, who, as Special Counsel to the Chairman, helped to get the study underway and continuously provided thoughtful counsel, and Brian J. Lane, Counselor to the Chairman, who helped to bring the study to conclusion. Finally, I would like to thank Commissioner Roberts and his office for their guidance and insight.

In preparing the report, we actively sought the opinions of the utility industry, consumer groups, trade associations, investment banks, rating agencies, economists, state, local and federal regulators, and others. Their comments, both formal and informal, were extremely useful to our review.

The Division has concluded that significant changes are needed in the current regulatory system. We believe that the Holding Company Act is unnecessarily restrictive in many regards, and may prevent companies from responding effectively to the changes now occurring in the utility industry. These effects, we have concluded, are clearly detrimental to both investors and consumers.

In the report, we recommend that the Commission offer Congress three legislative options designed to remedy the situation. The legislative option preferred by the Division is repeal of the Holding Company Act coupled with legislation to continue federal protection of energy consumers. The latter legislation would include provisions for state access to the books and records of holding company systems, and federal audit authority and oversight of transactions between system companies. A second option described in the report is unconditional repeal of the Act. The third legislative option is to broaden the Commission's authority under the Act to exempt holding companies where state regulation is found to be adequate.

Pending legislative action, the Division believes the Commission should act administratively to modernize and simplify holding company regulation, reduce the delay inherent in the current administration of the Holding Company Act, and minimize regulatory overlap, while protecting the interests of consumers and investors. To that end, the report details a number of administrative proposals, including rulemaking and significant changes in interpretation of the Act, for the Commission's consideration. Together, the administrative proposals, if adopted, could reduce the number of applications filed under the Act by approximately sixty-four percent.

Taken as a whole, the report reflects our concern that the regulation contemplated by the Holding Company Act to address the problems of a different era may prevent companies from responding effectively to the changes now occurring in the utility industry. We believe the appropriate implementation of our recommendations would facilitate consumer protection, encourage innovation and flexibility, and promote competition by acting to remove unnecessary regulation, thus enabling companies to provide energy to America's consumers in a flexible, efficient and competitive manner.

Sincerely,

Barry Barbash

Barry P. Barbash
Director

ACKNOWLEDGEMENTS

In the preparation of this report, the Division had the able assistance of many members of the Commission staff. The Division's study team was headed by William C. Weeden, Associate Director and Joanne C. Rutkowski, Assistant Director. Many others contributed to the drafting or editing of the report, including:

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THE REGULATION OF PUBLIC-UTILITY HOLDING COMPANIES

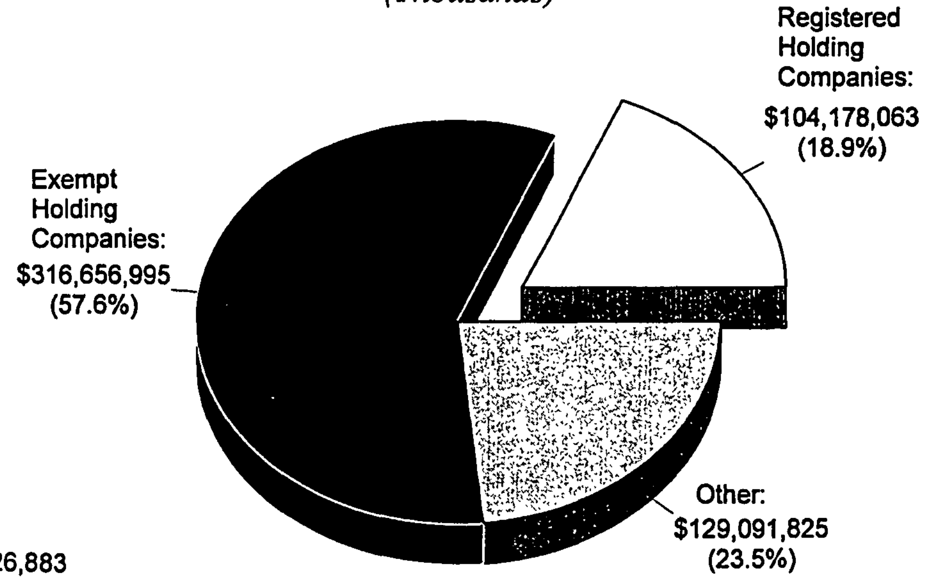
EXECUTIVE SUMMARY

The Public Utility Holding Company Act was enacted in 1935 to respond to the problems associated with the growth of public-utility holding company systems in the first part of this century. By the 1920s, America's utilities were largely controlled by a handful of holding companies. Even before the stock market crash in 1929, the vast size of these companies and the increasing concentration of control in the gas and electric industry had caused Congressional concern.

The studies that preceded the Holding Company Act documented a pattern of widespread abuses by holding company systems, promoters and underwriters. Among other things, inadequate disclosure made it difficult for investors to appraise the financial position or earning power of the issuer. In addition, excessive debt and abusive affiliate transactions tended to prevent voluntary rate reductions at the operating company level. Constitutional doctrines that limited the reach of economic regulation frustrated states' efforts to respond to these problems.

Congress determined in 1935 that direct federal regulation was necessary to control the operations of multistate public-utility holding companies. Thus, holding companies that are confined to a given state or area and so presumed to be susceptible to effective state regulation, are largely exempted from federal regulation under the Act. In contrast, holding companies with multistate operations must register with the SEC and comply with a comprehensive federal framework of regulation under the Holding Company Act.

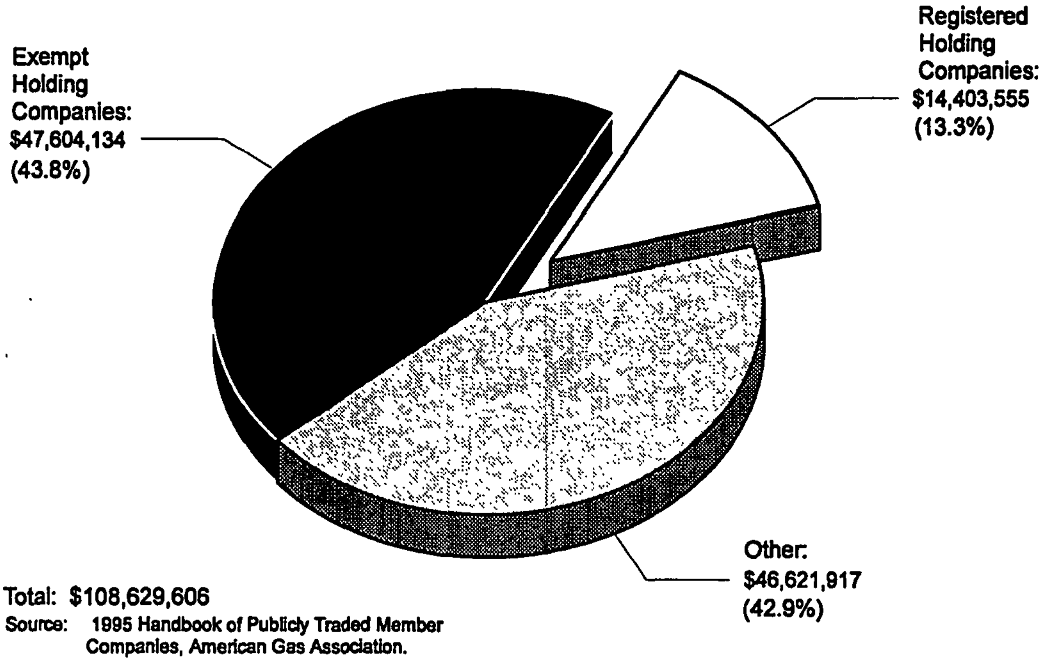
1993 Total Assets of Investor-Owned Electric Utilities (Thousands)



Total: $549,926,883

Source: 1993 Uniform Statistical Report and FERC Form No. 1.

1993 Total Assets of Investor-Owned Gas Utilities (Thousands)



The early work of the SEC was directed toward simplifying and reorganizing the complex financial and corporate structures of holding company systems, as required by section 11 of the Holding Company Act. This task was largely completed by 1952. At present, there are 15 registered holding companies, and several hundred exempt holding companies.

Under the Holding Company Act, a registered public-utility holding company is generally limited to a single, integrated public utility system and to those nonutility businesses that are "reasonably incidental, or economically necessary or appropriate" to the system's utility operations. SEC approval is required before such companies may:

- issue and sell securities or alter the rights of security holders,
- acquire any securities or utility assets or any interest in a nonutility business, or
- sell utility assets or securities.

The Act also restricts intrasystem loans and extensions of credit, as well as affiliate service, sales and construction contracts. In addition, registered holding companies are subject to extensive reporting and accounting requirements.

The regulatory system established by the Holding Company Act was not intended to reach the production and sale of gas and electricity. Congress vested the Federal Power Commission, now the Federal Energy Regulatory Commission, with jurisdiction over these operations at the federal level and, in section 21 of the Act, preserved the right of state regulators to exercise authority over utilities. These federal and state ratemaking authorities -- not the SEC -- most directly protect consumer interests. In this regard, the Act was intended to facilitate the work of the other regulators by placing certain restraints on the activities of public-utility holding companies.

The Holding Company Act, unlike the other federal securities laws, requires not only disclosure but also SEC review of the merits of various transactions. Since 1935, developments in other regulation have made the SEC's merit review increasingly redundant. At the same time, the changes in the industry have brought into question the continuing relevance of a monopoly-based model of regulation.

In the early 1980s, the SEC determined that the purposes of the Holding Company Act had been achieved and recommended to Congress that it be repealed. Due in part to concerns about consumer protection and the lack of a consensus for change, repeal legislation was not passed. Over the next decade, the SEC continued to attempt to respond flexibly and responsibly to the changes in the gas and electric industry.

In 1993, SEC Chairman Arthur Levitt directed the SEC staff to reexamine existing programs and policies to identify those that were effective and those that were not, including the SEC's position on repeal of the Act. The Division of Investment Management, under the direction of Commissioner Richard Y. Roberts, therefore undertook a study of the regulation of public-utility holding companies. The study began with a roundtable discussion in Washington, D.C. on July 18 and 19, 1994, in which the utility industry, consumer groups, trade associations, investment banks, rating agencies, economists, state, local and federal regulators, and others participated. Although the participants expressed widely divergent views on the future of the industry, all agreed that changes were needed in the existing system of regulation.

In response to a concept release issued last fall, the Commission received thousands of pages of useful comments. During the past year, the staff met with numerous interested parties, including representatives of the holding companies, consumer groups, industrial concerns, state and local regulators, and other federal regulators. In addition, the

Division collaborated with the National Association of Regulatory Utility Commissioners on a survey of state regulation.

Having concluded its study, the Division agrees that significant changes are needed in the current regulatory system. The Division's recommendations are of two types: legislative recommendations for Congress to consider, and proposals for administrative reform of the Act.

I. Legislative Recommendations

Conditional repeal of the Act

One option for Congress, and the option the Division prefers, is conditional repeal of the Holding Company Act, with an adequate transition period. Under this option, Congress would repeal the Act but, at the same time, enact legislation to continue federal protection of energy consumers. The legislation should include provision for state access to books and records of all companies in the holding company system, and for federal audit authority and oversight of affiliate transactions.

As the SEC has long recognized, the current regulatory system imposes significant costs, in direct administrative charges and foregone economies of scale and scope, that often cannot be justified in terms of benefits to utility investors. Acting under authority in the Securities Act of 1933 and the Securities Exchange Act of 1934, the SEC has, over the past six decades, created a comprehensive system of investor protection that obviates the need for many of the specialized provisions of the Holding Company Act.

Nonetheless, the Division believes that the Act continues to play a role in protecting energy consumers. Most importantly, the SEC can obtain, audit and oversee a multistate holding company system's books and records, particularly in regard to affiliate transactions. The Division believes past efforts to repeal the Act were unsuccessful largely because they failed to account for the continuing importance of this aspect of the regulatory scheme.

In following the option preferred by the Division, Congress would repeal the Holding Company Act, including its limits on financing and geographic and business diversification. At the same time, Congress would enact new provisions to ensure access to books and records required for the effective discharge of a state's regulatory responsibilities and to establish federal audit authority and oversight of intrasystem transactions. The task of carrying out these provisions logically should be given to the federal agency that most directly protects energy consumers, the Federal Energy Regulatory Commission.

The Division recommends that even legislation for conditional repeal of the Act incorporate, at a minimum, a one-year transition period to protect the validity of existing activities and contracts of registered holding company systems, and to enable the states to take appropriate action to ensure the continued protection of utility consumers.

Unconditional repeal of the Act

A second option is unconditional repeal of the Act, with an adequate transition period. Those who favor this option argue that state legislatures have the ability, if they desire, to create legal and regulatory systems that will adequately protect their energy consumers from problems that may arise with the operations of multistate holding companies that would otherwise be subject to federal regulation under the Act. Many state regulators, however, have expressed concern about their ability to protect consumers of multistate holding companies, and they will therefore oppose unconditional repeal.

Broader exemptive authority under the Act

A third option for Congress to consider is a grant of broader exemptive authority under the Act. The SEC's exemptive authority in this area is considerably narrower than that under other federal securities laws. If Congress were to give the Commission broader authority to exempt holding companies and others from the Act, the SEC could use this authority to exempt holding companies and transactions when state regulation is adequate. Expanded exemptive authority, however, would not achieve all the economic benefits of some form of repeal, nor would it significantly simplify the federal regulatory structure. Indeed, this option would further enmesh the SEC in difficult issues of energy policy.

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Because it would achieve the benefits of unconditional repeal, and yet would also preserve the ability of states to protect consumers, the Division prefers the conditional repeal option. Of course, the choice among the various legislative options is one that Congress will make.

II. Administrative Recommendations

The Division recommends that the SEC, pending legislative consideration of the options described above, act administratively to modernize and simplify regulation, reduce the delay inherent in the current administration of the Act, and minimize regulatory overlap, while protecting the interests of consumers and investors. The Division proposes a number of administrative reforms. The major recommendations are summarized below.

The SEC should consider rules to broaden exemptions for routine financings.

The Division recommends that the SEC adopt amendments to rule 52 under the Holding Company Act to broaden the exemption for routine financings by subsidiaries of registered holding companies. The amendment would exempt the issue and sale of any common stock, preferred stock, bond, note or other form of indebtedness if the financing is solely for the purpose of financing the business of the subsidiary and if, with respect to utility subsidiaries, the relevant state commission has expressly authorized the issue and sale. The amendment also would exempt the acquisition by a parent holding company of securities issued by a subsidiary company pursuant to the rule. The Division further recommends that the SEC amend rule 45(b)(4) to exempt all capital contributions and open account advances, without interest, by a parent company to a subsidiary company.

At the same time, the Division recommends that the SEC seek public comment on a further amendment to rule 52 to exempt the issue and sale of any security where the conditions of the rule are met. These amendments would eliminate unnecessary regulatory and paperwork burdens associated with obtaining SEC approval for routine financings.

The SEC should liberalize the treatment of financings that are not exempted under rule 52.

Although the proposed amendments to rule 52 would exempt most routine financings by subsidiaries of a registered holding company, the rule would not reach financings by the holding company itself, or by utility subsidiaries where the state does not have authority to approve financings. These transactions would thus continue to require SEC approval under the Act. The Division recommends that the SEC approve the use of a "budget approach" for these remaining financing proposals. Under this approach, the SEC would review a single filing outlining a company's anticipated financing requirements for an extended period of time instead of requiring a separate filing for each proposed financing.

The Division also recommends rescission of the SEC's Statements of Policy relating to first mortgage bonds and preferred stock issued by companies in a registered system. The SEC has previously noted that the Statements of Policy, which were formulated by the SEC's staff nearly forty years ago, are "anachronistic" and "no longer relevant to contemporary financial markets."

The SEC should avoid unnecessary restraints on utility acquisitions.

Although prior SEC approval is generally required for utility acquisitions, these transactions are also subject to FERC, and possibly state, approval. Many commenters have noted, and the Division agrees, that the SEC's review in this area largely duplicates the work of the FERC and state and local regulators. It does not appear, however, given the structure of the statute, that the SEC could readily promulgate a rule that would broadly exempt utility acquisitions from review under the Holding Company Act.

The Division recommends that the SEC interpret the geographic and functional integration standards more broadly. Where the affected states agree, the SEC should permit new types of holding company systems, including combination gas and electric registered holding companies. With a view to the proposed disaggregation of the electric utility industry, the SEC should consider rules to exempt a corporate restructuring that does not result in the addition of new utility operations.

Further, the SEC should seek to minimize regulatory overlap while continuing to protect the interests of consumers and investors. In this regard, the Division recommends that the SEC continue to work in coordination and consultation with the FERC and state and local regulators and, where appropriate, "watchfully defer" to the work of those regulators.

The SEC should consider a rule to reduce the burdens on energy-related diversification.

The Division recommends a rule to exempt most energy-related diversification by registered holding companies. Such a rule would deem energy-related diversification to be "appropriate in the ordinary course of business" of a company in a registered system. The rule would apply to certain nonutility activities that the SEC has previously found to satisfy the standards of sections 10 and 11, and the SEC could broaden the list of exempted activities by order upon application. Investment under the rule would be limited to the greater of $50 million or 15% of the registered holding company's consolidated capitalization.

The rule would also permit, without limit, investments by gas registered holding companies in activities authorized under the Gas

Related Activities Act of 1990. The rule should eliminate unnecessary regulatory burdens, while continuing to protect the interests of investors and consumers.

The SEC should continue to administer the Act flexibly, in consultation with other regulators, with respect to matters that do not fall under the proposed diversification rule.

The proposed diversification rule described above would exempt a significant number of nonutility acquisitions. The remaining filings are likely to concern either novel activities that should be considered on a case-by-case basis or routine matters that involve nominal amounts of capital. The Division recommends that the SEC endorse the use of a budget approach for the latter de minimis investments. Under this approach, a registered holding company could file an application under sections 9(a) and 10 of the Act, requesting authorization for a stated dollar amount to be invested in diversified activities, on an "as needed" basis, over a specified period, without the need for prior SEC approval of each specific transaction. The applicant would be required to take steps to ensure that potential losses would be limited to the amount of the investment.

With respect to the other diversified activities that will continue to require approval on a case-by-case basis, the Division recommends that the SEC interpret the Act to permit holding companies to engage in nonutility businesses that are economically appropriate and in the public interest, regardless of whether such activities are ancillary to the utility business.

The SEC should withdraw its proposal to amend rule 90 concerning affiliate service, sales and construction contracts.

The proposed rule amendment, which would have applied a lower-of-cost-or-market standard to intrasystem transactions, has received largely negative comments. The rule was intended to address concerns, raised by the Ohio Power decision, that SEC orders may impair the ability of the FERC, and state and local regulators, to protect consumers through traditional ratemaking proceedings. It appears that legislation may be needed to address these concerns. In the interim, the Division recommends that the SEC reaffirm its intention not to preempt the ratemaking authority of the FERC or of state and local ratemaking authorities.

The SEC should apply more liberal interpretations of the standards for exemption, where the affected states agree.

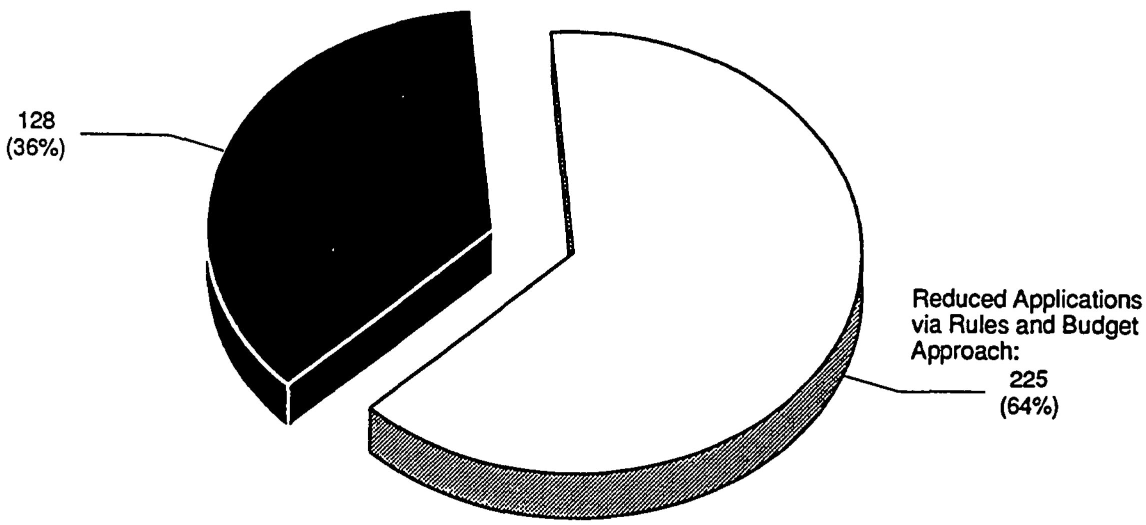
In the past, the SEC has narrowly interpreted the statutory standards for exemption. The Division believes it is appropriate for the

SEC to adopt broader readings of the exemptions in consultation with the relevant state commissions.

The SEC should direct more Holding Company Act resources to the audit function.

The Division recommends that the SEC continue to assist states in obtaining access to books and records, wherever located, if such examination is required for the effective discharge of their responsibilities, and intensify its efforts, in consultation and cooperation with the FERC and state and local regulators, to audit regulated companies.

Reduced Applications As a Result of PUHCA Administrative Reforms (Total Applications Filed in 1993 & 1994: 353)



As illustrated above, the proposed administrative reforms should reduce the number of filings under the Act by nearly two-thirds. These reforms should address the pressure points most troubling to the regulated companies, while continuing to protect the interests of investors and consumers. Some commenters have suggested that billions of dollars of savings could result for the regulated companies.

The proposed administrative reforms will also affect the work of the Office of Public Utility Regulation, which is responsible for the day-to-day administration of the Act. The remaining applications are likely to involve significant and complex issues. To the extent the reforms make available any regulatory resources, the SEC should redirect these resources to the audit function, to assist the FERC and state and local regulators in the continued protection of utility consumers.

PART I. OVERVIEW OF LEGISLATION, REGULATION AND TECHNOLOGY

A. Energy Utility Expansion and the Public Utility Holding Company Act of 1935

From the end of World War I to the early 1930s, holding companies acquired numerous and widely scattered utility and nonutility properties throughout the United States and abroad.[1] This was a period of intense growth in the electric and gas industry. In the electric industry, generating capacity approximately doubled every five years between 1902 and 1927. Similar but less spectacular growth occurred in the gas industry, most notably after 1925, due to the construction of major interstate pipelines.[2]

During this period, holding company expansion was also encouraged by investment bankers, who saw opportunities for profits and commissions from the sale of securities, and by promoters, who saw opportunities for increased fees. The holding-company structure permitted these persons to concentrate control of vast utility empires in a few hands, which led to deception of investors, excessive rates for consumers, and obstruction of state utility regulation.[3]

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[1] In 1935, an electric-utility system generally included local generation, transmission and distribution facilities. The first electric generating plants and distribution systems in the United States were built in major cities. Edwin Vennard, The Electric Power Business 42 (2d ed. 1970). When the Public Utility Holding Company Act of 1935 ("Holding Company Act" or "Act") was passed, power plants were relatively small and isolated, and there was no economical way to transmit power over any great distance. See id. Large portions of the country were wholly without electricity. In 1923, only 177,561 out of a total of 6,341,000 farms in the United States, or 2.8 percent, received central station electric service. By 1935, over 90 percent of farms still lacked central station electric service.

[2] When the Holding Company Act was passed, most of the retail gas supplied in large parts of the nation was manufactured. Because the process of reducing coal to coke had become increasingly expensive, many smaller gas plants were closed and even metropolitan gas utilities became unprofitable. The construction of major interstate pipelines in the 1930s and 1940s resulted in an almost universal substitution of natural gas service, or propane gas distribution in areas inaccessible to the pipelines.

[3] See Federal Trade Commission, Report on Utility Corporations, S. Doc. No. 92, 70th Cong., 1st Sess. (1928-1935) (in 101 volumes) (hereinafter referred to as "FTC Report"); id., pt. 72-A at 136-155. Most often, minority control was achieved by the purchase of

(continued...)

The multistate character of the holding companies prevented effective control by state regulators.[4] Between 1900 and 1935, the U.S. Supreme Court struck down many state efforts to undertake economic regulation on grounds of interference with contract and property interests.[5] In addition, states were unable to regulate matters, such as the activities of multistate holding companies, that had a "direct" effect on interstate commerce.[6]

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[3](...continued)
voting control in a top holding company that raised capital primarily by the sale of bonds or nonvoting preferred stock. To control an entire holding company system, the top holding company would buy a majority voting interest in a series of subholding companies, each of which also would be capitalized largely through the sale of bonds or nonvoting stock. The subholding companies would in turn own voting control in the utility operating companies. Through such pyramiding of control, five public-utility holding company systems were controlled in 1931 by the holders of common stock worth less than one percent of the entire system's assets. See Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 128 (1982); FTC Report, pt. 72-A at 154-66.

[4] In addition, state regulation of utilities was still in its infancy in 1935. The first generation of modern state utility commission statutes had been enacted only 15 to 25 years earlier, and not all states had established statewide utility commissions.

[5] See, e.g., Nebbia v. New York, 291 U.S. 502 (1934); Lochner v. New York, 198 U.S. 45 (1905). By 1935, the Court had invalidated nearly 200 laws regulating economic activity on "substantive due process" grounds. See Laurence H. Tribe, American Constitutional Law § 8-2 at 567-568 (2d ed. 1988).

[6] See, e.g., Smith v. Illinois Bell Tel. Co., 282 U.S. 133 (1930); Missouri ex rel. Barrett v. Kansas Natural Gas Co., 265 U.S. 298 (1924); Public Util. Comm'n of Kan. v. Landon, 249 U.S. 236, vacated on other grounds, 249 U.S. 590 (1919); Minnesota Rate Cases, 230 U.S. 352 (1913).

In the area of power transactions, including transactions between affiliated companies, the Supreme Court created a bright-line wholesale/retail rule dividing permissible state regulation (retail-level regulation) from impermissible state regulation (wholesale-level regulation). The rule was devised in two cases involving natural gas. See Missouri ex rel. Barrett v. Kansas Natural Gas Co., 265 U.S. 298 (1924); Public Util. Comm'n of Kan. v. Landon, 249 U.S. 236 (1919). The Court applied the rule to electric utilities in 1927. Public Util. Comm'n of R.I. v. Attleboro Steam & Elec. Co., 273 U.S. 83 (1927).

Federal regulation of utilities was largely nonexistent.[7] The vast size of public-utility holding companies and the increased concentration of control over the nation's electric power aroused concern at the federal and state government levels.[8]

1. Background Studies and Enactment of the Holding Company Act

Extensive factual studies preceded enactment of the Holding Company Act.[9] Pursuant to a 1928 resolution of the Senate, the Federal Trade Commission undertook a study of the public-utility industry that spanned 7 years and ultimately comprised 101 volumes.[10] The House Interstate and Foreign Commerce Committee conducted a second study from 1933 to 1935.[11] These studies documented a pattern of widespread abuses that

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[7] The Federal Water Power Act of 1920 originally established the Federal Power Commission, but its functions were limited to the licensing of hydroelectric projects and related matters, and did not include general authority over electric power transactions in interstate commerce. See Federal Water Power Act, Pub. L. No. 66-280, 41 Stat. 1063-77 (1920); Richard Lowitt, Federal Power Commission, in Government Agencies 233, 234 (Donald R. Whitnah ed., 1983). When the Holding Company Act was passed, jurisdiction over holding companies consisted largely of indirect regulation under the Securities Act of 1933, 15 U.S.C. §§ 77a et seq. ("Securities Act"), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. ("Exchange Act").

[8] During the period 1929-1932, for example, 16 major holding company systems produced 76.4 percent of the electric energy generated by privately-owned utility plants, and three systems produced 44.5 percent of the electric output. See FTC Report, pt. 72-A at 37. In addition, four holding company systems controlled more than 56 percent of the total natural gas pipeline mileage and 15 holding companies controlled over 80 percent. Id. at 46 (Table 14). See generally Charles F. Phillips, Jr., The Regulation of Public Utilities Theory and Practice (2d ed. 1993).

[9] Pub. L. No. 74-333, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. § 79a et seq.).

[10] FTC Report; S. Res. 83, 70th Cong., 1st Sess. (1928).

[11] Report on the Relation of Holding Companies in Power and Gas Affecting Control, H.R. Rep. No. 827, 73d Cong., 2d Sess. (6 Vol. 1933-35) (undertaken pursuant to H.R. Res. 59, 72d Cong., 1st Sess. (1932) and H.J. Res. 572, 72d Cong., 2d Sess. (1933)).

were detrimental to both investors and consumers.[12] The studies found "a number of almost inherent incidental abuses in the holding-company system which cannot be reached by direct regulation of the operating company,"[13] and concluded that "[t]he only practical control over public-utility holding companies will be one which can directly reach the holding company itself and supervise its security structure and its use of capital . . . . Only in that way can Government protect the investors who supply that capital and the consumers who must bear its cost."[14] These studies formed the factual basis for the Holding Company Act and are expressly cited in section 1(b), which sets forth the abuses addressed by the statute.[15]

These conditions and practices had a disastrous effect upon the investing public. A principal consequence of financing public-utility systems with large proportions of debt securities was a significant increase in the risk of business failure, because the fixed interest charges on debt securities must be paid, regardless of the earnings of the utility. Excessive debt-to-equity ratios were the primary cause of the bankruptcies of 53

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[12] The FTC Report listed nineteen general categories of abuses. These included: the issuance of securities to the public that were based on unsound asset values or on paper profits from intercompany transactions; the extension of holding company ownership to disparate, nonintegrated operating utilities throughout the country without regard to economic efficiency or coordination of management; the mismanagement and exploitation of operating subsidiaries of holding companies through excessive service charges, excessive common stock dividends, upstream loans and an excessive proportion of senior securities; and the use of the holding company to evade state regulation. FTC Report, pt. 73-A at 62.

[13] FTC Report, pt. 73-A, at 3 ("For example, no matter how strict the regulation of an operating company, improper payments of dividends and of other items still can be made by the holding company out of surplus other than earned surplus. Excessive capital issues can be floated by the holding company, with an important indirect effect upon rates charged by the operating company to the public.").

[14] Report of National Power Policy Committee on Public-Utility Holding Companies, S. Doc. No. 137, 74th Cong., 1st Sess. 8 (1935) (hereinafter referred to as "Report of Power Committee").

[15] Holding Company Act section 1(b). The United States Supreme Court has noted that the congressional findings as to the abuses listed in section 1(b) were based on some of the most exhaustive and comprehensive studies ever to underlie a federal statute. North American Co. v. SEC, 327 U.S. 686, 701 n.11 (1946) (upholding the constitutionality of section 11(b)(1) of the Act).

holding companies during the 1929-1936 period.[16] Twenty-three additional holding companies with publicly held securities exceeding $530 million offered readjustment or extension plans after defaulting on interest payments.[17] Investors in the holding companies lost millions of dollars. Investors in the operating company subsidiaries of the holding companies also suffered large losses.[18]

The FTC Report emphasized the unsound accounting techniques employed by holding companies. The study revealed that the combined capital assets of the 151 firms studied were written up by $1.4 billion to inflate earnings and justify dividends. Holding companies further increased their profits by providing engineering, construction, accounting and managerial services to utility operating companies, in some instances exacting profits ranging from 50 percent to over 300 percent of the actual cost of such services. The appearance of even larger profits was created by unsound accounting methods such as inadequate recognition of depreciation expenses for physical assets, recognition of income from the undistributed earnings of subsidiaries, and recognition of income from the sale of

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[16] Twentieth Century Fund, Electric Power and Government Policy 35-36 (1948); Study of Operations Pursuant to the Public Utility Holding Company Act of 1935 (hereinafter referred to as "Study of Operations"), Hearings before the Securities Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, 79th Cong., 2d Sess. 851 (1946). The aggregate capitalizations of these holding companies represented by their outstanding securities in the hands of the public totalled in excess of $1.6 billion. Study of Operations at 851.

[17] At the end of 1938, the year in which most of the holding companies registered under the Act, the public held approximately $2 billion of registered holding company preferred stock (on an involuntary liquidating basis), of which more than half were in arrears. Total arrearage as of that date was approximately $282 million. Id.

[18] From 1929 to 1936, 36 utilities with outstanding publicly held securities of $345 million went into bankruptcy or receivership. Sixteen additional companies with $154 million of outstanding publicly held securities offered readjustment or extension plans after defaulting on interest payments. Public investors, with investments in utility preferred stocks totalling approximately $1.5 billion at the end of 1938, also suffered seriously. Mismanagement and exploitation by holding companies through excessive service charges, excessive common stock dividends, upstream loans, and an excessive proportion of senior securities, were among the factors which led to an accumulation of arrears at the end of 1938 of $90 million on preferred stocks of the face amount of $412 million. Study of Operations at 851.

properties to controlled subsidiaries at amounts higher than market values.[19]

As part of the New Deal, President Roosevelt, an advocate of holding company abolition, created the National Power Policy Committee in 1934 to formulate legislative proposals. Shortly before the release of the FTC Report, the committee recommended to Congress the practical abolition of most holding companies. It recommended legislation directing a federal administrative commission to oversee "the elimination of unnecessary corporate complexities and of properties which do not fit into an economically and geographically integrated whole." The committee also recommended that a federal administrative agency undertake the following responsibilities: supervise the issuance of securities by utilities and the acquisition of new securities and properties; prevent holding companies from owning nonutility ventures; prevent electric utility and interstate gas transmission or production firms from being commonly owned; and police holding company service, sales and construction arrangements to ensure that controlled operating companies receive work performed at cost.[20]

Once the underlying studies were completed, passage of the Holding Company Act was relatively expeditious. Introduction, hearings, debate, consideration and enactment were completed in less than seven months. Despite the speed of passage, however, industry opposition was formidable.[21]

Substantially similar bills were introduced on February 6, 1935 by Senator Wheeler and Congressman Rayburn, and were referred to committees.[22] After the House and Senate held hearings,[23] the Senate

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[19] FTC Report, pt. 72-A at 496-515.

[20] Report of Power Committee at 8-12.

[21] One historian has described the events preceding the Act as "the most bitter legislative battle of [President] Roosevelt's first term." Michael E. Parrish, Securities Regulation and the New Deal 145 (1970).

[22] S. 1725, 74th Cong., 1st Sess. (1935); H.R. 5423, 74th Cong., 1st Sess. (1935).

[23] See Public Utility Holding Companies: Hearings on H.R. 5423 Before the House of Representatives Committee on Interstate and Foreign Commerce, 74th Cong., 1st Sess. (continued...)

committee reported a substitute bill, which the Senate passed with minor amendments.[24] Especially controversial was the provision for the integration and reorganization of public-utility holding companies, the so-called "death sentence" provision.[25] The House Committee made extensive changes to the bill that would have preserved the holding company systems virtually as they existed and merely subjected them to regulation.[26] The House of Representatives approved the committee's new version. The bills were sent to conference for reconciliation of the contrasting approaches.[27] The compromise reached among the Senate, House of Representatives and the President mandated the integration of public-utility operations of registered holding companies, with an allowance for the ownership of additional integrated systems under certain circumstances.[28] President Roosevelt signed the Act into law on August 26, 1935.

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[23](...continued)
(1935); Public Utility Holding Company Act of 1935: Hearings on S. 1725 Before the Senate Committee on Interstate Commerce, 74th Cong., 1st Sess. (1935). See generally Edward T. Bullock and Otto J. Wieland, Guide and Index to the Hearings on the Public Utility Act of 1935: A Cyclopedia on the Electric Light and Power, and Gas Industries (1935).

[24] See S. 2796, 74th Cong., 1st Sess. (1935); S. Rep. No. 621, 74th Cong., 1st Sess. (1935) (Report of Senator Wheeler from the Committee on Interstate Commerce) (hereinafter referred to as "Senate Report").

[25] Seligman, note 3 above, at 130.

[26] H.R. Rep. No. 1318, 74th Cong., 1st Sess. (1935) (hereinafter referred to as "House Report"); Commonwealth & Southern Corp., 11 S.E.C. 369, 377 (1942).

[27] H.R. Rep. No. 1903, 74th Cong., 1st Sess. (1935).

[28] The basic integration provision appears in section 11 of the Act, and the definition of an "integrated public-utility system" appears in section 2(a)(29) of the Act. The compromise also authorized the SEC to permit the retention of nonutility businesses if the SEC finds such retention "necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning" of the holding company system. Holding Company Act section 11(b)(1). For a description of the arguments raised in connection with the conditions for allowing holding companies to continue to exist, see Parrish, note 21 above, at 145-78.

2. Major Provisions of the Holding Company Act

Congress entrusted the SEC, the agency with expertise in financial transactions and corporate finance, with administration of the Holding Company Act.[29] The major features of the Holding Company Act as enacted in 1935 are outlined below:

- **Registration**. All holding companies must either register under section 5 of the Act or seek an exemption from the Act's provisions.

- **Definitions**. A "holding company" is generally a company that owns ten percent or more of the voting stock of a "public-utility company."[30] A "public-utility company" is an electric or gas utility company.[31] An "electric utility company" is generally a company that owns or operates facilities used to generate, transmit or distribute electric energy for sale.[32] A "gas utility company" is generally a company that owns or operates facilities used to distribute gas at retail.[33]

- **Exemptions**. The SEC must exempt holding companies that meet any of five defined categories, unless it finds the exemption "detrimental to the public interest or the interest of investors or consumers." These categories encompass any holding company that (1) operates predominantly within a single state; (2) is predominantly an operating public-utility company and operates in a single state and contiguous states; (3) is primarily not in the public-utility business; (4) is only temporarily a holding company; or (5) is not principally a public-

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[29] See Arcadia, Ohio v. Ohio Power Co., 111 S.Ct. 415, 423 (1990) (Stevens, J., concurring).

[30] Holding Company Act section 2(a)(7). The SEC has limited authority under this section to declare a company not to be a "holding company."

[31] Holding Company Act section 2(a)(5).

[32] Holding Company Act section 2(a)(3).

[33] Holding Company Act section 2(a)(4). Other defined terms include "subsidiary company" (Holding Company Act section 2(a)(8) (generally a company in which a holding company owns at least ten percent of the outstanding voting securities)) and "affiliate" (Holding Company Act section 2(a)(11)).

utility business within the United States.[34] Other sections of the Act provide more limited exemptive relief.[35]

- **Integration and Simplification.** Section 11 requires the integration and simplification of holding company systems. Section 11(b)(1) requires that each registered holding company be limited to a single "integrated public-utility system," i.e., a group of related operating properties within a confined geographic region susceptible to local management.[36] Nonutility businesses can be acquired and retained only if they are "reasonably incidental, or economically necessary or appropriate" to the operations of the integrated public-utility system.[37] Section 11(b)(2) requires the elimination of unnecessary corporate complexities and inequitable voting power among security holders.

- **Issuance and Acquisition of Securities and Assets.** Section 7 of the Act prescribes standards for the type and amount of securities for the registered holding company and its subsidiaries. In particular, section 7(d) requires that a security be reasonably adapted to the earning power of the issuing company and to the capital structure of the company and the holding-company system. Registered holding companies and their subsidiaries must also obtain SEC approval before

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[34] Holding Company Act section 3(a).

[35] See, e.g., Holding Company Act sections 3(b), 3(d), 6(b), 9(b), 9(c), 10(c)(2) and 13(b).

[36] Holding Company Act section 2(a)(29). Section 11 authorizes the SEC to permit a registered holding company to control one or more additional integrated public-utility systems if it determines that certain economies justify the control, the systems are located in adjoining states or in a contiguous foreign country, and the combination of systems will not impair management, regulation, or efficient operation. Holding Company Act sections 11(b)(1)(A) - (C).

[37] Holding Company Act section 11(b)(1). As discussed further in Part II, Chapter 3, the quoted language has been interpreted by the SEC and the federal courts to mean nonutility businesses that are "functionally related" to the utility business. See Michigan Consolidated Gas Co. v. SEC, 444 F.2d 913 (D.C. Cir. 1971); In re North American Co., 11 S.E.C. 194 (1942), aff'd, 133 F.2d 148 (2d Cir. 1943), aff'd, 327 U.S. 686 (1946).

acquiring any securities, utility assets, or any other interest in any business.[38]

- **Dual Affiliation with Public Utilities**. Any person (including an exempt holding company) who is an affiliate of a holding company or of a public-utility company, must obtain SEC approval before it becomes an affiliate of another public-utility company.[39]

- **Other Affiliate Transactions**. Registered holding companies may not borrow or receive any extension of credit or indemnity from any system public-utility company (i.e. "upstream loans").[40] The SEC also has rulemaking authority over other types of affiliate transactions such as intra-system loans;[41] declaration and payment of dividends;[42] acquisition, retirement or redemption of a company's own securities;[43] disposal of assets and securities;[44] solicitation of proxies in connection with holding company and subsidiary company securities;[45] and books, records, disclosures of interest, duration of contracts, and similar matters concerning affiliate transactions.[46]

- **Service Company Regulation**. Service, sales and construction contracts between system service companies and associate companies in the same holding company system must be performed "economically and efficiently for the benefit of such associate

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[38] Holding Company Act sections 9(a)(1) and 10.

[39] Holding Company Act section 9(a)(2).

[40] Holding Company Act section 12(a).

[41] Holding Company Act section 12(b).

[42] Holding Company Act section 12(c).

[43] Id.

[44] Holding Company Act section 12(d).

[45] Holding Company Act section 12(e).

[46] Holding Company Act section 12(f).

companies at cost, fairly and equitably allocated among such companies."[47]

- **Coordination with State Regulatory Authorities.** A major purpose of the Holding Company Act was to facilitate state regulation.[48] Section 6(b), for example, exempts the issuance of certain securities by subsidiary companies if approved by a state commission, subject to the SEC's authority to impose additional terms and conditions. Section 9(b) also exempts certain security and utility asset acquisitions from the provisions of section 10 where approved by a state commission. In addition, the SEC may not authorize the issuance of securities or the acquisition of assets unless the applicant has complied with state laws.[49]

B. Developments in the Technology and Regulation of Electric and Gas Utilities After 1935

Since enactment of the Holding Company Act, change has been the most consistent feature of the technology and regulation of electric and gas utilities. Over the past sixty years, the methods of providing energy services have changed dramatically, and federal and state governmental regulation has evolved during the same period, both in response to technological advances and as a result of enhanced regulatory expertise. This section discusses the key developments in technology and regulation.

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[47] Holding Company Act section 13(b).

[48] In characterizing section 11 as "the very heart of the title," the Senate Report noted that the purpose of that section "is simply to provide a mechanism to create conditions under which effective Federal and State regulation will be possible." Senate Report, note 23 above, at 11.

[49] Other sections of the Act that refer to state law include section 8, which relates to the ownership of electric and gas utility properties in violation of state law, and section 20(b), which requires that accounting standards established by the SEC not be inconsistent with state law. See also Holding Company Act section 18 (availability of SEC investigatory powers and information to state authorities); Holding Company Act section 19 (admission of state and local regulatory authorities to SEC proceedings); Holding Company Act section 33 (conditioning foreign utility company exemption on state certification).

1. Electricity

Electricity is a unique industrial product. Although it may be generated in a variety of ways and transmitted over long distances, it may not, under current technology, be stored feasibly or accessed even a short time after its creation.[50] Thus, the history of electricity during much of the twentieth century has revolved around the development of facilities designed to provide sufficient electricity to meet the growing demand for power. More recently, advances in the technology of generation, the benefits of pooling electricity in geographic regions, and the ability to reduce or modify demand for electricity, have caused a shift in emphasis from growth and expansion to coordinated development and industrial restructuring.

a. The Federal Power Act

The Holding Company Act was Title I of the Public Utility Act of 1935. Title II contained the Federal Power Act ("FPA"),[51] which established federal regulation of the rates, practices and operations of electric utilities operating in interstate commerce.[52] Congress enacted the Holding Company Act to prevent financial abuses among public-utility holding companies and their affiliates. It entrusted the SEC, the agency with expertise in financial transactions and corporate finance, with the task of administering the Act, primarily through monitoring affiliate transactions and eliminating potential conflicts of interest. Congress enacted the Federal Power Act to regulate the wholesale interstate sale and distribution of electricity. It entrusted administration of the FPA to the Federal Power Commission, ("FPC"), which is now the Federal Energy Regulatory

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[50] See Donald F. Santa, Jr. and Clifford S. Sikora, Open Access and Transition Costs: Will the Electric Industry Transition Track the Natural Gas Industry Restructuring?, 15 Energy L.J. 273 (1994). For a discussion of attempts to create electrical storage devices, see David L. Douglas and James R. Birk, Secondary Batteries For Electrical Energy Storage, 5 Ann. Rev. Energy 61-89 (1980).

[51] The remainder of the Public Utility Act consisted of amendments to the Federal Water Power Act.

[52] Pub. L. No. 74-333, 49 Stat. 838 (1935) (codified as amended at 16 U.S.C. §§ 791a - 828c). The Public Utility Holding Company Act was enacted as Title I of the legislation. Pub. L. No. 74-333, 49 Stat. 803 (1935).

Commission ("FERC")[53], as the agency with the technical expertise required to regulate energy transmission.[54]

The Federal Power Act responded to a gap in state regulation of utility rates and services that arose from a 1927 Supreme Court decision that interstate wholesale sales of electricity were beyond the reach of state regulation.[55] The major provisions of the FPA as enacted in 1935 are outlined below:

- **Jurisdiction**. Congress gave the FERC jurisdiction over the transmission of electricity in interstate commerce and the sale of electricity at wholesale in interstate commerce. It also gave the FERC jurisdiction over all facilities for such transmission or sale of electricity, but not over facilities (1) used for the generation of electricity, (2) used in local distribution or only for the transmission of electricity in intrastate commerce, or (3) for the transmission of electricity "consumed wholly by the transmitter."[56] Jurisdiction over retail sales is left to the states.[57]

- **Just and Reasonable Rates**. The FPA requires that all rates and charges by public utilities in connection with the transmission and sale

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[53] In 1977, the regulatory responsibilities of the FPC were transferred to the FERC, an independent regulatory commission located within the Department of Energy. For convenience, references to the FPC have been changed to the FERC, including those before 1977.

[54] See Arcadia, Ohio v. Ohio Power Co., 111 S.Ct. 415, 423 (1990) (Stevens, J., concurring); Northeast Utils., Holding Co. Act Release No. 25273 (Mar. 15, 1991), pet. for review denied sub nom. City of Holyoke Gas & Elec. Dept. v. SEC, 972 F.2d 358 (D.C. Cir. 1992).

[55] Public Util. Comm'n of R.I. v. Attleboro Steam & Elec. Co.,273 U.S. 83, 86-90 (1927), overruled in part, Arkansas Elec. Coop. v. Arkansas Pub. Serv. Comm'n, 461 U.S. 375, 390-96 (1983). See New Eng. Power Co. v. New Hampshire, 455 U.S. 331, 340 (1982). See generally Note, Federal Regulation of Holding Companies: The Public Utility Act of 1935, 45 Yale L.J. 468 (1936).

[56] Federal Power Act section 201(b), 16 U.S.C. § 824(b).

[57] Federal Power Act section 201(a), 16 U.S.C. § 824(a). See also Pacific Gas & Elec. Co. v. State Energy Resources Conservation and Dev. Comm'n, 461 U.S. 190, 205 (1983).

of electricity subject to the FERC's jurisdiction be "just and reasonable."[58] All such public utilities must file with the FERC "rates and charges for any transmission or sale subject to the jurisdiction of the [FERC], and the classifications, practices, and regulations affecting such rates and charges," as well as contracts that "in any manner affect or relate to such rates, charges, classifications, and services."[59]

- **Discrimination Prohibited**. The FPA (1) prohibits public utilities from making or granting "any undue preference or advantage to any person" and from subjecting any person to "any undue prejudice or disadvantage," and (2) prohibits public utilities from maintaining any "unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service."[60]

- **Authority to Modify Rates and Terms**. The FPA authorizes the FERC and other parties to initiate actions to modify any rate, charge, classification, rule, regulation, practice, or contract that is unjust, unreasonable, unduly discriminatory, or preferential.[61]

- **Prior Approval of Mergers and Securities Issuances**. The FPA prohibits public utilities from selling, leasing, merging or consolidating jurisdictional facilities, and from buying or acquiring securities of other public utilities, without obtaining FERC approval in advance.[62] The FPA also prohibits public utilities from issuing any security or assuming any obligation or liability as guarantor, endorser

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[58] Federal Power Act section 205(a), 16 U.S.C. § 824d(a).

[59] Federal Power Act section 205(c), 16 U.S.C. § 824d(c).

[60] Federal Power Act section 205(b), 16 U.S.C. § 824d(b).

[61] Federal Power Act section 206(a), 16 U.S.C. § 824e(a). This authority, as enacted in 1935, authorized the FERC to make such modifications prospectively, only after issuance of a final order. See Michael E. Small, A Guide to FERC Regulation and Ratemaking of Electric Utilities and Other Power Suppliers 15 (3d ed. 1994).

[62] Federal Power Act section 203(a), 16 U.S.C. § 824b(a).

or surety, without obtaining FERC approval in advance.[63] This authority over securities and assumptions of obligations, however, does not apply to public utilities organized and operating in states in which the state commission regulates security issuances.[64]

The FPA also recognized that problems might arise with overlapping jurisdiction with the SEC. Section 318 generally provides that, for certain specified matters, if a person is subject both to a requirement of the Federal Power Act (or rule or order thereunder) and to a requirement of the Holding Company Act (or rule or order thereunder), the Holding Company Act requirement will apply.[65]

Like the Holding Company Act, many of the provisions of the Federal Power Act are designed to supplement state jurisdiction and to ensure the

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[63] Federal Power Act section 204(a), 16 U.S.C. § 824c(a). If a security issuance is approved, the FPA permits the public utility to file with the SEC duplicate copies of reports filed with the FERC in lieu of reports, information, and documents required under section 7 of the Securities Act and sections 12 and 13 of the Securities Exchange Act. Federal Power Act section 204(h), 16 U.S.C. § 824c(h).

[64] Federal Power Act section 204(f), 16 U.S.C. § 824c(f).

[65] Federal Power Act section 318, 16 U.S.C. § 825q. The entire text of section 318 provides:

> If, with respect to the issue, sale, or guaranty of a security, or assumption of obligation or liability in respect of a security, the method of keeping accounts, the filing of reports, or the acquisition or disposition of any security, capital assets, facilities, or any other subject matter, any person is subject both to a requirement of the Public Utility Holding Company Act of 1935 or of a rule, regulation, or order thereunder and to a requirement of [the Federal Power Act], or of a rule, regulation, or order thereunder, the requirement of the Public Utility Holding Company Act of 1935 shall apply to such person, and such person shall not be subject to the requirement of this Act, or of any rule, regulation, or order thereunder, with respect to the same subject matter, unless the Securities and Exchange Commission has exempted such person from such requirement of the Public Utility Holding Company Act of 1935, in which case the requirements of this Act shall apply to such person.

The Supreme Court has interpreted the phrase "any other subject matter" in section 318 to refer to matters related to the acquisition or disposition of securities, capital assets, or facilities. See Arcadia, Ohio v. Ohio Power Co., 498 U.S. 73 (1990).

effectiveness of state regulation. For example, the FPA requires the FERC to "make available to the several State commissions such information and reports as may be of assistance in State regulation of public utilities" and to make rate, valuation and other experts from the FERC available to the states as witnesses.[66] In addition, the FPA requires the FERC to notify the states concerning certain events, such as an application for the transfer of jurisdictional assets,[67] and before taking certain other actions.[68] Finally, the FPA authorizes the FERC to coordinate joint action and cooperative efforts with state regulators.[69]

b. Expansion of the Electric Utility Industry

The Holding Company Act was part of a broader governmental strategy designed to encourage the provision of electricity to remote and

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[66] Federal Power Act section 209(c), 16 U.S.C. § 824h(c). In addition, with respect to certain exempt wholesale generators and affiliated holding companies, the Federal Power Act provides state commissions with access to books, accounts, memoranda, contracts and records wherever such documents may be located, in order to ensure "the effective discharge of the State commission's regulatory responsibilities affecting the provision of electric service." Federal Power Act section 201(g), 16 U.S.C. § 824(g).

[67] Federal Power Act section 203(a), 16 U.S.C. § 824b(a).

[68] See, e.g., Federal Power Act section 202(a), 16 U.S.C. § 824a(a) (before establishment of districts for the promotion of interconnection and coordination of electric utilities, the FERC "shall give notice to the State commission of each State situated wholly or in part within such district, and shall afford each such State commission reasonable opportunity to present its views and recommendations, and shall receive and consider such views and recommendations"). If a hearing is held, the Federal Power Act authorizes the FERC to admit any interested state, state commission, or municipality as a party, as well as any representatives of interested consumers or security holders, competitors and others. Federal Power Act section 308(a), 16 U.S.C. § 825g(a).

[69] See Federal Power Act section 206(b), 16 U.S.C. § 824e(b) (authorizing FERC to investigate and determine production and transmission costs for electricity from jurisdictional facilities upon request of any state commission in cases where FERC has no authority to establish a rate governing the sale of such electricity). See also Federal Power Act section 207, 16 U.S.C. § 824f (directing FERC to ensure adequacy of any public utility's interstate service "upon complaint of a State commission, after notice to each State commission . . . affected.").

underdeveloped areas of the country.[70] The Roosevelt Administration, for example, promoted the widespread development of hydroelectric power. The Tennessee Valley Authority ("TVA") Act of 1933[71] established a federal agency to oversee the construction of hydroelectric facilities along the Tennessee River Valley,[72] and over the next several decades the TVA built and sold cheap electric power from 32 major dams whose capacity totalled over 6000 megawatts.

From the 1930s to the early 1960s, the federal government promoted the construction of large dams for the generation of inexpensive electricity.[73] Government agencies were established to sell electric power from dams constructed with government oversight and funds.[74] By 1990, hydroelectric facilities generated about 10 percent of the 22.8 trillion kilowatt hours of electricity generated in the United States. The Rural Electrification Act of 1936[75] also promoted the expansion of electric

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[70] See Don E. Kash and Robert W. Rycroft, U.S. Energy Policy: Crisis and Complacency 68-69 (1984); Parrish, note 21 above, at 160-61 (1970). As a practical matter, the integration requirement of section 11 had the secondary effect of encouraging universal service through the build-out of a system's service territory and the spread of electrification to contiguous unelectrified areas, thereby complementing the work of the Tennessee Valley Authority, the Rural Electrification Administration, and the Bonneville Power Administration.

[71] 48 Stat. 58 (1933).

[72] See Tennessee Elec. Power Co. v. TVA, 306 U.S. 118, 134 (1939).

[73] For example, the U.S. Army Corps of Engineers built eight major dams along the Cumberland River Valley. The Bureau of Reclamation of the U.S. Department of the Interior initiated the construction of the massive Hoover Dam in the Boulder River Canyon.

[74] The Bonneville Power Administration, for example, was created to sell electric power from the Bonneville Dam, the Grand Coulee Dam, and other dams constructed along the Columbia River in the Northwest. See generally Bonneville Project Authority Act of 1937, 50 Stat. 731 (codified at 16 U.S.C. § 832 et seq.); Aluminum Co. of Am. v. Central Lincoln Peoples' Util. Dist., 467 U.S. 380 (1984).

[75] 49 Stat. 1363 (1936) (codified at 7 U.S.C. § 901 et seq.).

power transmission and distribution to rural residents through low-interest government loans.[76]

In part as a result of these efforts, electric power consumption in the United States doubled every decade between 1935 and 1970, and the years after the Great Depression witnessed the expansion of electric facilities across the United States. Until the late 1960s, the electric utility industry grew 7 percent annually.[77] During this period, the cost of supplying electricity declined dramatically, from 4 dollars per kilowatt-hour for U.S. consumers in 1892 to 60 cents in 1930 to only 7 cents in 1970.[78] The economic boom that followed World War II also contributed to the surge in consumption. Among other things, the post-war focus of American industry in the 1950s shifted toward the production of household electric appliances and other devices that increased consumption. The increase in electric power consumption required new technologies for its generation, transmission and distribution.

In the 1960s, an emphasis on nuclear power replaced the earlier emphasis on hydroelectric power. Nuclear power offered the promise of abundant electricity "too cheap to meter," and Congress allowed private commercial development of nuclear power in the Atomic Energy Act of 1954.[79] The first commercial nuclear power plant began operation in 1957. In 1970, nuclear power accounted for only 1 percent of all electric power generated in the United States. By 1980, it accounted for 11 percent, and by 1994 it accounted for nearly 22 percent -- more than double the amount of electricity generated in hydroelectric facilities.[80]

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[76] See Tri-State Generation & Transmission Ass'n, Inc. v. Shoshone River Power, Inc., 874 F.2d 1346, 1348 (10th Cir. 1989).

[77] Phillips, note 8 above, at 623.

[78] Christopher Flavin and Nicholas Lenssen, Power Surge: Guide to the Coming Energy Revolution 243 (1994) (figures are in 1993 dollars).

[79] 68 Stat. 919 (1954) (codified at 42 U.S.C. § 2011 et seq.). The Atomic Energy Act removed a previous prohibition on the ownership and use of nuclear materials. See English v. General Elec. Co., 496 U.S. 72, 80-81 (1990).

[80] Energy Information Administration, Monthly Energy Review 95, Table 7.1 (Mar. 1995).

In the mid-1960s the northeastern United States experienced two electric power failures that led to the creation of formal and informal power pools, which were designed to coordinate the planning and operation of power facilities. Interconnections of electric systems, along with the development of high-voltage transmission lines, allowed the transmission of periodic surpluses of electric power to areas that might experience periodic shortages. Some power pools also provided for centralized dispatch[81] of electricity and penalties to enforce compliance with pooling agreements.[82] Today power pools are an important part of the structure of the electric utility industry.[83]

In contrast to the prior emphasis on promoting and refining the development of generation and transmission arrangements, the 1970s witnessed heightened concern with the level of energy consumption. Several factors contributed to this shift. In addition to growing concern over imported oil, the environmental movement, which demonstrated its political importance with the first annual Earth Day in 1970, fostered a national dialogue on the environmental consequences of electric power generation by dams, nuclear power plants, and electric power plants that burn fossil fuels. The 1979 accident at the Three Mile Island nuclear power plant in Pennsylvania also highlighted the public health and safety hazards of commercial nuclear power.[84]

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[81] "Dispatch" refers to the assignment of power supply from generation to meet total power demand (or load). A utility's dispatching operations utilize available generators based on information about each generator such as the cost of electricity generated, maximum capacity, maintenance requirements, and environmental considerations. Public Utilities Reports, Public Utilities Reports Guide 2-28 (1992).

[82] Phillips, note 8 above, at 640.

[83] See FERC, Inquiry Concerning Alternative Power Pooling Institutions Under the Federal Power Act, Docket No. RM94-20-000 (Oct. 26, 1994).

[84] This accident and other safety concerns with nuclear power led to a dramatic decline in the construction of nuclear plants. See Edward S. Cassedy and Peter Z. Grossman, Introduction to Energy: Resources, Technology, and Society 156-63 (1990) (describing Three Mile Island and Chernobyl reactor accidents and cancellation of Shoreham nuclear plant on Long Island, New York).

These events contributed to the development of an energy conservation culture in the United States.[85] Consumers began to weather-strip homes, turn off lights when not needed, and moderate thermostats. Electric utilities implemented demand-side management ("DSM") programs in order to reduce peak demands for electricity and thereby reduce the need to construct new power plants. In response to environmental concerns that prompted the 1977 amendments to the Clean Air Act,[86] electric utilities began to search for fossil-fuel sources and new technologies that emitted less pollution.

In addition to declining energy demand, the economies of scale that favored the construction of large generating facilities began to subside in the 1970s, in part as a result of fuel-cost increases, interest-rate increases, heightened environmental and safety requirements, and intentional construction delays due to decreased demand.[87] Other technological advances allowed scale economies to be achieved by smaller size generation units.[88]

Congress sought to promote generation technologies that offered an alternative to large and increasingly inefficient electric power plants. In 1978 it enacted the Public Utility Regulatory Policies Act ("PURPA").[89] PURPA granted "qualifying facilities" ("QFs") -- predominantly

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[85] See, e.g., Energy Policy and Conservation Act, 42 U.S.C. § 6201 et seq.; Energy Conservation and Production Act, 42 U.S.C. § 6801 et seq.; National Energy Conservation Policy Act of 1978, 42 U.S.C. § 8201 et seq.

[86] 42 U.S.C. § 7401 et seq.

[87] Energy Information Administration, The Changing Structure of the Electric Power Industry 1970 - 1991 24 (Mar. 1993). Most of the increase in electric generating costs in this period are attributable to increased costs in the nuclear power industry. Id. at 33 (observing that from 1974 to 1982, nuclear plant operation and maintenance costs increased from $17 per kilowatt to almost $45 per kilowatt, in 1982 dollars).

[88] FERC, Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities & Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Dkt. Nos. RM95-8-000 & RM94-7-001, 70 FERC ¶ 61,357 (Mar. 29, 1995) ("FERC NOPR"), at 35.

[89] 92 Stat. 3117 (1978).

cogenerators[90] and small power producers[91] -- significant regulatory advantages over traditional generating facilities. Among other things, PURPA provided for the exemption of most QFs from the Holding Company Act.[92] PURPA also required utilities to purchase power from QFs at a price not greater than the utility's avoided costs, and to sell backup power to QFs.[93]

After the enactment of PURPA, other independent power producers and utility-affiliated power producers sought to compete in bulk power markets.[94] To promote the development of these sources of power supply, the FERC -- which had traditionally required cost-based rates for electric power -- authorized market-based rates for power sales where power

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[90] Cogeneration refers to a generating facility that produces electricity and another form of useful thermal energy (such as heat or steam) for industrial and commercial heating, or cooling purposes. See Energy Information Administration, Electric Power Annual 1992 171 (Jan. 1994). See also Federal Power Act section 3(18), 16 U.S.C. § 796(18).

[91] PURPA defines a small power producer as a facility that generates electricity through solar, wind, waste, or geothermal power in accordance with FERC regulations. See Federal Power Act section 3(18), 16 U.S.C. § 796(18).

[92] Most qualifying facilities are deemed to be nonutilities for purposes of the Holding Company Act. See 18 C.F.R. § 292.602.

[93] See FERC v. Mississippi, 456 U.S. 742, 751 (1982). This aspect of PURPA has proven to be controversial, particularly with regard to the requirement to purchase electricity at avoided costs, and is now the subject of repeal efforts before Congress. See S. 708, 104th Cong., 1st Sess. (1995) (repeal of PURPA section 210, 16 U.S.C. § 824a-3); FERC Ruling Fuels Fire of PURPA Repeal, The Energy Daily, May 10, 1995, at 1-2.

PURPA also authorized the FERC to order wholesale transmission services by public utilities and by certain other entities. There were significant procedural and substantive limitations on this authority, however, and FERC issued only one order pursuant to this authority. See Central Power & Light Co., 17 FERC ¶ 61,078 (1981), order on reh'g, 18 FERC ¶ 61,100 (1982), further order, Texas Util. Elec. Co., 40 FERC ¶ 61,077 (1987).

[94] Independent power producers ("IPPs") are generally single-asset generation companies that do not own transmission or distribution facilities. Affiliated power producers ("APPs") also arose to compete in this business. APPs are similar to IPPs, but are owned by or affiliated with traditional, investor-owned utilities. The utilities preferred to exclude the generators from utility rate base because of their reluctance to invest in new generating facilities under cost of service regulation.

producers lacked market power and encouraged more widely available transmission access.[95] The SEC also attempted to enable independent power producers to structure operations to avoid unnecessary burdens under the Holding Company Act.[96]

c. Recent Regulatory Developments

The most sweeping changes in recent years followed the passage of the Energy Policy Act of 1992.[97] The legislation was intended to provide a "comprehensive national energy policy" designed to increase U.S. energy security "in cost-effective and environmentally beneficial ways."[98] Among other things, the Energy Policy Act authorized the FERC to promote

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[95] See, e.g., Commonwealth Atlantic Ltd. Partnership, 51 FERC ¶ 61,368 (1990). As traditional, investor-owned utilities began to seek market-based rates for wholesale sales of excess capacity, the FERC extended its market power analysis to these companies. In applying the market-based rates to traditional, investor-owned utilities, the FERC required that the utility mitigate its transmission market power by opening its transmission system to other wholesale sellers and buyers. See, e.g., Public Service Co. of Indiana, 51 FERC ¶ 61,367 (1990). The FERC also relied on open access transmission tariffs to mitigate the anticompetitive effects of proposed mergers.

[96] See, e.g., Thousand Springs Project, SEC No-Action Letter (Feb. 1, 1989) (division of ownership interests designed to avoid ten percent ownership threshold); Ocean State Power, SEC No-Action Letter (Feb. 16, 1988) (partnership); Catalyst Energy Co., SEC No-Action Letter (Jan. 21, 1988) (limited partnership). See also Sierra Pacific Resources, Holding Co. Act Release No. 24566 (Jan. 28, 1988) (approving participation by exempt holding company in independent power production enterprise), aff'd sub nom. Environmental Action, Inc. v. SEC, 895 F.2d 1255 (9th Cir. 1990).

[97] Pub. L. 102-486, 106 Stat. 2776 (1992) ("Energy Policy Act").

[98] H.R. Rep. No. 474(I), 102d Cong., 2d Sess. 132 (1992). The goals of the legislation included the following:

> [T]o reduce the costly, impending rise in U.S. oil imports; to conserve energy and use it more efficiently; to reduce our use of oil-based fuels in our motor vehicle sector; to increase competition in the electricity, natural gas, coal renewable energy, and oil markets in order to provide new energy options and more diverse supplies; to increase the strategic oil reserves that shield us from another world oil disruption; to implement solutions to our nuclear waste and uranium enrichment problems; and to address greenhouse warming.

Id.

competition in wholesale bulk power markets by requiring companies to provide transmission services upon request if the FERC finds that such transmission would be in the public interest and would not unreasonably impair the continued reliability of affected electric systems.[99]

In addition, the Energy Policy Act facilitated the development of competition by permitting any person (including registered holding companies) to acquire "exempt wholesale generators" ("EWGs")[100] without the need to apply for or receive prior SEC approval. Congress gave the FERC responsibility to determine whether an entity may be classified as an EWG under the statute. Congress directed the SEC to adopt rules with respect to financing transactions that may have a "substantial adverse impact on the financial integrity of the registered holding company system."[101]

Following the Energy Policy Act, the FERC has engaged in a series of initiatives to encourage the development of competitive energy markets. Most recently, in March 1995, the FERC issued a notice of proposed rulemaking that would require utilities that own or control transmission facilities in interstate commerce to file tariffs under which they will provide service to third parties. The rules, if adopted, would also require such utilities to offer transmission service to eligible customers comparable to the service they provide to themselves.[102]

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[99] "Any electric utility, Federal power marketing agency, or any other person generating electric energy for sale for resale" may apply to the FERC for an order requiring a utility to provide "transmission services (including any enlargement of transmission capacity necessary to provide such services)." Federal Power Act section 211(a) (codified at 16 U.S.C. § 824j(a)).

[100] An exempt wholesale generator is exempt from all provisions of the Holding Company Act. See Holding Company Act section 32(e).

[101] Holding Company Act section 32(h). In 1993, the SEC adopted rules 53 and 54 (17 C.F.R. §§ 250.53 & 54) to protect consumers and investors from any substantial adverse effect associated with investments in exempt wholesale generators. These rules are currently the subject of litigation in the U.S. Court of Appeals for the District of Columbia Circuit. NARUC v. SEC, No. 93-1778 (D.C. Cir. filed Nov. 22, 1993; oral argument held May 11, 1995).

[102] FERC NOPR, note 88 above.

Increasingly, the FERC has played a central role in the review of utility mergers and acquisitions. At the same time that Congress gave the SEC jurisdiction to review mergers and acquisitions,[103] it also provided the FERC substantial jurisdiction over such transactions that involve utilities. The FPA requires that mergers "be consistent with the public interest,"[104] and the FERC may condition its approval of the acquisition "upon such terms and conditions as it finds necessary or appropriate."[105] In recent cases, the FERC has emphasized issues related to competition and market power as well as alleged savings from the merger.[106]

Moreover, the FERC has recently announced an expansion of its review of such transactions: a proposed merger of two public utility holding companies with electric utility subsidiary companies creates a "rebuttable presumption" of an indirect merger of the two electric utilities, and the proposed merger will require FERC approval under section 203 or rebuttal of the presumption.[107] In part as a result of the FERC's comprehensive review of utility mergers, the SEC now "watchfully defers"

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[103] See section 9(a)(1) (requiring SEC approval before registered holding company or subsidiary acquires any securities, utility assets, or any other interest in any business). As late as 1971, the acquisition of Arkansas-Missouri Power Company by Middle South Utilities, Inc., a registered holding company, required only the approval of the SEC and the Public Service Commission of Missouri.

[104] Federal Power Act section 203(a), 16 U.S.C. § 824b(a).

[105] Federal Power Act section 203(b), 16 U.S.C. § 824b(b).

[106] See, e.g., Utah Power & Light Co., 41 FERC ¶ 61,283, p. 61,752 (1987); Northeast Utilities Service Co., Opinion No. 364, 56 FERC ¶ 61,269, p. 61,998, reh'g denied, Opinion No. 364-A, 58 FERC ¶ 61,070, aff'd in part, 993 F.2d 937 (1st Cir. 1993). The FERC has also conditioned approval of mergers on the filing of open-access transmission tariffs. Utah Power & Light, 45 FERC at 61,290; Northeast Utilities, 56 FERC at 62,011-14.

[107] Illinois Power Co., 67 FERC ¶ 61,136 (1994). The order was a response to concerns with a regulatory loophole: because the FERC's historically narrow interpretation of its authority to review proposed mergers limited its review to utility mergers but not holding company mergers, utilities were able to avoid FERC review by first establishing holding companies and then merging the holding companies. See, e.g., Missouri Basin, 53 FERC ¶ 61,368, reh'g denied, 55 FERC ¶ 61,464 (1991); see also Lawrence J. Spiwak, Expanding the FERC's Jurisdiction to Review Utility Mergers, 14 Energy L.J. 385 (1993).

to the FERC as the primary federal regulator with respect to many issues involved in these transactions.[108]

Perhaps the most controversial regulatory effort currently underway at the state level is the assessment of required retail wheeling.[109] The California Public Utilities Commission is considering among other alternatives a proposal under which power customers could have direct access to all power producers and thus enjoy the right to contract with the producer of their choice.[110] Rhode Island, Wisconsin and other states have also begun to explore a possible shift to retail wheeling.[111]

2. Natural Gas

The natural gas industry developed as an incident to oil exploration, where its toxic and explosive qualities caused it to be viewed initially more as a nuisance than a resource.[112] Transportation of natural gas was also impractical until the 1920s, when it became possible to construct leakproof pipelines with electrical welds. Oil producers then began to realize that

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[108] See City of Holyoke Gas & Elec. Dept. v. SEC, 972 F.2d 358 (D.C. Cir. 1992); CINergy Corp., Holding Co. Act Release No. 26146 (Oct. 21, 1994); Entergy Corp., Holding Co. Act Release No. 25952 (Dec. 17, 1993).

[109] "Wheeling" is the electricity analogue of wholesale transmission that the FERC has required in its regulation of the natural gas industry. Mandated retail wheeling would require owners of electric transmission or distribution facilities to transmit power from third-party suppliers to customers connected to the transmission lines. See Matthew C. Hoffman, "The Future of Electricity Provision," Regulation 55-62 (1994).

[110] See Proposed Policy Decision Adopting a Preferred Industry Structure, California Public Utilities Commission File Nos. R.94-04-031 & I.94-04-032 (May 25, 1995).

[111] See David Stipp, Rhode Island Alliance Clears Guidelines To Form Open Market For Electricity, Wall St. J., May 15, 1995, at A4. In re Application of the Association of Businesses advocating Tariff Equity for Approval of an Experimental Retail Wheeling Tariff for Consumers Power Company, Michigan Public Service Commission Case No. U-10143, 150 P.U.R. 4th 409 (Apr. 11, 1994); Re Changes in the Structure of the Electric Energy Industry, Illinois Public Utilities Commission No. 94-RI (Apr. 20, 1994); Nevada Senate Bill 231 (limited retail wheeling statute designed to assist economic development); W. Garner and L. Burkhart, Wisconsin Initiates Competition Proceedings, Fortnightly, Mar. 15, 1995, at 14.

[112] David Howard Davis, Energy Politics 132-33 (4th ed. 1993). Before the advent of effective pipeline technology, natural gas was typically burned off.

natural gas, if properly controlled, was a valuable fuel source. The natural gas industry began to develop rapidly, and the consumption of natural gas increased significantly.

Before 1938, state regulatory authorities had traditionally regulated the production of natural gas due to its close relation to the production of oil, and had regulated the local distribution of natural gas as a natural monopoly. Neither the federal nor state governments regulated interstate pipelines, however, which carried gas from the wellhead to local distributors. These unregulated pipelines were therefore able to control the price and quality of gas service, to the detriment of the consuming public.[113]

a. The Natural Gas Act

In 1938, Congress passed the Natural Gas Act ("NGA"), which gave the Federal Power Commission authority over the interstate transportation of natural gas.[114] The NGA authorized the FERC to set "just and reasonable" rates for pipelines selling natural gas for resale in interstate commerce.[115] Under this act, the FERC had jurisdiction over both the price and the allocation of natural gas sold at the wellhead for resale in interstate commerce. Like the Federal Power Act, the Natural Gas Act filled a regulatory "gap" that had existed with respect to intrastate transactions and supplemented state authority through a scheme of comprehensive federal regulation of interstate transactions.

The Natural Gas Act confers authority on the FERC with respect to natural gas utilities in a manner similar to that with respect to electric utilities. The major provisions of the NGA as enacted in 1938 are outlined below:

- **Jurisdiction**. Congress gave the FERC jurisdiction over the transportation in interstate commerce of natural gas and over the sale

[113] Id. at 137.

[114] Pub. L. No. 75-688, 52 Stat. 821 (1938) (codified as amended at 15 U.S.C. §§ 717 - 717w).

[115] Natural Gas Act section 4(a), 15 U.S.C. § 717c(a). In 1954, the U.S. Supreme Court ruled that sales by independent producers were also subject to regulation under the Natural Gas Act. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

in interstate commerce of natural gas for resale. It also gave the FERC jurisdiction over companies engaged in such transportation and sales. The FERC, however, has no jurisdiction over the local distribution of natural gas, over facilities used for the local distribution of natural gas, or over the production or gathering of natural gas.[116]

- **Just and Reasonable Rates**. The NGA requires that all rates and charges by natural gas companies for interstate transportation of natural gas or for interstate sales of natural gas for resale be "just and reasonable."[117] Natural gas companies engaged in jurisdictional sales and transportation must file with the FERC schedules of all rates and charges for such sales and transportation, all classifications and practices related to such rates and charges, and all contracts related to such rates and charges.[118]

- **Discrimination Prohibited**. The NGA prohibits undue preferences or advantages, as well as undue prejudices or disadvantages, with respect to jurisdictional sales and transportation of natural gas; it also requires natural gas companies, with respect to jurisdictional sales and transportation, not to maintain unreasonable differences in rates, charges, facilities, or services.[119]

- **Modification of Rates and Terms**. The NGA authorizes the FERC to amend by order, after administrative adjudication, rates, charges, classifications, and practices relative to jurisdictional sales and transportation of natural gas that are determined to be unjust or unreasonable.[120]

- **Certificates of Public Convenience and Necessity**. The NGA requires all natural gas companies engaged in jurisdictional sales and transportation to acquire from the FERC a certificate of public

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[116] Natural Gas Act section 1(b), 15 U.S.C. § 717(b). See generally FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942) (holding NGA constitutional).

[117] Natural Gas Act section 4(a), 15 U.S.C. § 717c(a).

[118] Natural Gas Act section 4(c), 15 U.S.C. § 717c(c).

[119] Natural Gas Act section 4(b), 15 U.S.C. § 717c(b).

[120] Natural Gas Act section 5(a), 15 U.S.C. § 717d(a).

convenience and necessity for the construction or extension of facilities used for such jurisdictional sales and transportation.[121] The NGA authorizes the FERC to require natural gas companies engaged in jurisdictional sales and transportation to construct or extend facilities used for such sales and transportation if required to improve transportation or expand sales.[122]

The Natural Gas Act also contains provisions designed to enhance and ensure the effectiveness of state regulation. Among other things, the Natural Gas Act authorizes the FERC to establish joint boards for the determination of any matter arising under the Natural Gas Act,[123] to confer with state commissions regarding rate structures, costs and other matters and to hold joint hearings with state commissions,[124] and to act upon complaint or request of a state, state commission or municipality.[125] The FERC is also required to make information and reports available to state commissions.[126] Like the Federal Power Act, the Natural Gas Act allows states, state commissions, municipalities, consumer representatives, security-holder representatives and others to participate as parties in proceedings under the statute.[127]

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[121] Natural Gas Act section 7(c), 15 U.S.C. § 717f(c).

[122] Natural Gas Act section 7(a), 15 U.S.C. § 717f(a).

[123] Natural Gas Act section 17(a), 15 U.S.C. § 717p(a).

[124] Natural Gas Act section 17(b), 15 U.S.C. § 717p(b).

[125] Natural Gas Act section 5(b), 15 U.S.C. § 717d(b) (fixing rates and charges; determination of costs of production or transportation in cases where FERC lacks authority to establish rates).

[126] Natural Gas Act section 17(c), 15 U.S.C. § 717p(c) (FERC "shall make available to the several State commissions such information and reports as may be of assistance in State regulation of natural-gas companies" and "upon request from a State commission, . . . make available any of its trained rate, valuation, or other experts").

[127] Natural Gas Act section 15(a), 15 U.S.C. § 717n(a).

b. Expansion of the Gas Utility Industry

The depletion of the first natural gas wells in the Appalachian region in the twentieth century resulted in a gradual shift of focus -- first to the Midwest and next to the Great Plains and the Gulf of Mexico -- for new wells.[128] At the same time, the practical limitations on the transportation of natural gas prevented its importation from countries from which pipeline transmission was impractical.

The inability to import natural gas resulted in a focus on domestic sources. Demand for gas, however, exceeded supply. During the late 1960s and the early 1970s, the FERC restrained the wellhead price of natural gas sold in the interstate market. The price restraint encouraged consumption -- but discouraged production -- of gas sold in the interstate market. Because natural gas is a relatively clean fuel that has less environmental impact than most fossil fuels, the advent of the environmental movement in the 1970s contributed to increased demand for natural gas. The shortage of oil in the aftermath of the 1973 Middle East war also highlighted the disadvantages of U.S. dependence on imported oil and contributed to increased demand for natural gas. As a result, a series of gas shortages in the interstate market occurred in the mid-1970s.[129]

In response to these shortages, Congress enacted the Natural Gas Policy Act of 1978, which provided for partial decontrol of natural gas at the wellhead.[130] Gas supply has also become more plentiful as a result of increased imports of natural gas from Canada and Mexico.[131]

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[128] By 1992, most natural gas wells in the United States were located in Texas, Louisiana, or along the coast of the Gulf of Mexico.

[129] Meanwhile, state regulatory authorities allowed intrastate gas prices (i.e., gas produced and sold in the same state) to fluctuate more freely, thereby increasing price and supply compared to the interstate market. Some manufacturing companies relocated their operations to gas-producing states in order to gain access to ample (but more expensive) gas supply. See generally Davis, note 112 above, at 132-62.

[130] 92 Stat. 3351 (1978) (repealed in 1987). Northwest Cent. Pipeline Corp. v. State Corp. Comm'n of Kan., 489 U.S. 493, 502 (1989) ("[A]n acute shortage of natural gas during the 1970's prompted Congress to enact the Natural Gas Policy Act of 1978.").

[131] Today, Canada exports to the United States about one-half of its production of natural gas. In addition, the gas industry has developed technologies to liquefy natural gas

(continued...)

Increased supply of gas coincided with moderation in demand. The emphasis on energy conservation in the 1970s affected the natural gas industry in the same manner that it affected the electric utility industry: consumers adopted conservation techniques, and natural gas utilities, like electric utilities, implemented demand-side management programs to reduce demand.

c. Recent Regulatory Developments

Congress and the FERC have worked to encourage competition in the natural gas industry. In 1985, the FERC issued Order No. 436, which allowed pipelines to contract to transport third-party gas. The order was intended to facilitate direct sales between gas producers and local distribution companies.[132]

Deregulation proceeded further under the Natural Gas Wellhead Decontrol Act of 1989, pursuant to which the FERC implemented full producer deregulation, effective January 1, 1993.[133] In 1990, Congress enacted the Gas Related Activities Act ("GRAA"), which permits registered holding companies that own gas utilities to acquire significant production and transportation assets that do not directly serve the needs of their retail distribution systems.[134]

In 1992, the FERC issued a major deregulatory rulemaking order. Order No. 636 requires pipelines to offer "a variety of transportation services to their shippers" under a system that treats all gas equally,

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[131](...continued)
through a super-cooling process and transport it thousands of miles by ship. Liquefied natural gas thus can be imported from Algeria, for example, to the northeastern United States, which produces little of its own natural gas.

[132] Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 436, 50 Fed. Reg. 42,408 (1985).

[133] Pub. L. No. 101-60, 103 Stat. 157 (1989) (codified as amended at 15 U.S.C. § 3331).

[134] Pub. L. 101-572, 104 Stat. 2810 (1990). Gas production and transportation activities are nonutility businesses for purposes of the Holding Company Act. See Holding Company Act section 2(a)(4) ("gas utility company" includes only companies owning or controlling assets used for retail gas distribution).

whether sold or merely transported by the pipeline companies.[135] Pipeline companies could no longer treat gas purchased and resold by them more favorably in circumstances when transportation space is limited. Rather, the FERC attempted to restrict pipeline companies to the role of transporters, and to discourage them from acting as middlemen between producers and consumers.[136] Although the long-term effects of Order No. 636 remain uncertain, the order has supported the development of a direct-sale spot market for natural gas, which has contributed to greater fluctuations in gas prices.[137] There have also been costs associated with competition.[138]

3. Other Developments

Since 1935, the regulation of public-utility holding companies has been augmented under statutes other than the Holding Company Act. State commissions have strengthened the regulation of electric and gas utilities. In addition, the SEC has enhanced its regulation of issuers of securities, which issuers include public-utility holding companies, whether registered under the Holding Company Act or exempt.

a. State Regulation of Utilities

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[135] Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 636, 57 Fed. Reg. 13,267 (Apr. 16, 1992) ("Order No. 636").

[136] Id. at 13,272-75.

[137] See Comment, Reworking Relationships in the Natural Gas Industry: Exploring the New Spot Market and Its Operation, 68 Tulane L. Rev. 655, 660-63 (1994) (noting analyst comment that producers and buyers are on a "seasonal spot price roller coaster."). The Commodity Futures Trading Commission ("CFTC") has also designated natural gas as a commodity and thereby permitted the trading of futures in natural gas. See 57 Fed. Reg. 8632 (Mar. 11, 1992). See also CFTC, Division of Economic Analysis, New York Mercantile Exchange Designation Application for Natural Gas Futures (Feb. 20, 1990).

[138] For example, many producers went out of business when wellhead prices declined. See Donald F. Santa, Jr. and Patricia J. Beneke, Federal Natural Gas Policy and the Energy Policy Act of 1992, 14 Energy L.J. 1, 8 (1993). The Columbia Gas System, a registered gas utility holding company, filed for bankruptcy in large part as a result of uneconomic take-or-pay contracts.

In addition to the regulatory advances described above in the area of retail wheeling, state regulators have generally increased their powers over electric and gas utilities. In the late 1930s, courts began to narrow the applicability of the substantive due process doctrine and relax the restrictions on state regulation under previous interpretations of the Commerce Clause.[139] As a result, as the courts began to remove many of the judicial constraints on state regulatory power, many state regulators have taken a more aggressive position toward the utilities that serve their constituents. Nonetheless, some limitations remain on the ability of states to regulate utilities.[140]

Today, although regulation of electric (and gas) utilities varies among state governments,[141] most state commissions have authority to issue licenses, franchises or permits for the initiation of service,[142] for construction or abandonment of facilities and for related matters.[143] With

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[139] Regarding the narrowing of substantive due process, see, e.g., West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937) (upholding minimum wage legislation); NLRB v. Jones & Laughlin Steel Co., 301 U.S. 1 (1937) (upholding National Labor Relations Act); United States v. Darby, 312 U.S. 100 (1941) (upholding Fair Labor Standards Act); Wickard v. Filburn, 317 U.S. 111 (1942) (upholding Agricultural Adjustment Act); Lincoln Fed. Labor Union v. Northwestern Iron & Metal Co., 335 U.S. 525, 536-37 (1949) (repudiating the Lochner approach to economic substantive due process). Regarding the relaxation of the interpretation of the Commerce Clause, see Arkansas Elec. Coop. v. Arkansas Pub. Serv. Comm'n, 461 U.S. 375, 390 (1983) (quoting Illinois Natural Gas Co. v. Central Ill. Pub. Serv. Co., 314 U.S. 498, 505 (1942)).

[140] See, e.g., Mississippi Power & Light Co. v. Mississippi ex rel. Moore, 487 U.S. 354 (1988) (FERC proceeding preempted state prudence proceeding); Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953 (1986) (FERC allocation of power between two utilities for rate purposes preempted similar state determination).

[141] See generally National Association of Regulatory Utility Commissioners, Utility Regulatory Policy in the United States and Canada: Compilation 1993-1994 (1994) (covering a broad range of issues regarding state jurisdiction and regulatory policy). See also Appendix A (results of SEC survey of state regulatory commissions).

[142] See, e.g., D.C. Code Ann. § 43-501(b) (public utility must obtain order granting certificate of present and future public convenience and necessity before furnishing utility service).

[143] See, e.g., Cal. Pub. Util. Code § 761 (authority to fix rules, service to be furnished or facilities to be constructed); Ohio Rev. Code Ann. § 4905.21 (prior approval requirement for abandoning facilities).

respect to retail rates, state commissions generally have the power to require prior authorization of rate changes,[144] to suspend proposed rate changes, to prescribe interim rates[145] and to initiate rate investigations.[146] Most state commissions also have authority to control the quantity and quality of service,[147] to require uniform systems of accounting,[148] and to regulate the issuance of securities.[149] In addition, many states have enacted change-in-control statutes.[150] These statutes generally require utilities to obtain state regulatory approval before control of the utilities may be transferred to other persons.

In an attempt to assess the current regulatory environment among the states, the Division, together with the National Association of Regulatory Utility Commissioners, distributed a questionnaire that solicited responses from all state regulatory authorities. The questionnaire sought information on the current status of state regulation of utility companies in the areas

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[144] See, e.g., Fla Stat. Ann. § 366.04(1) (authority to regulate and supervise public utility with respect to rates and service).

[145] See, e.g., Fla. Stat. Ann. § 366.071 (power to authorize collection of interim rates).

[146] See, e.g., Cal. Pub. Util. Code § 729 (California "commission may, upon a hearing, investigate . . . the entire [rate] schedule . . . of any public utility").

[147] See, e.g., Cal. Pub. Util. Code § 761; Fla. Stat. Ann. § 366.04(1).

[148] See, e.g., D.C. Code Ann. § 43-509; Fla. Stat. Ann. § 366.04(2)(a).

[149] See, e.g., Ohio Rev. Code Ann. § 4905.40 (prior approval required before issuing securities). See generally Phillips, note 8 above, at 136. A compilation of state regulatory authority based on a questionnaire submitted by the SEC to state commissions is summarized in Appendix A.

[150] See Aaron W. Morse, Corporate Law I: The Constitutionality of State Insurance and Utility Takeover Statutes, 1989 Ann. Surv. Am. L. 607. The SEC has emphasized that these statutes should not be preempted by federal takeover regulation. In 1983, the SEC Advisory Committee on Tender Offers recommended that federal takeover regulation should not preempt substantive state regulation of utilities, banks, insurance companies, and similar businesses where state change-of-control provisions are justified in the overall regulatory objectives, do not conflict with federal procedural provisions, and relate to a significant portion of the issuer's business. SEC, Advisory Committee on Tender Offers, Report of Recommendations 18 (1983) (Recommendation 9(c)).

covered by the Holding Company Act.[151] With respect to securities issuances, all but three of the respondents to the questionnaire stated that they have the authority to regulate such issuances by jurisdictional utilities. The responses also indicate varying levels of states' ability to regulate acquisition and diversification activities and transactions between jurisdictional utility affiliates and various affiliated and unaffiliated entities. With respect to accounting and audit review, all respondents stated that they prescribe a uniform system of accounts and are able to access the books and records of their jurisdictional utility companies.

Many respondents, however, stated that they had no statutory authority or cooperative agreements to obtain books and records of out-of-state companies. Further, it is unclear exactly how many have authority to access the books and records of holding companies and books and records of nonutility companies including service companies. This issue is the subject of a brief follow-up survey that NARUC is currently conducting.[152]

b. SEC Securities Regulation Under Statutes Other Than the Holding Company Act

Through its administration of other federal securities laws such as the Securities Act and the Exchange Act, the SEC regulates public-utility holding companies by virtue of their status as issuers of securities.[153] The provisions of the Securities Act and the Exchange Act, and the rules the SEC has adopted under them, require the orderly disclosure of timely and

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[151] A copy of the questionnaire and a summary of the responses received by the SEC is included in Appendix A. A narrative digest of the responses of the state commissions to this questionnaire is available in the Public Reference Room of the SEC in public file number S7-32-94. As a follow-up to the questionnaire, the SEC also conducted telephone interviews with state regulatory authorities concerning certain details related to diversification activities, affiliate transactions and auditing practices. A copy of the questions and the individual responses of the state regulatory authorities to those questions is available in the Public Reference Room of the SEC in public file number S7-32-94.

[152] See Letter from Charles D. Gray, Assistant General Counsel, NARUC, to William C. Weeden, Associate Director, Office of Public Utility Regulation, Division of Investment Management, SEC (June 1, 1995) (copy in Appendix A).

[153] All 15 registered holding companies are reporting companies under the Securities Act and the Exchange Act.

accurate information about issuers of the securities and lay the foundation for efficient markets in those securities.

When Congress enacted the Holding Company Act in 1935, these laws were still in their infancy. In addition, there were doubts as to their ability to withstand constitutional scrutiny by the courts.[154] Since 1935, however, courts have upheld the validity of the statutes. In addition, Congress has amended the Securities Act and the Exchange Act several times since 1935, in order to expand and strengthen the disclosure and reporting requirements, as well as the SEC's ability to enforce these provisions.[155] Thus, investors today have greater access to information concerning their investment decisions than they had in 1935.

The three principal methods by which these securities laws provide for the disclosure of material information about securities are the registration requirements, the periodic reporting requirements, and the antifraud provisions. First, the Securities Act requires registration of every offer and sale of a security, unless an exemption from registration is available.[156] The information that is required to be filed with the SEC may vary depending on whether the issuer is a start-up business or an established, well-capitalized business that has previously filed reports with the SEC.

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[154] See, e.g., Oklahoma-Texas Trust v. SEC, 100 F.2d 888 (10th Cir. 1939) (contesting the constitutionality of the Securities Act); Coplin v. United States, 88 F.2d 652 (9th Cir. 1937) (contesting the constitutionality of the Securities Act), cert. denied, 301 U.S. 703 (1937); Wright v. SEC, 112 F.2d 89, 94 (2d Cir. 1940) (contesting the constitutionality of the Exchange Act).

[155] See, e.g., Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964) (extending Securities Exchange Act registration requirements to over-the-counter securities); Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (additional disclosure requirements in situations of control acquisitions); Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990) (increasing SEC's authority to seek and impose remedies against securities law violations).

[156] Exemptions from the registration requirements are available for specific types of securities (e.g., U.S. and state government securities, securities issued or guaranteed by U.S. banks and certain agencies and branches of foreign banks) and for specific types of transactions (e.g., private placements of securities, most resales by holders of securities on a securities exchange or in the over-the-counter market or securities issued in exchange for other securities of the same issuer).

An example of the registration of securities issuance is an initial public offering of securities by a start-up business on Form S-1. The form includes a variety of information designed to inform potential investors about the business of the issuer, including the risks and potential for future profit. Especially important are the financial statements and the sections termed "Business," "Management's Discussion and Analysis" ("MD&A") and "Use of Proceeds." The Business section includes descriptions of general business development, prior revenues, principal products, competitive conditions, and costs of regulatory compliance.[157] The MD&A section provides textual analysis of the financial statements, including descriptions of trends or known demands on liquid assets, trends or commitments of capital resources, and significant or unusual developments related to operations.[158] The Use of Proceeds section includes descriptions of the principal purposes for which funds are being raised, the order of priority of such purposes, and the identities of any businesses that are planned to be acquired with the funds raised.[159]

Second, the Exchange Act requires registration by issuers of entire classes of securities under certain circumstances in order to provide investors and the trading markets with current information about the issuer's business, management and financial condition. In general, registration is required in two cases: (1) securities listed for trading on a national securities exchange or quoted on NASDAQ[160] and (2) securities

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[157] See Sailors v. Northern States Power Co., 4 F.3d 610 (8th Cir. 1993) (no securities fraud where utility disclosed that rate increase was subject to regulatory approval).

[158] See also Securities Act Release No. 6835 (May 18, 1989), 54 Fed. Reg. 22427 (May 24, 1989) (interpretive release concerning MD&A); In re Caterpillar, Inc., Exchange Act Release No. 30532 (Mar. 31, 1992) (consent to cease and desist from future disclosure violations and to implement and maintain procedures designed to ensure compliance with MD&A requirement).

[159] SEC, Form S-1: Registration Statement Under the Securities Act of 1933. See also Frederick D. Lipman, Going Public: Everything You Need to Know to Successfully Turn a Private Enterprise into a Publicly Traded Company 66-76 (1994). Other important sections of the Form S-1 include Regulation S-K Item 103 (legal proceedings), Item 202 (description of securities), Item 304 (changes in and disagreements with accountants on accounting and financial disclosure), Item 402 (executive compensation), Item 404 (certain relationships and related transactions), and Item 503 (summary information, risk factors, and ratio of earnings to fixed charges).

[160] Exchange Act section 12, 15 U.S.C. § 78l.

held of record by 500 or more persons and issued by issuers with assets of $5 million or more.[161] Issuers with securities registered under the Exchange Act and issuers of securities under an effective Securities Act registration statement are obligated to file annual and other periodic reports.[162]

The Exchange Act and SEC rules also govern proxy solicitations and tender offers. Certain information must be provided to holders of securities registered under the Exchange Act when holders are asked to vote by proxy at meetings of security holders. The SEC's proxy rules govern the solicitation of proxies by the issuer and by persons other than the issuer, and they address when, and in what manner, shareholder proposals for matters to be voted upon at a shareholder meeting must be included in the issuer's proxy soliciting material. The Exchange Act governs the acquisition of control of an issuer through a friendly or hostile tender offer if the securities are registered under the Exchange Act. The tender offer rules are intended to ensure that shareholders receive full and fair disclosure regarding the offeror and the terms of the offer. In hostile tender offers (i.e., those opposed by the issuer's management), the rules are intended to operate in a neutral manner, favoring neither the offeror nor management. The tender offer rules provide procedural and substantive protections to facilitate shareholder deliberation and ensure equal treatment, including mandatory minimum offering periods, withdrawal rights, proration in oversubscribed offers, and "all holders" and "best price" protections.

Third, the antifraud provisions apply to all securities offered, sold or purchased, regardless of whether the securities must be registered with the SEC. These provisions prohibit the use of any "manipulative or deceptive device or contrivance" in contravention of SEC rules,[163] and prohibit the

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[161] Id.; Exchange Act rule 12g-1, 17 C.F.R. § 240.12g-1.

[162] Certain "foreign private issuers" that would otherwise be required to register under the Exchange Act (because they have 500 or more shareholders, including 300 or more shareholders in the United States, and assets of $5 million or more), but that have taken no voluntary steps to enter the U.S. market, may establish an exemption from Exchange Act registration and reporting requirements by providing the SEC copies of the documents they are required to file, make public, or deliver to shareholders in their home country. See Exchange Act rule 12g3-2(b), 16 C.F.R. § 240.12g3-2(b).

[163] Exchange Act section 10(b), 15 U.S.C. § 78j(b).

use of any "device, scheme, or artifice to defraud."[164] There are also special provisions that prohibit fraudulent conduct in connection with a tender offer.[165] The SEC has applied the antifraud provisions to combat a wide range of fraudulent conduct in connection with securities, including inadequate and misleading financial disclosures, other types of fraudulent misrepresentations, insider trading, and market manipulation. Persons injured by certain types of fraudulent conduct may also bring lawsuits against perpetrators of the fraud.[166]

The SEC has also developed extensive accounting and recordkeeping requirements under the Securities Act and the Exchange Act. Section 13(b)(1) of the Exchange Act[167] authorizes the SEC to prescribe accounting methods under which the financial statements of all publicly held companies must be prepared. Section 7 of the Securities Act[168] (and Schedule A thereunder) confers similar authority on the SEC for the financial statements included when securities are registered under that Act. The SEC's Regulation S-X[169] establishes the standardized form and content for all registration statements and reports filed pursuant to both Acts, and the SEC has expressed its views on a wide variety of accounting and auditing principles in hundreds of releases where particular issues of financial disclosure warrant more extensive discussion and analysis.

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[164] Securities Act section 17(a)(1), 15 U.S.C. § 77q(a)(1).

[165] See, e.g., Exchange Act section 14(e), 15 U.S.C. § 78n; Exchange Act rule 14e-3, 17 C.F.R. § 240.14e-3.

[166] See, e.g., Securities Act sections 11 - 12, 15 U.S.C. §§ 77k - 77l (civil liability for false registration statement, prospectus or communication); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, reh'g denied, 423 U.S. 884 (1975) (implied private right of action for securities fraud).

[167] 15 U.S.C. § 78m(b)(1).

[168] 15 U.S.C. § 77g.

[169] 17 C.F.R. § 210.

PART II. MODERNIZING ADMINISTRATION OF THE HOLDING COMPANY ACT

Part I of this study discussed the background of the Holding Company Act and the evolution of the regulation of the gas and electric utility industry under statutes other than the Act. Part II turns to the administration of the Holding Company Act, describing the history of its application and interpretation by the SEC, and outlining the Division's recommendations for reform within the framework of the Act.

Much of the tension in this area arises because, while the energy industry has changed substantially in this period, the Act has been amended significantly only once since it was passed in 1935. Although the SEC has attempted to administer the Act responsively, there are limits to the SEC's ability to respond to developments in the utility industry within the framework of the Act. Accordingly, as discussed in Part III, legislation ultimately will be needed to repeal or reform the Holding Company Act. The Division, however, recognizes the difficulties and uncertainties of the legislative process and, therefore, has developed a series of recommendations that the SEC can implement without legislation.

Part II addresses the major topics in this area: financing, utility ownership, diversification, affiliate transactions, the audit function and exemptions. The recommendations range from specific rule proposals, ready for SEC consideration at this time, to more general suggestions concerning the interpretation of the Act. Underlying the recommendations is a common theme, the need for greater flexibility and responsiveness than in the past.

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Chapter 1. Financing Transactions

A. Background

As discussed in Part I, prior to 1935, holding companies engaged extensively in financing practices that were detrimental to the customers of their utility subsidiaries and to investors in the securities issued. These abuses included issuance of securities on the basis of inflated asset values. Consumers were not protected because the states did not have an opportunity to review the transactions, and investors were harmed because they could not obtain the information necessary to make an informed investment decision. The Holding Company Act includes provisions regulating financing transactions by registered holding companies and their subsidiaries that were intended to prevent recurrence of these abuses.[1]

Section 6 of the Holding Company Act requires SEC approval of most issuances and sales of securities by registered holding companies and their subsidiaries, and section 7 establishes specific guidelines for the SEC to follow in approving such issuances and sales. Since 1935, the staff of the SEC has acted upon thousands of filings under sections 6 and 7 of the Holding Company Act, covering the issuance of billions of dollars of securities.[2]

Sections 6 and 7 also contemplate the adoption of rules and regulations by the SEC to govern terms that are not specified by the statute. Early in its administration of the Holding Company Act, the SEC adopted general rules to carry out the procedural requirements of these sections (as well as other sections of the Holding Company Act),[3] and specific rules to carry out their substantive provisions and to exempt limited types of financing.[4]

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[1] See section 1(b)(1) of the Holding Company Act.

[2] For instance, in fiscal year 1993, the SEC approved the issuance of more than $10 billion of securities by registered holding companies and their subsidiaries.

[3] The SEC's general regulations include rule 20, 17 C.F.R. § 250.20 (prescribing forms to be used for applications under section 6(b), declarations under section 7, and certificates of notification under section 6(b)); rule 22, 17 C.F.R. § 250.22 (general requirements applicable to applications and declarations); rule 23, 17 C.F.R. § 250.23 (procedures relating to notice of filing and effectiveness of applications and declarations); and rule 24, 17 C.F.R. § 250.24 (terms and conditions applicable to declarations and orders granting applications).

[4] See, e.g., rule 48, 17 C.F.R. § 250.48 (exempting from the requirements of section 6(a) the guarantee of customer evidences of indebtedness incurred for the purchase of standard electric or gas appliances and the issuance of notes secured by a pledge of such evidences of indebtedness); rule 49, 17 C.F.R. § 250.49 (exempting the issuance by a subsidiary that

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The SEC's application of sections 6 and 7, and its interpretation of the requirements of those sections, have not been static. As the utility industry and the securities markets have evolved over the years, the SEC has addressed developments both by issuing orders on a case-specific basis and by promulgating rules of general application. Most changes have been administrative, i.e., changes in the SEC's interpretation of the financing requirements of the Holding Company Act. Some recent changes, however, have been legislative in nature.[5] Since 1935, development in the utility industry has proceeded in phases, and the SEC has responded to each separate phase in the manner described below.

1. The Periods of Restructuring and Technological Refinement

After 1935, the SEC and the utility industry restructured the existing holding companies and their utility subsidiaries. This task was largely completed by 1952.[6] During the next fifteen years, the utility industry focused its attention on the development of technological advancements in engineering and power systems. During these years, the SEC formulated and enforced a number of policies and practices that not only implemented the requirements of sections 6 and 7, but also reflected the Holding Company Act's goal of simplifying the complex capital structures that had characterized holding company systems prior to its enactment. These measures included:

- **Adopting statements of policy regarding first mortgage bonds and preferred stock.** These policy statements outlined various terms required to be included in issues of such securities to satisfy the standards of section 7(d), including redemption provisions, dividend limitations, sinking and improvement fund and renewal and replacement fund provisions, and other terms for bonds; and unsecured

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[4](...continued)
is not a holding company, a public utility company, or an associate service company of securities to the vendor of supplies or equipment to be used in the business of such subsidiary); and rule 50, 17 C.F.R. § 250.50 (requiring that securities be sold by means of solicitation of competitive proposals, in furtherance of section 7(d)) (rescinded in 1994).

[5] For example, section 32 of the Holding Company Act, as amended by the Energy Policy Act of 1992, establishes standards applicable to financing of investments in exempt wholesale generators. See section 32(h).

[6] Eighteenth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1952, at 82. Annual reports of the SEC to the United States Congress are hereinafter cited as "Annual Report of [Year]."

debt limitations, voting rights, redemption provisions and other terms for preferred stock.[7]

- **Creating general standards for debt and equity as a percentage of total capitalization.**[8] The SEC established requirements for balanced capitalization ratios in order to maintain conservative capital structures that would tend to produce economies in the cost of new capital.[9]

- **Imposing limitations on types of securities issued.** In general, electric-utility holding companies issued common stock, while their subsidiaries issued preferred stock and first mortgage bonds to the public, and common stock to the parent. In contrast, gas-utility holding companies issued common stock, preferred stock and debentures to the public supported by the revenue-generating value of their utility subsidiaries. In each case, short-term borrowings were permitted as interim financing.

2. The Period of Construction Growth

From 1965 through 1979, the focus of the utility industry shifted to construction of new coal and nuclear generating facilities.[10] These construction programs generated significant external financing requirements

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[7] Statement of Policy Regarding First Mortgage Bonds Subject to the Public Utility Holding Company Act of 1935, Holding Co. Act Release No. 13105 (Feb. 16, 1956), as amended in Holding Co. Act Release No. 16369 (May 8, 1969), and Statement of Policy Regarding Preferred Stock Subject to the Public Utility Holding Company Act of 1935, Holding Co. Act Release No. 13106 (Feb. 16, 1956), as amended in Holding Co. Act Release No. 16758 (June 22, 1970) ("Statements of Policy").

[8] As a matter of regulatory policy, the SEC required that a registered holding company system and its public-utility subsidiary companies maintain a capital structure comprised of 65 percent debt and 30 percent common equity, with the remaining 5 percent preferred equity. See, e.g., Eastern Utilities Associates, 34 S.E.C. 390, 444-445 (1952), and Kentucky Power Co., 41 S.E.C. 29, 39 (1961). As discussed below, rule 52 now permits public utility subsidiary companies of registered systems to issue and sell securities without adhering to this ratio.

[9] Annual Report of 1944, at 99 ("A balanced capital structure provides a considerable measure of insurance against bankruptcy, enables the utility to raise new money most economically, and avoids the possibility of deterioration in service to consumers if there is a decline in earnings.") The SEC, at one point, considered issuing a statement of policy relative to capitalization ratios. Annual Report of 1956, at 161.

[10] See generally Hearing on H.R. 5220, H.R. 5465 and H.R. 6134, to Amend or Repeal the Public Utility Holding Company Act, before the Subcommittee on Energy Conservation and Power of the House Committee on Energy and Commerce, 97th Cong., 2d Sess. 630 (1982) (Statement of Aaron Levy, Director, Division of Corporate Regulation, Securities and Exchange Commission) ("Levy Testimony").

for utilities, resulting in increased activity under sections 6 and 7 of the Holding Company Act.[11] The SEC responded to this increased activity by:

- **Authorizing nontraditional securities in connection with financing of specific elements of new construction projects.** For instance, the SEC authorized sale-leaseback arrangements in connection with fuel handling facilities,[12] and the issuance of tax-exempt revenue bonds to finance environmental facilities.[13]

- **Approving the "budget method" for financing proposals, i.e., one filing outlining a company's total financing requirements for an extended period of time, as opposed to separate filings for each proposed transaction.** Although sections 6 and 7 refer to individual issuances of securities, the SEC always considered each transaction in the context of the company's total capital requirements over a period of time. During the late 1960s and 1970s, when utilities undertook large construction programs to prepare to meet future energy demand, their financing requirements were correspondingly large. A comprehensive approach to total financing requirements for an extended period of time reduced the number of applications, notices and orders that would otherwise have been necessary, and enabled utilities to respond more quickly to increasingly volatile securities markets.

- **Permitting departures from the conventional financing rule that electric utility holding companies issue only common stock and short-term bank indebtedness.** For instance, registered holding companies were permitted to issue medium-term debentures, commercial paper and notes.[14] Debt financing at the parent level was permitted because "[m]assive investment in plant under construction had outrun the bonding power of the operating companies and the

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[11] See, e.g., Annual Report of 1970, at 166 (noting "record volume of external financing by registered holding companies and their subsidiaries").

[12] See, e.g., Arkansas Power & Light Co., Holding Co. Act Release No. 21345 (Dec. 18, 1979) (financing of coal handling equipment at new generating station through sale and simultaneous leasing back of equipment).

[13] See, e.g., Georgia Power Co., Holding Co. Act Release No. 18088 (Sept. 12, 1973) (issuance of bonds by development authority to finance construction of pollution control facilities at generating plant). The first significant number of these transactions were authorized in fiscal 1974. Annual Report of 1974, at 118.

[14] See, e.g., General Public Utilities Corp., Holding Co. Act Release Nos. 16540 (Nov. 28, 1969) and 16550 (Dec. 8, 1969); Southern Co., Holding Co. Act Release No. 19439 (March 23, 1976); and Northeast Utilities Co., Holding Co. Act Release No. 19519 (May 7, 1976).

short-term borrowing limits of the Act. Practical limits on common stock sales left the debentures the only feasible source of financing."[15]

- **Temporarily suspending rule 50's competitive bidding requirements.** Rule 50 was suspended with respect to issuance of common stock for approximately five months because unsettled securities markets, high interest rates and high demand for new money inhibited the ability of holding companies to raise needed capital through competitive bidding.[16]

- **Modifying the redemption terms prescribed by the Statements of Policy.** The redemption provisions of the Statements of Policy were revised to permit refunding limitations for securities, reflecting then-current market conditions.[17]

- **Facilitating sale-leaseback transactions.** For some sale-leaseback transactions to be workable, it was necessary for the SEC to find that parties owning utility assets only for purposes of the financing were not "public-utility companies" under the Holding Company Act. The SEC initially made such findings on a case-by-case basis, and subsequently adopted rule 7(d) granting an exemption from the requirements of the Holding Company Act for these types of entities.[18]

- **Revisiting the appropriate mix of securities and imposing new limitations on short-term indebtedness.** During this period, companies began to increase the use of interim financing, in the form of short-term indebtedness, to continue their construction programs pending permanent financing. Because of the magnitude of these borrowings and the possible detriment to consumers if they were not repaid, the SEC began to limit the incurrence of short-term

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[15] Annual Report of 1976, at 147.

[16] Temporary Suspension of the Competitive Bidding Requirements of Rule 50 with respect to Common Stock of Holding Companies Registered under the Public Utility Holding Company Act of 1935 and Notice of Public Investigatory Hearing, Holding Co. Act Release No. 18646 (Nov. 7, 1974).

[17] Adoption of Modifications of Policies Regarding Redemption Provisions of Long-Term Debt Securities Issued and Sold Under Holding Company Act, Holding Co. Act Release No. 16369 (May 8, 1969), and Adoption of Modification of Policy Regarding Redemption Provisions of Preferred Stocks Issued and Sold under the Public Utility Holding Company Act of 1935, Holding Co. Act Release No. 16758 (June 22, 1970).

[18] Adoption of Rule 7(d) under the Public Utility Holding Company Act of 1935 to Exclude from the Definition of Ownership in Sections 2(a)(3) and 2(a)(4) the Interest of Certain Kinds of Lessors under Net Leases of Utility Facilities and Amendment of Rule 106, Holding Co. Act Release No. 17980 (May 31, 1973).

indebtedness based on the ability to repay the debt, which caused utilities to explore other means of financing new plants.[19]

3. The Move Toward Competition and Deregulation

During the 1980s, as the focus of the utility industry turned toward energy alternatives, competition and deregulation, the financing markets also underwent substantial changes, with less emphasis placed on traditional forms of financing and more creative financing alternatives available to issuers. Again the SEC responded to change by flexible interpretation and rulemaking. Examples included:

- **Relaxing the competitive bidding requirements of rule 50.** Rule 50 required registered holding companies to sell securities by means of competitive bidding and imposed strict time limits on publication of invitations for bids to purchase securities. When rule 415 under the Securities Act was adopted in 1982,[20] issuers in general had the flexibility to register large amounts of securities and to sell securities "off the shelf" on short notice. Registered holding companies and their subsidiaries were placed at a disadvantage because rule 50 made it almost impossible to sell securities on short notice. In response to this problem, and in an attempt to put registered holding companies and their subsidiaries on a more even footing with other issuers, the SEC relaxed the competitive bidding rules to permit issuers to use alternative procedures to solicit proposals for purchase on a more informal basis with less advance notice and to take full advantage of rule 415.[21]

- **Rescinding rule 50.** When the SEC determined that competitive bidding was no longer necessary to prevent abuses in the issuance and sale of securities, it rescinded rule 50.[22]

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[19] See Levy Testimony at 635-637 and cases cited therein (e.g., Georgia Power Co., Holding Co. Act Release No. 18517 (July 31, 1974) (short-term borrowings authorized only after evidentiary hearing and review)).

[20] Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (Mar. 3, 1982).

[21] Statement of Policy Concerning Application of Rule 50 Under the Public Utility Holding Company Act of 1935 (17 CFR 250.50) as Related to the Distribution of Securities Registered Under Rule 415 Under the Securities Act of 1933 (17 CFR 230.415), as Extended This Date, Holding Co. Act Release No. 22623 (Sept. 2, 1982), and Shelf Registration, Holding Co. Act Release No. 23122 (Nov. 17, 1983).

[22] Public Utility Holding Company Act Rules, Holding Co. Act Release No. 26031 (Apr. 20, 1994).

- **Approving the issuance of different types of securities.**[23] As discussed previously, through the 1970s, the focus of public financing by registered holding companies and their subsidiaries was primarily on traditional securities. In the 1980s, however, utility construction programs were scaled back; utility earnings declined due to difficulty in reflecting expensive new generating capacity in rates; there were fewer new property additions against which to issue first mortgage bonds; and rate "phase-in" plans simultaneously created new capital requirements and new types of assets for utilities. Also, the securities markets began to introduce innovative "products" that did not fit the mold of traditional financing.[24] To respond to these changes, the SEC began to permit jurisdictional companies to issue bonds on the basis of assets other than physical property, secured by second liens, and to issue non-traditional types of securities.[25]

- **Adopting rule 52 to exempt issuances of securities by public-utility companies from the requirements of sections 6 and 7 if the proceeds are to be used to finance their utility business and the issuance is expressly approved by the state commission in the state where the utility is organized and doing business.**[26] Over the years,

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[23] Section 7(c)(1) contemplates issuance of limited types of securities, including common stock and bonds secured by first liens on the physical properties of the issuer (or by an obligation of a subsidiary that is so secured) or by other assets that the SEC approves. Section 7(c)(2) permits the SEC to authorize other forms of financing.

[24] Examples include variable rate pollution control bonds, or "low floaters," and leveraged preferred stock. The SEC approved issuances of these types of securities, as noted below.

[25] See, e.g., New Orleans Public Service Inc., Holding Co. Act Release No. 24387 (May 12, 1987) (permitting issuance of rate recovery mortgage bonds, on the basis of the regulatory asset created by deferral of costs for future collection, secured, among other things, by a second lien on the utility's physical properties), and Louisiana Power & Light Co., Holding Co. Act Release No. 24072 (Apr. 28, 1986) (authorizing issuance of secured notes collateralized by a second lien and by first mortgage bonds to be issued in the future, where earnings were insufficient to support current issuance of first mortgage bonds). See also National Fuel Gas Co., Holding Co. Act Release No. 24871 (Apr. 25, 1989) (permitting a registered holding company to issue medium-term notes); Central Power and Light Co., Holding Co. Act Release No. 23095 (Oct. 24, 1983) (permitting utility subsidiary to issue leveraged preferred stock); and Connecticut Light and Power Co., Holding Co. Act Release No. 23366 (July 12, 1984) (permitting utility subsidiaries to enter into arrangements for the issuance of tax-exempt floating rate demand bonds). The SEC has also approved interest rate swaps, where one type of interest structure on debt is traded for another, e.g., fixed rate is traded for floating rate. See, e.g., General Public Utilities Corp., Holding Co. Act Release No. 25625 (Sept. 10, 1992), and Middle South Energy, Inc., Holding Co. Act Release No. 23119 (Nov. 15, 1983).

[26] Exemption of the Issuance and Sale of Certain Securities By Public-Utility Subsidiary Companies of Registered Public-Utility Holding Companies; Exemption of Acquisition of Public-Utility Subsidiary Company Securities By Registered Holding Companies, Holding Co. Act Release No. 25058 (Mar. 19, 1990).

state and local regulators increasingly have begun to regulate the issuance of securities by utilities subject to their jurisdiction.[27] Rule 52 was adopted to avoid duplicative regulation at the state and federal level and ease the regulatory burden on registered companies. Originally, use of rule 52 was also conditioned on compliance with the competitive bidding requirements of rule 50 and with the Statements of Policy, and on satisfaction of capitalization tests, among other things. These conditions have since been eliminated.[28]

- **Deviations from the requirements of the Statements of Policy.** As the securities markets have developed, the SEC has found that the Statements of Policy have become anachronistic and hinder the ability of registered companies to raise capital. As a result, the SEC has permitted more and more deviations on a case-by-case basis from the requirements of the Statements of Policy.[29] In addition, in 1992, for similar reasons, the SEC eliminated compliance with the Statements of Policy as a condition to use of rule 52.[30]

4. Intrasystem Financings

Throughout all of these periods, one type of financing -- intrasystem financing -- has created special concerns for the SEC. Prior to the Holding Company Act, companies in the same holding company system could issue securities to one another without any practical limitations or oversight by regulators and, consequently, could extract excessive interest and dividend rates that could be passed on to utility customers as costs of capital. Because

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[27] See Hearings on S. 1869, S. 1870, S. 1871 and S. 1977, to Amend or Repeal the Public Utility Holding Company Act of 1935, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong., 2d Sess. 407 (1982). A recent survey by the Division of the powers of state regulatory commissions indicates that at least 39 of the 50 states review some types of utility securities issuances. See Appendix A.

[28] See Exemption of Issuance and Sale of Certain Securities by Public-Utility Subsidiary Companies of Registered Public-Utility Holding Companies; Exemption of Acquisition of Public-Utility Subsidiary Company Securities by a Company in a Registered Public-Utility Holding Company System, Holding Co. Act Release No. 25573 (July 7, 1992).

[29] See, e.g., Georgia Power Co., Holding Co. Act Release No. 25033 (Feb. 7, 1990) (authorizing deviation from redemption provisions required by Statement of Policy for first mortgage bonds), and System Energy Resources, Inc., Holding Co. Act Release No. 24318 (Feb. 18, 1987) (authorizing charter amendment with earnings coverage requirement different from Statement of Policy for preferred stock). The Statements of Policy themselves contemplate that "deviations from these standards should be permitted in appropriate cases." Statement of Policy Regarding First Mortgage Bonds Subject to the Public Utility Holding Company Act of 1935, and Statement of Policy Regarding Preferred Stock Subject to the Public Utility Holding Company Act of 1935, note 7 above.

[30] See Holding Co. Act Release No. 25573, note 28 above.

of the absence of arms-length bargaining in such securities transactions, these types of issuances presented unique problems for the SEC in addition to the problems posed in connection with financing in general. The Holding Company Act regulates such transactions to assure that utility customers are not harmed by these intrasystem transactions.[31]

Intrasystem issuances of securities are subject to sections 6 and 7 to the same extent, and subject to the same standards and exceptions, as issuances to third parties. Sections 9 and 10 govern the acquisition of the security by the associate company. In addition to these provisions, section 12 of the Holding Company Act governs intrasystem financing transactions that may not involve issuance of a security. Section 12(a) prohibits upstream loans, extensions of credit, or indemnities from any subsidiary to the registered holding company. Rule 45(a)[32] under section 12(b) provides that a company in a registered holding company system must file a declaration and receive an order from the SEC before it may lend or extend credit to, indemnify, or make any donation or capital contribution to any company in the system.

SEC rules provide some exceptions from the filing and approval requirements. Rule 45(b)[33] excepts specified transactions from the declaration requirements of rule 45(a), including loans or extensions of credit involving securities acquisitions that are approved under or exempt from sections 9(a) and 10, extensions of credit without interest in connection with obligations in the ordinary course of business or to meet emergency requirements, limited amounts of capital contributions and open account advances without interest, failure to demand repayment of an obligation that has become due, certain limited guarantees issued in connection with surety bonds or obligations required by law, and filing of consolidated system tax returns. Rule 52[34] exempts from the filing requirements of sections 6(a), 7, 9(a) and 10 certain issuances by public-utility subsidiaries, and acquisitions by associate companies, of securities that have been authorized by a state commission. In addition, sections 32(g) and 33(c) permit acquisitions by registered holding companies of securities of exempt wholesale generators and foreign utility companies without prior SEC approval.[35]

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[31] See Chapter 4 in this Part II for a discussion of the types of potential abuses inherent in affiliate transactions and the actions taken by the SEC to prevent these abuses.

[32] 17 C.F.R. § 250.45(a).

[33] 17 C.F.R. § 250.45(b).

[34] 17 C.F.R. § 250.52.

[35] Section 33(c)(1) provides that the SEC shall promulgate rules regarding registered holding companies' acquisition of interests in foreign utility companies to protect customers of associate public utility companies and to maintain the financial integrity of the holding company system. The SEC has proposed such rules (see Proposed Rules and Forms

(continued...)

B. Recommendations for Future Regulation of Financing Transactions

The Division believes that continued SEC review of financing is unnecessary in most instances. As discussed previously, many states review utility financing transactions. In addition, the disclosure requirements of the Securities Act and the Exchange Act and the regulation inherent in the public securities markets have imposed substantial controls on financing transactions that were not present when the Act was adopted.

Accordingly, the Division is proposing to broaden the exemptions from SEC review for financings and to increase use of a "shelf" method for financing still subject to review. The effect of these actions should be to reduce significantly the number of applications requiring SEC approval and to provide more flexibility for registered holding companies and their subsidiaries. In addition, the Division is suggesting several other administrative changes, including rescission of the Statements of Policy, and a broader reading of the exemption provided in section 6(b) for issuance of short-term debt, to streamline regulation.

The SEC should promulgate rules to reduce the regulatory burdens associated with routine financings.

The Division recommends that the SEC amend rule 52 to broaden, in several respects, the exemption for routine financing by registered holding company subsidiaries. The Division also recommends amending rule 45 to remove the dollar limitation from the exception for capital contributions and open account advances from a parent to a subsidiary. These amendments were proposed in 1992, and the Division recommends their immediate adoption.

Rule 52, as originally adopted in 1990, exempted, on certain conditions, the issuance and sale of certain specified types of securities by public-utility subsidiary companies of registered public-utility holding companies from the requirement of prior SEC authorization.[36] The rule was

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[35](...continued)
Relating to Exempt Wholesale Generators and Foreign Utility Companies, Holding Co. Act Release No. 25757 (March 8, 1993)), but they have not yet been adopted. See Chapter 7, Part II, below.

[36] The conditions included, among other things, requirements that the issuance and sale are to finance the business of the public utility and are approved by the appropriate state commission, compliance with the competitive bidding requirements of rule 50 and with the Statements of Policy, and satisfaction of capitalization tests. See Exemption of the Issuance and Sale of Certain Securities By Public-Utility Subsidiary Companies of Registered
(continued...)

amended in 1992 to, among other things, expand the types of securities within the exemption to include common stock, preferred stock, mortgage bonds, or notes issued to a parent holding company (the interest rate and maturity date of which are designed to parallel a debenture or preferred stock issued by the parent holding company (the "mirror image" requirement)) and to eliminate most of the conditions to use of the rule.[37] Rule 52 also exempts from the requirement of prior SEC authorization under section 9(a)(1) the acquisition by a company in a registered holding company system of any securities issued by a public-utility subsidiary company pursuant to the rule.

The Division recommends amending rule 52 to broaden the list of debt securities that may be issued in reliance upon the exemption and to make the exemption available to nonutility subsidiaries of a registered holding company in connection with routine financing transactions. Further, the amendment would make the exemption more useful in connection with intrasystem financing, by revising the "mirror image" requirement so that the interest rate and maturity date of any debt security issued to an associate company would be designed to parallel the effective cost of capital of the associate company. The Division also recommends amending rule 45 to exempt, without any dollar limitation, capital contributions and open account advances without interest by a parent company to its subsidiary companies from the requirement of prior SEC approval.

Moreover, the Division recommends that the SEC propose and seek public comment on additional amendments to these rules. The Division recommends an additional amendment to rule 52 to exempt the issuance and sale of any security by a subsidiary company in a registered holding company system where the conditions of the rule are otherwise met. This additional change is intended to eliminate unneeded regulation of routine financings by existing subsidiaries of a registered holding company. The Division also proposes a further change to rule 45 to conform the exemption from section 12(b), which is provided by rule 45, to the exemption from section 6(a), which is provided by rule 52. Such a conforming amendment is necessary because a guaranty may require approval both as a security under section 6(a) and as an extension of credit under section 12(b).

The proposed amendments to rule 52 would exempt most routine financings by subsidiaries of a registered holding company. The rule,

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[36](...continued)
Holding Companies; Exemption of Acquisition of Public-Utility Subsidiary Company Securities By Registered Holding Companies, note 26 above, at 6-9.

[37] All conditions were eliminated except those relating to purpose of the financing and state commission approval. See Exemption of Issuance and Sale of Certain Securities by Public-Utility Subsidiary Companies of Registered Public-Utility Holding Companies; Exemption of Acquisition of Public-Utility Subsidiary Company Securities by a Company in a Registered Public-Utility Holding Company System, note 28 above, at 3-6.

however, would not cover a financing by the holding company itself, or by a utility subsidiary where the state commission has not expressly authorized the transaction.[38] These financings, which would continue to require SEC approval by order under the standards of section 7 of the Act, are generally not subject to review by any other regulator.

The SEC should endorse the use of a shelf approach for financings that are not exempted under rule 52.

A number of state and local regulators emphasize the need for continued SEC oversight of holding company financings. For example, the National Association of Regulatory Utility Commissioners ("NARUC") believes that state statutes would require amendment to provide protection for consumer interests if the SEC no longer reviews holding company financings.[39] At the same time, the registered companies ask the SEC to consider ways to streamline its review of financings that will not be exempted by rule. To balance these legitimate interests, the Division recommends a shelf approach similar to that used under the Securities Act.

Rule 415 under the Securities Act provides that a block of securities may be registered in one registration statement and issued on a delayed or continuous basis if the amount registered is reasonably expected to be sold within two years and if certain other conditions are satisfied. This "shelf registration" rule permits issuers to file a registration statement and obtain a Securities Act order prior to the time any specific transaction is contemplated, and to determine the type of securities to be issued, and consummate subsequent issuances, without regulatory delay.[40]

The procedure for regulatory approval under the Holding Company Act is more cumbersome. Under sections 6 and 7, an issuer must file a declaration describing the terms of the securities to be issued and obtain an order on those specific terms. Given the time required to file and approve a request for authorization under the Holding Company Act, the regulatory delays inherent in this process are apparent. Even using the "budget

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[38] Section 6(b) of the Act does not permit exemption of such financing from the requirement of prior SEC approval.

[39] See Comments of NARUC, Request for Comments on Modernization of the Regulation of Public-Utility Holding Companies, Holding Co. Act Release No. 26153 (Nov. 2, 1994) ("Concept Release"). Comments received by the SEC, as well as a summary of the responses, are included in public file no. S7-32-94 (hereinafter referred to as "Comments of [name]").

[40] 17 C.F.R. § 230.415.

method"[41] to expedite the approval process, the specific terms of the securities proposed to be issued must be described and separate orders on each issuance must still be obtained in most cases.

The SEC has used an approach similar to Securities Act shelf registration in some limited cases under the Holding Company Act. At present, a registered holding company can obtain current authorization for all short-term debt financings contemplated for a two-year period.[42] The SEC has also used this approach to issue orders covering multiyear periods that authorize registered holding company subsidiaries, in advance of the specific transactions, to enter into arrangements for pollution control and other similar tax-exempt financing arrangements,[43] and to issue securities by means of competitive bidding under former rule 50 (now rescinded),[44] and, more recently, for specified types of utility financing.[45] A number of commenters, including registered holding companies, regulators and others, urge the SEC to expand its use of a shelf approach modeled on rule 415 under the Securities Act.[46]

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[41] The "budget method", described above in Section A, involves filing one declaration to cover several years' financing requirements.

[42] See, e.g., Entergy Corp., Holding Co. Act Release No. 26162 (Nov. 18, 1994) (two-year authorization of issuance and sale of commercial paper and short-term notes to banks and intrasystem loans through money pool arrangements, subject to dollar limitations on principal amount outstanding, to finance registered holding company system's interim capital requirements).

[43] See, e.g., Louisiana Power & Light Co., Holding Co. Act Release Nos. 25314 (May 17, 1991) and 25320 (May 29, 1991) (authorizing entry into arrangements for issuance of pollution control revenue bonds by governmental issuers and entry into credit support arrangements by the utility, subject to overall limit on principal amount and use of approved forms of agreements, for periods up to two years). If the terms of the proposed transactions change, however, a supplemental authorization is required. See Louisiana Power & Light Co., Holding Co. Act Release No. 25834 (June 18, 1993).

[44] See, e.g., Gulf Power Co., Holding Co. Act Release No. 25894 (Sept. 27, 1993) (authorizing issuance of first mortgage bonds and preferred stock up to specified amounts through December 31, 1996, so long as the terms are within parameters specified in the order).

[45] See, e.g., West Penn Power Co., Holding Co. Act Release No. 26298 (June 1, 1995) (authorizing issuance of debentures with specified terms, subject to maximum limitations on interest rate and underwriting commissions).

[46] See, e.g., Comments of the American Gas Association ("AGA"), CINergy Corp. ("CINergy"), Consolidated Natural Gas Company ("Consolidated"), National Fuel Gas Company ("National"), Columbia Gas System, Inc. ("Columbia"), General Public Utilities Corporation ("GPU"), the Securities Regulation Committee of the New York State Bar Association ("New York Bar Committee"), the Staff of the Michigan Public Service Commission ("Michigan Commission Staff"), and the Virginia State Corporation Commission ("Virginia Commission").

The registered holding companies urge the SEC to expand the use of this approach to permit approval of a wide range of financing transactions, including those involving commercial paper, backup lines of credit, bank term loans, revolving credit loans, medium term notes, senior debentures, subordinated debt, convertible debentures, preferred stock, convertible preferred stock, common stock issuances and repurchases, and parent company guarantees or letters of credit for subsidiaries in support of normal business activities. They further recommend that the SEC lengthen the authorization period from two to a minimum of five years to reduce the regulatory burdens caused by more frequent filings. The companies also ask the SEC to require less specificity in the terms of anticipated credit facilities, bond financings, and other similar transactions prior to issuance of an order, to eliminate the need for later supplemental orders if immaterial changes in terms should occur. They note that the issuer would continue to file certificates pursuant to rule 24 with the specific terms of each issuance, so that the SEC can monitor compliance with the requirements of the Act and the order.[47]

The Virginia Commission supports the use of a shelf approach, noting that Virginia employs a similar approach for utility financings. As it said in its comments, "[t]he company then has the flexibility it needs to time its entrance into the market. At the same time, the [Commission] reviews in advance, the possible terms, conditions and impact that a proposed issue may have on the utility. The Commission is able to look at a worst case scenario to see how this may impact the [utility's] capital structure, cost of capital and its overall financial health."[48]

The Division recommends that a shelf approach be adopted that permits the issuance of orders covering blocks of securities to be sold at one time or from time to time over periods of up to five years. Similar to rule 415, such filings could relate to a wide variety of securities issuable in any combination, with general descriptions of the terms of each type of security covered. Specific terms of each issuance would be provided by a certificate filed pursuant to rule 24. The shelf approach would be consistent with, but would expand the coverage of, the Division's present procedure of issuing orders that authorize certain types of securities for multiyear periods so long as the terms fall within broad parameters stated in the order. Consumer interests would be protected because financings would continue to be measured against the standards of section 7. At the same time, this approach should address the registered holding companies' timing concerns by permitting them to select the type of securities to be issued, and price and close transactions on an expedited basis, without the need for a supplemental order approving the specific terms of each issuance.

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[47] See Comments of CINergy, Consolidated, National and Columbia, and GPU.

[48] Comments of the Virginia Commission at 5.

The SEC should rescind the Statements of Policy concerning first mortgage bonds and preferred stock.

The Statements of Policy, formulated by the staff nearly forty years ago, limit the terms used in issuances of first mortgage bonds and preferred stock by companies in registered holding company systems. The SEC has previously noted that the Statements of Policy are "anachronistic"[49] and "no longer relevant to contemporary financial markets."[50] For that reason, in 1992, rule 52 was amended to eliminate compliance with the Statements of Policy as a condition to its use.[51] The SEC has also granted numerous deviations from the Statements of Policy by order with respect to specific transactions.[52]

The Division believes that the Statements of Policy are out of date and have not kept pace with rapidly changing securities markets. They also impose on those companies in registered systems that are not eligible to take advantage of rule 52 the burden of either complying with outdated requirements that are not applicable to other issuers, or demonstrating why compliance should not be required. The Division recommends that the SEC seek public comment on the proposed rescission of the Statements of Policy.

The SEC should deem nominal par value stock to be no par value stock for purposes of determining the amount of short-term debt securities that can be issued under section 6(b) of the Act without prior SEC approval.

Section 6(b) provides an exemption from the approval requirements of sections 6(a) and 7 for the issuance, renewal or guaranty of short-term debt securities in an aggregate total of not more than five percent of the principal amount and par value of all other securities of the company then outstanding. For purposes of section 6(b), equity securities having no par value are valued at their fair market value as of the date of the issuance. The Division recommends that the SEC clarify that, for purposes of calculating the five percent limit in section 6(b) for exempt sales of short-term notes, penny

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[49] Seeking of Additional Comment on Provisions Now in Rule 52 Providing for the Exemption of the Issue and Sale of Certain Securities By Public-Utility Subsidiary Companies of Registered Public-Utility Holding Companies and Exemption of Acquisition of Public-Utility Subsidiary Company Securities By Registered Holding Companies, Holding Co. Act Release No. 25059 (March 19, 1990).

[50] Exemption of Issuance and Sale of Certain Securities by Public-Utility Subsidiary Companies of Registered Public-Utility Holding Companies; Exemption of Acquisition of Public-Utility Subsidiary Company Securities by a Company in a Registered Public-Utility Holding Company System, note 28 above.

[51] Id.

[52] See, e.g., Georgia Power Co., note 29 above.

($.01) par value, or other nominal par value, stock is equivalent to no par value stock. This clarification would result in valuation of penny par stock at its fair market value as of the date of issuance for purposes of section 6(b), and thus permit issuance of additional amounts of short-term debt without a prior SEC order for companies that utilize penny or other nominal par value stock.

At the time the Act was passed, utility holding companies were generally not capitalized with nominal or penny par value stock and the par value of stock was set to approximate fair market value. The use of nominal par value stock evolved in response to state franchise taxes that are assessed on the basis of the par value of a corporation's common stock; the greater the par value of the stock, the higher the assessment.[53] As a result of this development, companies whose common stock carries a market value far in excess of the penny or other nominal par value per share are virtually precluded from using the exemption.

The Division believes that the exemption afforded by section 6(b) was intended to be determined on the basis of the value of outstanding stock, and that penny par value and other nominal value stock is the equivalent of no par value stock for this purpose.

Other Proposals

- **Issuance of nontraditional securities.** In the case of financings that are not exempt from the requirement of SEC approval, the Division recommends that the SEC permit registered companies wider latitude to structure the types and terms of their securities to the demands of the market in order to achieve the lowest possible capital costs. The Division believes that a more flexible approach is justified by changes in the financial markets and is consistent with the proposed amendments to rule 52 that would broaden the types of securities that qualify for exemption under the rule. The SEC would continue to monitor the types of innovative securities issued by jurisdictional companies, to determine whether the risks inherent in these securities preclude approval of their issuance.[54]

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[53] See e.g., Arkansas Power & Light Co., Holding Co. Act Release No. 24520 (Dec. 8, 1987).

[54] In particular, the SEC should carefully study any proposed transactions involving potentially volatile financial instruments that are leveraged, such as certain derivatives.

- **Payment of dividends out of capital or unearned surplus.** Rule 46, under section 12(c),[55] prohibits the declaration or payment by a registered holding company or subsidiary of any dividend out of capital or unearned surplus, unless SEC approval under the Act has been obtained. In light of the dividend restrictions in state laws and governing documents and the oversight of corporate dividend practices by the financial markets and rating agencies, the Division believes that SEC review may no longer be required in all cases. Consequently, the Division recommends that the SEC study the question of whether payment of dividends out of capital or unearned surplus should be permitted in some cases without an order of the SEC, particularly with respect to the dividend policy of nonutility companies in a registered system, and consider a possible amendment to rule 46 to except such cases from SEC review.

- **Use of securities ratings as evidence of compliance with the standards of the Act.** The SEC looks to the existence of investment grade ratings by nationally recognized statistical rating organizations as a factor in the administration of some securities statutes,[56] and the use of ratings is "an important component of the SEC's regulatory program."[57] The concept release issued by the SEC in 1994 questioned whether ratings could be used to determine whether the standards of the Act have been satisfied in some circumstances. The Division believes that ratings should not be the single determinative factor in considering whether to approve a proposed transaction, but they may be useful in considering such transactions. The Division recommends that the SEC consider securities ratings in making determinations under the Act in connection with consideration of applications relating to financing, acquisitions, dividends and diversification.

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[55] Section 12(c) makes it unlawful for a registered holding company or subsidiary to pay or declare a dividend in contravention of such rules as the SEC deems necessary to protect the system's financial integrity, safeguard the working capital of utilities and prevent dividend payments out of capital or unearned surplus.

[56] See, e.g., 17 C.F.R. § 240.15c3-1 (net capital rule for broker-dealers); 17 C.F.R. § 239.13(b)(2) (instructions for Securities Act Registration Form S-3). The SEC issued a release in 1994 in which it posed questions regarding the SEC's reliance on ratings by nationally recognized statistical ratings organizations. See Nationally Recognized Statistical Rating Organizations, Securities Act Release No. 7085 (Aug. 31, 1994). Comments on the release are available for public inspection in File No. S7-23-94.

[57] Id. at 8. The SEC has also proposed mandatory disclosure of securities ratings in Securities Act and Exchange Act filings, because of their importance to investors and changes in the securities markets. See Disclosure of Security Ratings, Securities Act Release No. 7086 (Aug. 31, 1994).

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Chapter 2. Utility Ownership

A. Background

As discussed previously, holding company systems dominated the United States electric and gas utility industry by 1935. The properties acquired by these vast combinations were often geographically and economically unrelated to one another, as acquisitions were often motivated by the profits to be gained by promoters and investment bankers, and were made at inflated prices, financed by the issuance of securities to the public.[1] Congress found that the national public interest and the interest of investors and consumers were adversely affected by "the growth and extension of holding companies [that] bear no relation to economy of management and operation or the integration and coordination of operating properties."[2]

To address this problem, the Holding Company Act requires the simplification and integration of holding company systems. Section 11(b)(1) directs the SEC to take action to limit the operations of each registered holding company system to a single integrated public-utility system.[3] Section

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[1] Annual Report of 1944, at 84.

[2] Section 1(b)(4) of the Act. See H.R. Conf. Rep. No. 1903, 74th Cong., 1st Sess. 68 (1935). See generally North American Co. v. SEC, 327 U.S. 686, 704 (1946); Douglas, Scatteration v. Integration of Public Utility Systems, 24 A.B.A. J. 800 (1938). See also United Gas Improvement Co. v. SEC, 138 F.2d 1010, 1019 (3d Cir. 1943).

[3] See Senate Report at 11. Under the Act, an integrated public-utility system, as applied to electric utility companies, means:

> 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.

Section 2(a)(29)(A).

As applied to gas utility companies, it means:

> a system consisting of one or more gas utility companies which are so located and related that substantial economies may be effectuated by being operated as a single 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 operations, and the effectiveness of regulation: Provided, That gas utility companies deriving

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11(b)(2) similarly requires the SEC to eliminate needless complications from the corporate structures of registered holding companies, and to ensure the equitable distribution of voting power among security holders.[4] The legislative history explains that "the purpose of section 11 is simply to provide a mechanism to create conditions under which effective Federal and State regulation will be possible. It is therefore the very heart of the title, the section most essential to the accomplishment of the purposes set forth in the President's message [recommending the legislation]."[5]

Enforcement of the Act was not intended to eliminate the holding company as a viable corporate device in the public utility field. Indeed, the Act expressly permits a holding company that meets the standards of the Act to function and develop as a regional system.[6] Congress intended these provisions "to give the Commission supervision over the future development of utility-holding company systems so that the systems will be subjected to the limitation of geographic and economic integration laid down in section 11."[7]

Section 9(a)(1) requires prior SEC approval under the standards of section 10 for the acquisition of "any securities or utility assets" by a registered holding company or its subsidiary; section 9(a)(2) requires approval for the acquisition of any security of any public-utility company by "any

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[3](...continued)

> natural gas from a common source of supply may be deemed to be included in a single area or region.

Section 2(a)(29)(B).

As discussed in footnote 19 below, the SEC may permit a registered holding company to control more than one integrated public-utility system in certain circumstances.

[4] Section 11(b)(2), among other things, requires the elimination of unnecessary and "great-grandfather" holding companies, the reorganization of holding companies which are overcapitalized, and the redistribution of voting power among security holders of holding companies and operating companies.

[5] See Senate Report at 11.

[6] See Senate Report at 30; House Report at 15. See also sections 9 and 10 of the Act, governing acquisitions of utilities and utility assets.

[7] Senate Report at 30. See also House Report at 16 (section 10 was intended to prevent acquisitions that would be "attended by the evils which have featured the past growth of holding companies"), cited in American Electric Power Co., Inc., 46 S.E.C. 1299, 1306 (1978).

person" who is, or will by virtue of an acquisition become, an affiliate of two or more public-utility companies.[8]

Section 10, in turn, directs the SEC to consider the potential anticompetitive effects of a utility acquisition, the adequacy of the consideration, and the effect of the acquisition upon the system, the public interest and the interest of investors and consumers. The SEC must also be satisfied that there is compliance with relevant state laws. In addition, under section 10(c)(1), the SEC cannot approve an acquisition that "is unlawful under the provisions of section 8 or detrimental to the carrying out of the provisions of section 11," and, under section 10(c)(2), the SEC must find that a proposed acquisition "serve[s] the public interest by tending towards the economical and efficient development of an integrated public-utility system."[9]

In its first year of the administration of the Holding Company Act, the SEC stated that "[t]he general policy of the Commission in administering this legislation is to give full effect to the Congressional intent of preventing the repetition of the abuses which led to the passage of the Act and to make the administration of the law as workable as possible without imposing restrictions of a kind which bear no relationship to the purposes to be achieved."[10]

1. The Restructuring of the Industry

A major part of the SEC's work during the first decades following the passage of the Holding Company Act involved the reorganization and simplification of holding company systems required by section 11 of the Act. All holding companies were required to register with the SEC and to comply with the Act.[11] There was a three year phase-in period during which companies instituted a number of unsuccessful legal challenges to the Act. In

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[8] For purposes of section 9(a)(2), an "affiliate" is any person that directly or indirectly owns 5% or more of the outstanding voting securities of a public-utility company.

[9] The requirement of benefits to an integrated system does not apply to the acquisition of securities or utility assets of a public-utility company operating exclusively outside the United States. <u>See</u> <u>Southern Co.</u>, Holding Co. Act Release No. 25639 (Sept. 23, 1992) (permitting acquisition of foreign utility operations by registered holding company). The order is discussed below.

[10] <u>Annual Report of 1936</u>, at 35.

[11] Section 11(e) permits the filing of voluntary plans for compliance with the standards of section 11(b) while section 11(d) permits recourse to the courts if necessary to enforce the SEC's orders. The Act requires SEC approval of all plans, whether voluntary or involuntary, for the reorganization of registered holding companies or their subsidiaries. <u>See</u> <u>generally</u> <u>Annual Report of 1939</u>, at 72-73.

1938, the Supreme Court upheld the constitutionality of the registration provisions of the Act.[12] Thereafter, the SEC's work began in earnest.[13]

Early decisions focused on section 11's integration requirement, described by the SEC as a specialized antitrust provision designed to address the serious and uneconomic concentration of control of public-utility companies.[14] Under section 11(b)(1), the SEC required divestiture of utility properties that did not contribute to an integrated system, as well as nonutility subsidiaries that were not reasonably incidental or economically necessary to utility operations.[15] Questions arose concerning, among other things, the permissible size of a system and the ownership of both gas and electric operations by a single holding company.

With respect to size, the SEC looked primarily to the effect on localized management and the effectiveness of regulation.[16] With respect to combination systems, the SEC first held that gas and electric properties could constitute a single integrated system,[17] then, in a series of subsequent decisions, abandoned this position, finding that a combination of gas and electric properties does not constitute a single integrated utility system within

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[12] Electric Bond & Share Co. v. SEC, 303 U.S. 419 (1938). See also North American Co. v. SEC, note 2 above (upholding constitutionality of section 11(b)(1) integration provisions), and American Power Company v. SEC, 329 U.S. 90 (1946) (upholding constitutionality of section 11(b)(2)).

[13] See Annual Report of 1941, at 73 (the SEC initiated integration proceedings against nine systems and simplification proceedings with respect to three more).

[14] Annual Report of 1944, at 87.

[15] Id. at 89-90.

[16] See, e.g., American Gas & Electric Co., 22 S.E.C. 808 (1946). In denying a request for acquisition, the SEC concluded that "the substantially enlarged group of properties that would result from the acquisition . . . cannot be found to be 'not so large as to impair . . . the advantages of localized management and the effectiveness of regulation.'" Id. at 816-17. One Commissioner dissented, stating that "we cannot deny this application by general appeals to the evils of bigness without particular reference to the specific standards of the Act." Id. at 819.

[17] See American Water Works and Electric Co., 2 S.E.C. 972 (1937). The SEC reasoned that "[n]o specific mention is made in the definition of an integrated public utility system concerning a combined gas and electric system," and held that "it is proper to regard such a combined property as a single integrated system, provided that all of the electric properties are integrated and all of the properties, both gas and electric, are in fairly close geographic proximity and are so related that substantial economies may be effectuated by their coordination under common control." Id. at 983.

the meaning of the Act.[18] As a result, companies seeking to retain gas, as well as electric, properties were required to satisfy the "additional system" standards set forth in the (A), (B) and (C) clauses of section 11(b)(1).[19]

2. The Transition Period

By 1952, the SEC reported that the task of bringing about compliance with section 11 "is rapidly nearing completion."[20] The liquidation of unnecessary holding companies with the return of their subsidiaries to independent ownership, and the streamlining of a number of others into compact regional systems offering the benefits of large scale centralized generation and transmission of electric power and of integrated long distance transmission and distribution facilities for natural gas had revitalized the industry.[21]

The challenges of the post-reorganization period involved the development of parameters for the future structure of the industry, particularly in light of changing circumstances. The SEC's application of the integration requirement generally recognized such changes. The SEC noted that holding companies hoping to expand their systems, and to justify their continuing existence, would have to do more than simply establish physical interconnections among their subsidiary companies. The SEC stated, "[t]here must be a realization of important economic and engineering benefits obtainable only by the knitting together of a compact group of operating properties having basic functional relationships with one another. In addition,

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[18] Philadelphia Co., 28 S.E.C. 35, 44 (1948), citing Columbia Gas and Electric Corp., 8 S.E.C. 443 (1941); United Gas Improvement Co., 9 S.E.C. 52 (1941); North American Co., 11 S.E.C. 194 (1942); Engineers Public Service Co., 12 S.E.C. 41 (1942). The SEC reasoned that the Act separately defines "integrated public-utility system" for electric utility companies and for gas utility companies and, so doing, prescribes different standards which preclude the possibility of a definition that could be applicable to a combined system.

[19] Under the A-B-C clauses, the SEC shall permit a registered holding company to retain an additional integrated system if the additional system cannot be operated as an independent system without the loss of substantial economies, the additional system is located in one or adjoining states or a contiguous country, and the combination of such systems under the control of a single holding company is not so large as to impair the advantages of localized management. The SEC construed these clauses restrictively to require a showing of "substantial hardship to investors and consumers were its relationship with the holding company terminated," Philadelphia Co., note 18 above, at 46, cited in SEC v. New England Electric System, 384 U.S. 176, 181 (1966), and to require that additional systems be located in states contiguous to that of the principal system, Engineers Public Service Co., 9 S.E.C. 764, 774-87 (1941), rev'd and remanded on other grounds, Engineers Public Service Co. v. SEC, 138 F.2d 936 (D.C. Cir. 1943), vacated as moot, 332 U.S. 788 (1947).

[20] Annual Report of 1952, at 82.

[21] Id.

the parent holding companies must be in a position to furnish sound and constructive assistance to their operating subsidiaries in the financing of expansion programs."[22]

The types of proposed acquisitions, and the technologies used, changed in the 1950s and 1960s. Companies increasingly sought SEC approval for joint ownership of large generating and other utility facilities outside of their service territories. The SEC responded flexibly to these new circumstances. Thus, in 1955, the SEC authorized a proposal by 12 utilities located throughout New England for the acquisition and financing of a pioneering atomic power plant to be constructed in Massachusetts.[23] Thereafter, in 1963, the SEC authorized a similar proposal relating to the construction of a nuclear-powered generating plant.[24] The SEC also applied a liberal reading of the integration requirement in a line of utility acquisition decisions, related to the development of nuclear power and the concern with national security in the post-World War II era, in which registered holding companies and unaffiliated utilities formed generating companies to furnish power to Atomic Energy Commission installations.[25]

The SEC also signaled a more flexible application of the integration requirement when it approved an acquisition that it had denied in 1946 because the resulting system was too large.[26] In reversing its position, the SEC noted that "the determination of whether to permit enlargement of a

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[22] Annual Report of 1951, at 92.

[23] Yankee Atomic Electric Co., 36 S.E.C. 552 (1955). The SEC found the coordination requirement of section 2(a)(29) satisfied because each system could absorb its full share of plant output, as set by a predetermined schedule, and because operating necessity or technological developments would determine when the plant would be serviced, modified or retired.

[24] Connecticut Yankee Atomic Power Co., Holding Co. Act Release No. 14947 (Sept. 26, 1963). Again, the company's capital stock would be owned in various proportions by a group of 12 New England utility companies, including subsidiaries of certain registered holding companies. The SEC found that the integration requirement was satisfied because the New England transmission grid already interconnected the various owner companies. Connecticut Yankee Atomic Power Co., 41 S.E.C. 705, 710 (1963). See also Electric Energy, Inc., 38 S.E.C. 658, 669 (1958) (holding that direct interconnection not required in circumstances which would have resulted in an uneconomic duplication of transmission facilities).

[25] See Central Illinois Public Service Co., 32 S.E.C. 202 (1951); Ohio Valley Electric Corp., 34 S.E.C. 323 (1952), and Electric Energy, Inc., note 24 above (finding standards of section 10 satisfied in connection with the acquisition by registered holding company systems of the capital stock of a generating company formed to supply power to a plant built by the Atomic Energy Commission); Mississippi Valley Generating Co., 36 S.E.C. 159 (1955) (Congress intended the concept of integration to be flexible).

[26] American Electric Power Co., Inc., note 7 above.

system by acquisition is to be made on the basis of all the circumstances, not on the basis of preconceived notions of size."[27] The SEC specifically noted that technological developments between 1946 and 1978, including the increased size of generating units and improved transmission of electricity over greater distances, justified larger systems than had been permitted in earlier years.[28]

The SEC continued its restrictive interpretation of the ownership by a registered holding company of combined gas and electric systems. In 1966, the U.S. Supreme Court upheld the SEC's interpretation of the standards for retention of combination systems.[29] As noted previously, the SEC narrowly construed clause (A) of section 11(b)(1) to require that the additional system, if separated from the principal system, would be incapable of independent economic operation.[30] Although this interpretation was ultimately sustained by the U.S. Supreme Court, two justices dissented, contending that the test formulated by the SEC was at odds with the wording of the Act, had little basis in the statutory history or aims of the Act, and could not be sustained by agency or judicial precedent.[31] Nevertheless, the SEC has required registered holding companies seeking ownership of combined gas and electric properties to satisfy the A-B-C clauses.[32]

The SEC's treatment of the ownership of combined properties by exempt holding companies, however, has been less consistent. Section 11's integration provisions apply only to registered holding companies. In early

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[27] Id. at 1309.

[28] Id. at 1309-10.

[29] SEC v. New England Electric System, note 19 above, at 185. See also SEC v. New England Electric System, 390 U.S. 207 (1968).

[30] New England Electric System, 41 S.E.C. 888 (1964) (having determined that this showing was not made, the SEC required divestiture of the gas properties of an electric registered company). The SEC rejected the state's arguments in favor of retention, reasoning that the standards of section 11, concerning retention of additional systems, should not yield to the views of state or local authorities. See id. at 902 (section 8, concerning the acquisition of additional systems, "does not relate to the divestment of properties under the policy embodied in Section 11(b)(1)").

[31] SEC v. New England Electric System, note 19 above, at 186 (Harlan, J. and Stewart, J., dissenting). Among other things, the dissenting justices described as "an illusion" the majority's perception of a policy in the Act against common control of gas and electric utility systems with its danger of stifled competition, and emphasized that "Congress' own careful compromise of the various conflicting policy interests" mandated the need for proof that freeing a gas system from control by an electric system will improve earnings by some extent. Id. at 190-91.

[32] See UNITIL Corp., Holding Co. Act Release No. 25524 (Apr. 24, 1992) (approving acquisition of gas properties as additional system under the A-B-C clauses).

cases involving requests for exemption from registration, the SEC found that exempt holding companies did not have to meet the strict requirements of the integration requirements.[33] Following the Supreme Court's decision in New England Electric System, however, the SEC reconsidered this view and, in 1970, denied a request by a combination gas and electric utility company and an exempt holding company for authorization to acquire another such company and remain exempt.[34] Four years later, the SEC revisited these issues and, granting an exemption, approved an acquisition in which an exempt holding company with gas and electric properties acquired another combination company.[35] Finally, the SEC came full circle and once again determined that section 11 was not applicable to exempt holding companies' ownership of combination properties.[36]

Also during this period, the SEC approved the formation of one new registered holding company, Northeast Utilities,[37] and denied the application for formation of another.[38]

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[33] Eastern Gas and Fuel Associates, 30 S.E.C. 834, 848-49 (1950).

[34] Illinois Power Co., 44 S.E.C. 140 (1970). The SEC also based its denial of the exemption on anticompetitive grounds, and approved the acquisition subject to divestment of the gas properties. Id. at 145.

[35] Union Electric Company, 45 S.E.C. 489 (1974), aff'd without opinion sub nom., City of Cape Girardeau v. SEC, 521 F.2d 324 (D.C. Cir. 1975). The SEC invoked the then-current energy crisis in approving the application, but retained jurisdiction over whether the gas companies could be retained.

[36] WPL Holdings, Inc., Holding Co. Act Release No. 24590 (Feb. 26, 1988), aff'd in part and rev'd in part sub nom., Wisconsin's Environmental Decade, Inc. v. SEC, 882 F.2d 523 (D.C. Cir. 1989), reaffirmed, Holding Co. Act Release No. 25377 (Sept. 18, 1991). The SEC stated that "we do not believe that the pro-competitive thrust of the Act expresses an absolute Federal policy against combination gas and electric operations." WPL Holdings, Inc., Holding Co. Act Release No. 24590. Relying on advice from the Wisconsin Public Service Commission that it could adequately regulate combined gas and electric operations, the SEC found that the "affirmative state regulation" evidenced that retention of the combined properties would not be detrimental to the public interest or the interest of investors or consumers. Id.

[37] Northeast Utilities, 42 S.E.C. 963 (1966). One of the system utilities distributed natural gas as well as electricity at retail. The SEC approved the acquisition only with respect to the electric utility operations. Jurisdiction was reserved over the question of retention of the gas properties and any nonutility operations. Id. at 968. The gas properties were ultimately spun off to a new gas holding company. See Northeast Utilities, Holding Co. Act Release No. 24908 (June 22, 1989).

[38] In 1968, two registered holding companies, New England Electric System and Eastern Utilities Associates, and a nonassociate electric utility company, Boston Edison Company, applied unsuccessfully for authorization to form a new registered holding company. See New England Electric System, 45 S.E.C. 684 (1975). The resulting holding company would have controlled nearly 40 percent of total New England generating capacity, making (continued...)

3. Consolidation and Disaggregation

In recent years, the gas utility industry has undergone fundamental restructuring, largely in response to legislative and regulatory initiatives. During this period, the first steps toward disaggregation of the electric utility industry have begun. Since 1980, due in part to increasing costs, electric companies have largely ceased construction of new generating units and have been increasing their operations and supply sources through merger and acquisition. Independent power projects have developed, and many companies find it more economic to purchase power than to produce it from new sources. At the same time, traditional utilities have evolved into energy companies that provide a wide range of energy-related services to their consumers.

This process of change was reflected in the SEC's approach to utility acquisitions. A number of the SEC's major decisions involving mergers and acquisitions reveal the extent to which FERC jurisdiction had evolved in this area and the SEC's increasing recognition that mergers and acquisitions were reviewed by the FERC and other federal and state regulators. Indeed, in reviewing a registered holding company's proposed utility acquisition, the SEC looked to the FERC for its expertise in certain operational issues.[39] In particular, the SEC believed it proper to rely upon the FERC's resolution of the anticompetitive problems at issue in the matter -- the combined entity's control of key transmission facilities and of surplus power -- because the expertise and technical ability for regulating energy transmission lie with the FERC.[40] The Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") affirmed the SEC's decision, stating that "when the SEC and another regulatory agency both have jurisdiction over a particular transaction,

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[38](...continued)
it by far the largest electric system in New England and a dominant participant in the New England Power Pool ("NEPOOL"). The SEC did not read section 10(b)(1) of the Act as necessarily precluding its approval but instead, found insufficient evidence of savings as a result of the proposed transactions. The applicants had not presented savings that might accrue through the NEPOOL agreement. See id. at 691.

[39] Northeast Utilities, Holding Co. Act Release No. 25273 (Mar. 15, 1991), modifying Holding Co. Act Release No 25221 (Dec. 21, 1990), aff'd sub nom. City of Holyoke v. SEC, 972 F.2d 358 (1992) (Northeast Utilities acquisition of Public Service Company of New Hampshire approved). See also Sierra Pacific Resources, Holding Co. Act Release No. 24566 (Jan. 28, 1988), aff'd sub nom. Environmental Action Inc. v. SEC, 895 F.2d 1255 (9th Cir. 1990).

[40] Under section 203 of the Federal Power Act, the FERC "shall approve" a merger if it is "consistent with the public interest." In its determination, the FERC must consider the anticompetitive consequences of the proposed transaction. See Gulf States Utilities Co. v. FPC, 411 U.S. 747, 758 (1973).

the SEC may 'watchfully defer' to the proceedings held before -- and the result reached by -- that other agency."[41]

The SEC has continued to look to the FERC's resolution of certain anticompetitive issues. In a matter involving the acquisition of Gulf States Utilities Company by Entergy Corporation, the SEC relied on Entergy's FERC-approved "open access" transmission tariff to mitigate any increase in market power resulting from the proposed combination.[42] Problems with this approach became evident when the underlying FERC order was reversed and remanded by the D.C. Circuit.[43] In consequence, the appeal from the SEC orders was remanded to allow the SEC to supplement or modify its record concerning the competitive effect of the acquisition.[44]

The SEC also expanded its interpretation of whether systems were, or could be, integrated and thereby satisfy the integration requirement. Specifically, in the Northeast decision, the SEC found that the combined electric system would satisfy the Act's integration requirements, even though the transmission lines of the two utilities were interconnected through the lines of a nonaffiliated utility.[45] A year later, the SEC authorized the formation of a new registered holding company, whose utility operations would be interconnected through a power pool.[46] In each decision, however,

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[41] City of Holyoke Gas & Electric Department v. SEC, note 39 above, at 363, citing Wisconsin's Environmental Decade v. SEC, note 36 above, at 526-27 ("we are not prepared to say that the Commission abdicates its duty in an exemption determination by deciding to rely, watchfully, on the course of state regulation").

[42] Entergy Corporation, Holding Co. Act Release No. 25952 (Dec. 17, 1993), request for reconsideration denied, Holding Co. Act Release No. 26037 (April 28, 1994), remanded sub nom. Cajun Electric Power Cooperative, Inc. v. SEC, 1994 WL 704047 (D.C. Cir.).

[43] The open-access tariff provides access to Entergy's bulk transmission system for utilities, electric cooperatives and wholesale power sellers at a single cost-based rate. In orders dated March 3, 1992 and August 7, 1992, the FERC held that with the tariff in place, Entergy had no market power in its relevant geographic market (first tier entities) or product markets (bulk power and transmission) and authorized Entergy to sell power at market-based rates. Entergy Services, Inc., 58 FERC ¶ 61,234 (1992), order on reh'g, 60 FERC ¶ 61,168 (1992). After the SEC issued its order, the Court of Appeals found that the FERC had failed to address adequately the impact of the open access tariff on Entergy's market power, and so remanded that matter. Cajun Electric Power Cooperative Inc. v. FERC, 28 F.3d 173 (D.C. Cir. 1994).

[44] Cajun Electric Power Cooperative, Inc. v. SEC, 94-1112 (Nov. 16, 1994), 1994 U.S. App. LEXIS 36626.

[45] Northeast Utilities, Holding Co. Act Release No. 25221 (Dec. 21, 1990).

[46] UNITIL Corporation, note 32 above. Although there would be no particular line through which transfers of power would be made among the system utilities, the SEC found that participation of the UNITIL utility subsidiaries in NEPOOL would satisfy the requirement
(continued...)

the SEC stated that contract rights cannot be relied upon to integrate two distant utilities.[47]

The ownership of combined gas and electric operations by a registered holding company continued to raise questions. Generally, combination systems were approved where the standards of the A-B-C clauses of section 11(b)(1) were met.[48]

This period was also one in which the profile of the industry -- historically dominated by vertically-integrated, investor-owned utilities controlling generation, distribution and transmission facilities -- began to change. As discussed previously, PURPA opened the door to new participants in the production of electric energy. As this nontraditional industry grew, developers increasingly sought to construct, own and operate other types of independent power projects. Although the SEC attempted to respond to these changes, it became increasingly clear that the Act did not contemplate, and so could not readily accommodate, independent power production.[49]

This period also witnessed growing interest in foreign utility operations. In 1992, the SEC approved, as a matter of first impression, a registered holding company's acquisition of a foreign public-utility company.[50] The SEC found that the integration requirement did not apply to acquisitions

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[46](...continued)
of section 2(a)(29) that the combined electric utility assets may, under normal conditions, be economically operated as a single interconnected and coordinated system.

[47] Northeast Utilities, note 45 above, at n.75 and UNITIL Corporation, note 32 above, at n.30, citing section 2(a)(29)(A) (an integrated system must be "confined in its operations to a single area or region").

[48] See, e.g., UNITIL Corp., note 32 above; Entergy Corp., note 42 above. But see CINergy Corp., Holding Co. Act Release No. 26146 (Oct. 21, 1994) (the SEC reserved jurisdiction for up to three years over the proposed acquisition by CINergy of the gas properties of Cincinnati Gas & Electric Co.)

[49] To avoid regulation under the Act, developers relied on a number of approaches described as "PUHCA pretzels." These approaches ranged from dispersion of ownership interests or voting rights so that no single participant would have a 10 percent voting interest in the independent power project (see Thousand Springs Project, SEC No-Action Letter (Feb. 1, 1988) and Ocean State Power, SEC No-Action Letter (Feb. 16, 1988)), to various limited partnership arrangements. Each approach had its limits; none made good business sense. The Energy Policy Act removed the obstacles to such projects that the Holding Company Act had created.

[50] Southern Co., note 9 above. The SEC noted that "[t]he plain language of section 10(c)(2) makes its provisions inapplicable to an acquisition of foreign utility operations" and added, "[i]f ambiguity is created by section 11, our permission of the acquisition is nevertheless consistent with statutory purposes."

of securities or utility assets of a public-utility company operating exclusively outside the United States. The SEC looked to the policies and purposes of the Act to resolve the statutory conflict but made clear that in this determination, it did not consider itself bound by the historical circumstances and understandings at the time of enactment. Instead, the SEC stated that it would consider a proposed acquisition "in the light of contemporary circumstances . . . and of our present view of the Act's requirements."[51] Again, the SEC's work in this area was largely superceded by the Energy Policy Act.

The SEC noted in a number of these matters that its approval did not guarantee the financial success of a venture.[52] Rather, SEC approval meant that the standards of the Act were met and, in particular, the new venture should not be detrimental to the public interest or the interest of investors or consumers, or the proper functioning of the holding company system.[53] Most recently, the SEC relied on a finding of no detriment to the protected interests in approving the acquisition of a United States utility by a Canadian holding company.[54] Clearly, the SEC has attempted to interpret the integration standards of the Act flexibly and avoid application of a rigid view of the industry.

B. Recommendations for Future Regulation of Utility Ownership

The SEC must continue to respond flexibly to the legislative, regulatory and technological changes that are transforming the structure and shape of the utility industry. In recognition of the changing environment in the utility industry, the Division believes that the SEC must adopt a more flexible interpretation of the geographic and physical integration standards, with more emphasis on whether an acquisition will be economical and subject to effective regulation. The Division also recommends that the SEC broaden its interpretation of the A-B-C clauses to permit combination systems by registered holding companies if the affected states concur. The Division also recommends that the SEC avoid duplicative review of acquisitions and, where possible, defer to the work of other regulators in reviewing acquisitions. These recommendations will permit registered holding companies to take advantage of developing markets and technologies, while avoiding duplicative and costly regulation.

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[51] Id., citing Union Electric Co., note 35 above, at 503.

[52] See Sierra Pacific Resources, note 39 above.

[53] See section 10(b)(3).

[54] Gaz Metropolitain, Inc., Holding Co. Act Release No. 26170 (Nov. 23, 1994).

The SEC should apply a more flexible interpretation of the integration requirements under the Act.

Satisfaction of the integration standards requires satisfaction of multiple criteria. Certain physical and geographical yardsticks must be met. In addition, the resulting system must be economical and efficient. Most important, the system must be subject to effective regulation. The statute recognizes, however, that the application of the integration standards must be able to adjust in response to changes in "the state of the art." As discussed previously, the Division believes the SEC must respond realistically to the changes in the utility industry and interpret more flexibly each piece of the integration equation.

Interconnection through power pools, reliability councils and wheeling arrangements can satisfy the physical interconnection requirement of section 2(a)(29).

As discussed previously, the statutory definition of an integrated public-utility system requires that the utility assets of combining electric systems must be interconnected or "capable of interconnection." The SEC has previously found that proposals to contract for or to construct physical connections between utilities in a single system satisfy the interconnection requirement.[55] In addition, the SEC has found that two utilities that are physically capable of sharing power through wheeling or power pool arrangements are physically interconnected or capable of physical interconnection -- and therefore satisfy the interconnection requirement. The fact that the two facilities may be separated by other facilities that are not owned by the holding company does not change the fact that they are interconnected or, in the D.C. Circuit's words, "capable of physical connection and of supplying power to one another as needed."[56] Indeed, the SEC has already acknowledged that utilities can be interconnected through power pools or by means of contractual rights to use the lines of a third party.[57] A finding that wheeling and other forms of sharing power through reliability councils and proposed regional transmission groups also qualify as "interconnection" appears to be a logical extension of these prior SEC holdings.

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[55] See New England Electric System, 38 S.E.C. 193, 198-99 (1958) (engineering studies and testimony showing feasibility of direct interconnections among four small systems satisfied the requirement of the Act that utilities be "capable of physical interconnection"); Mississippi Valley Generating Co., note 25 above, at 187 (while complete direct physical interconnection between the companies involved did not currently exist, the SEC recognized that physical interconnection was possible through the construction of transmission lines).

[56] City of New Orleans v. SEC, 969 F.2d 1163, 1165 (D.C. Cir. 1992).

[57] See, e.g., Northeast Utilities, note 39 above; Centerior Energy Corp., Holding Co. Act Release No. 24073 (April 29, 1986); UNITIL Corp., note 32 above.

Similarly, the SEC should interpret the geographic requirements of section 2(a)(29) flexibly, recognizing technological advances, consistent with the purposes and provisions of the Act.

Under section 2(a)(29), an integrated public-utility system is "confined in its operations to a single area or region."[58] As noted above, the SEC has suggested that this requirement would preclude the integration through contract rights of two distant utilities.[59] The Division recommends that the SEC reconsider this view.

A number of commenters[60] suggest that the geographic aspect of integration is obsolete because technological and telecommunications advances, as well as the emergence of brokers and marketers, permit an integrated public-utility system to be comprised of remote utilities. Some submit that public policy encourages national competition, and suggest that technological innovations permitting central coordination of remote generation and transmission facilities justify a determination that integration now exists on a national scale. These commenters note that, where abuses are not implicated, the SEC has exercised significant flexibility to find that utility assets are integrated, even though the utility assets and load are outside and unconnected to the acquiring company's service territory.[61]

As noted above, gas companies that obtain natural gas from "a common source of supply may be deemed to be included in a single area or region."[62] Citing technological advances, as well as legislative and regulatory

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[58] Section 2(a)(29) refers to "a single area or region, in one or more States." The terms "area" and "region" are not defined in the Act. Section 2(a)(24) defines "State" to mean any State of the United States or the District of Columbia. The SEC, in a recent decision, found that the phrase "in one or more States" did not bar the acquisition of a Vermont utility by a Canadian holding company. See Gaz Metropolitain, Inc., note 54 above (Nov. 23, 1994) ("The Act contains no prohibitions against foreign holding companies as such.").

[59] Northeast Utilities, note 45 above, at n.75 and UNITIL Corporation, note 32 above, at n.30, citing section 2(a)(29)(A) (an integrated system must be "confined in its operations to a single area or region").

[60] See, e.g., Comments of American Electric Power Company ("AEP") and CINergy.

[61] Central and South West Corporation ("CSW") cites the SEC decisions in Electric Energy, Inc., note 24 above, and Ohio Valley Electric Corporation, note 25 above, as acquisitions that were consistent with national policies adopted after the passage of the Act, and urges the SEC to exercise similar flexibility to interpret the integration requirement in a way that complements the new competitive policies established by the Energy Policy Act.

[62] Section 2(a)(29)(B).

changes requiring open access, a number of commenters also suggest that gas companies located in the United States could be considered an integrated system because they can now be served by almost any natural gas supplier.[63]

In evaluating the "single area or region" requirement of section 2(a)(29), the SEC has considered not only size and distance, but also "the existing state of the arts of generating and transmission and the demonstrated economic advantages of the proposed arrangement."[64] The Public Utilities Commission of Ohio ("Ohio Commission") states that "[a] proper focus on savings will serve the public far better than historic considerations of proximity." Others note the problems associated with multistate systems, and urge the SEC not to read the definition more flexibly.[65] On balance, the Division believes it is appropriate to interpret the "single area or region" requirement flexibly, recognizing technological advances, consistent with the purposes and provisions of the Act.

The SEC must still evaluate whether a proposed acquisition promotes the economic and efficient development of the system under section 10(c)(2). This evaluation should be made, however, in light of the effect of technological advances on the ability to transmit electric energy economically over longer distances, and other developments in the industry, such as brokers and marketers, that affect the concept of geographic integration. Given that a relaxed geographic integration standard could potentially result in holding company ownership of scattered utility properties, the need for cooperation and consultation with the states is crucial in order to assure that the SEC's decisions in this area do not impair the effectiveness of state regulation. As technological advances and the emergence of marketers and brokers result in a national power market, and with the concurrence of state and local regulators, the SEC should rely more on an acquisition's demonstrated economies and efficiencies to satisfy the statutory integration requirements.

The SEC's analysis should focus on whether the resulting system will be subject to effective regulation.

The recent institutional, legal and technological changes noted above have reduced the relative importance of physical interconnection and geographic limitations by permitting greater control, coordination and

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[63] But see Comments of Michigan Commission Staff (the definition of "integrated public utility system" could be read to include nontraditional systems, but does not apply to all gas companies).

[64] See, e.g., Connecticut Yankee Atomic Power Co., note 24 above, at 710; Vermont Yankee Nuclear Power Corporation, 43 S.E.C. 693, 697-98 (1968), remanded on other grounds, Municipal Electric Association of Massachusetts v. SEC, 413 F.2d 1052 (D.C. Cir. 1969).

[65] See, e.g., Comments of The City of New Orleans ("New Orleans").

efficiencies. In particular, open access under FERC Order No. 636, wholesale wheeling under the Energy Policy Act and the development of an increasingly competitive and interconnected market for wholesale power have expanded the means for achieving the interconnection and the economic operation and coordination of utilities with non-contiguous service territories. The gas companies note that technological advances and the unbundling of services have resulted in a national gas supply market in which geographic integration is not appropriate.[66]

Although the relevance of physical and geographic integration to a sound public-utility industry has diminished, the Division believes that Congress' desire for an integrated system could be satisfied by an integrated delivery system. At the same time, the Division is concerned that the Act not serve as an artificial barrier where other energy regulators have determined that an acquisition will benefit utility consumers. The Division believes that the SEC should respond to technological and legislative changes where the concerns of the affected state and local regulators are met.

When considering any proposed acquisition, the SEC should consider whether the resulting system will impair the effectiveness of regulation. Where the affected state and local regulators concur, the SEC should interpret the integration standard flexibly to permit non-traditional systems if the standards of the Act are otherwise met.

The SEC should liberalize its interpretation of the "A-B-C" clauses and permit combination systems where the affected states agree.

As discussed above, the SEC has generally required electric registered holding companies that seek to own gas utility properties to satisfy the requirements of the A-B-C clauses concerning additional integrated systems. In contrast, exempt holding companies have generally been permitted to retain or acquire combination systems so long as combined ownership of gas and electric operations is permitted by state law and is supported by the interested regulatory authorities.[67]

In the past, the SEC has construed the A-B-C clauses narrowly to permit retention only where the additional system, if separated from the principal system, would be incapable of independent economic operations.[68] Although the Supreme Court upheld the SEC's reading, two justices dissented, contending that the "serious impairment" standard was at odds with the wording of the Act, had little basis in the statutory history or aims of the

[66] See Comments of Consolidated, Columbia and National.

[67] See, e.g., the cases cited in footnote 29 above.

[68] New England Electric System, note 30 above.

Act, and could not be sustained by agency or judicial precedent.[69] The dissenting justices believed that the statutory language "called for a business judgment of what would be a significant loss."[70]

Applicants in recent matters have argued that, in a competitive utility environment, any loss of economies threatens a utility's competitive position, and even a "small" loss of economies may render a utility vulnerable to significant erosion of its competitive position. There is general support for a more relaxed standard. A number of commenters emphasize that these are essentially state issues.[71] It does not appear that the SEC's precedent concerning additional systems precludes the SEC from relaxing its interpretation of section 11(b)(1)(A).[72] Indeed, the SEC has recognized that section 11 does not impose "rigid concepts" but rather creates a "flexible" standard designed "to accommodate changes in the electric utility industry."[73]

Congress, in 1935, recognized that competition in the field of distribution of gas and electric energy is essentially a question of state policy.[74] The Act was intended to ensure compliance with state law in this regard.[75] Moreover, it appears that the utility industry is evolving toward the

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[69] SEC v. New England Electric System, note 19 above, at 185 (Harlan, J. and Stewart, J., dissenting).

[70] Id. (citations omitted).

[71] See, e.g., Comments of the Ohio Commission and Comments of The Southern Company ("Southern").

[72] See Southern Co., note 9 above (authorizing registered holding company to acquire foreign utility subsidiary).

[73] UNITIL Corp., note 32 above; Mississippi Valley Generating Co., note 25 above, at 186.

[74] Senate Report at 29-30; House Report at 14-15 (section 8 "is concerned with competition in the field of distribution of gas and electric energy -- a field which is essentially a question of State policy").

[75] Accordingly, section 8 of the Act provides:

> Whenever a State law prohibits, or requires approval or authorization of, the ownership or operation by a single company of the utility assets of an electric utility company and a gas utility company serving substantially the same territory, it shall be unlawful for a registered holding company, or any subsidiary company thereof, by . . . any means or instrumentality of interstate commerce, or otherwise (1) to take any step, without the express approval of the State commission of such State, which results in its having a direct or indirect interest in an electric utility company and a gas utility company serving substantially the same territory; or (2) if it already has any such interest, to acquire, without the express approval of the State

(continued...)

creation of one-source energy companies that will provide their customers with whatever type of energy supply they want, whether electricity or gas. Accordingly, the Division believes it is appropriate to reconcile the treatment of registered and exempt companies in this regard, and so recommends that the SEC permit registered holding companies to own gas and electric utility systems pursuant to the A-B-C clauses of section 11(b)(1), where the affected states agree. [76]

The SEC should consider rules to exempt certain restructuring transactions.

The FERC NOPR, discussed in Part I, would require the filing of open access tariffs by all utilities subject to the FPA. It appears likely that functional and corporate restructuring would follow as companies respond to competitive pressures. Restructuring can take many forms, including reorganization along functional lines, sales and purchases of utility assets, and strategic mergers. The staff recommends that the SEC consider ways to exempt from sections 9(a) and 10 transactions that involve only reorganization of existing utility assets.[77] These transactions could involve the formation and capitalization of new utility subsidiaries, and the intrasystem transfer of utility assets. For registered holding companies, the acquisition of utility securities or assets generally would require SEC approval under sections 9(a)(1) and 10; for the sale, SEC approval pursuant to rules 43 and 44 under section 12(d) would be required. For exempt holding companies and free-standing utilities, SEC approval is required under section 9(a)(2) only if an acquisition would result in an affiliation with two or more utilities.[78]

It appears that the SEC could promulgate a rule under section 3(d) to facilitate internal restructurings by nonregistered companies. The rule would deem a class of persons not to be affiliates and so, exempt most internal restructuring transactions from section 9(a)(2). The rule would not, however, benefit registered holding companies that are subject to the requirement of

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[75](...continued)

commission, any direct or indirect interest in an electric utility company or gas utility company serving substantially the same territory as that served by such companies in which it already has an interest.

[76] See, e.g., Entergy Corp., note 42 above; UNITIL Corp., note 32 above.

[77] It does not appear that the SEC could readily adopt a rule exempting acquisitions of new utility operations. There is no general exemptive authority under section 9(a). See also section 1(b)(4) of the Act, noting Congress' concern with the "growth and extension of holding companies [that] bears no relation to economy of management and operation or the integration and coordination of related operating properties."

[78] Any resulting holding company, of course, must qualify for exemption or register with the SEC.

prior SEC approval for the acquisition of any security or utility asset under section 9(a)(1).

For registered holding companies, the Division believes that the SEC could adopt a rule under section 9(c)(3), deeming the acquisition of securities in connection with an internal restructuring to be in the ordinary course of business of a registered holding company.[79] The chief limitation on the adoption of such a rule would be concern that section 9(c)(3) not be used to evade the requirements of section 11.[80] It does not appear that a problem would arise under section 11 because the exempted transactions would involve only the reorganization of existing properties.

Registered holding companies are also subject to rules 43 and 44, which generally require SEC approval for any intrasystem sales of utility securities or assets. The rules, at present, exempt sales in an annual aggregate amount of $5 million. The rule could be amended to remove the overall limit where the acquisition is exempted, either pursuant to section 9(c)(3) (utility securities) or 9(b)(1) (utility assets).[81] However, intrasystem asset transfers raise many complex issues, and the Division recommends that this matter be studied further.

The SEC should "watchfully defer" to the work of other regulators.

Under section 9(a) of the Act, prior SEC approval is generally required for utility acquisitions. These transactions may also be subject to FERC, and possibly state, approval. Anticompetitive effects are reviewed not only by the SEC, but also by the Department of Justice and the Federal Trade Commission. As discussed above in Part I, the SEC's review in this area duplicates the work of these other regulators in some important respects.

Several commenters suggest an exemption from section 9(a) for acquisitions that are also subject to FERC and state review, but it does not appear that the SEC could readily adopt a rule to exempt utility acquisitions

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[79] See United Corp., 35 S.E.C. 591, 594 (1954), quoting Electric Bond and Share Co., 35 S.E.C. 236 (1953) (section 9(c)(3) permits the SEC to consider ordinary course of business "in light of the requirements of the applicant, rather than of applicants generally").

[80] See Michigan Consolidated Gas Co. v. SEC, 444 F.2d 913 (D.C. Cir. 1971).

[81] Section 9(b)(1) exempts from the requirement of SEC approval under sections 9(a) and 10, "the acquisition by a public-utility company of utility assets the acquisition of which has been expressly authorized by a State commission."

from review under the Holding Company Act.[82] Other commenters recommend specific legislative action to amend section 9 to minimize or eliminate SEC review. The Division, however, believes that a more comprehensive approach to legislative reform is needed.[83]

Absent repeal, it thus appears that utility acquisitions will continue to be subject to review on a case-by-case basis. A number of commenters criticize review of utility acquisitions by two federal agencies as duplicative and time-consuming, with the potential for conflicting determinations. The registered gas companies suggest that the SEC and the FERC could undertake more joint efforts, such as joint fact-finding, to minimize duplicative reviews.[84] While consolidated proceedings could reduce duplicative efforts, it is not altogether clear that this would be the result because the two agencies, in examining the same transaction, consider different issues and have different standards for approval. At least one commenter, while supporting more effective communication and coordination between the FERC and SEC, does not believe that their review should be consolidated, because separate reviews provide an appropriate "regulatory check and balance."[85]

Accordingly, the Division recommends that the SEC seek to streamline its review of utility acquisitions to minimize regulatory overlap. In previous matters, the SEC has looked to the FERC's analysis of issues that are closely linked to operations.[86] The Division recommends that the SEC continue to

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[82] Under section 9(a), an acquisition is unlawful unless it has been approved by the SEC under section 10. In order to adopt a rule broadly exempting acquisitions, the SEC would have to find, before the fact, that the requisite standards of section 10 were satisfied in every instance.

[83] See the discussion of the Division's legislative recommendations in Part III, below. Some state commenters favor continued SEC authority in this area, contending that repeal of the Act would leave regulatory gaps and that the states lack the authority, staff and financial resources to deal with interstate acquisitions. See Comments of the Indiana Utility Regulatory Commission ("Indiana Commission") (SEC restrictions more stringent than those of FERC and should be retained) and the Michigan Commission Staff (regulatory gap without SEC review).

[84] See Comments of Consolidated, National and Columbia.

[85] Comments of Southwestern Public Service Co. (functions of FERC and SEC should not be consolidated; agencies should coordinate better).

[86] The FERC has recently announced that utility mergers are presumptively subject to its approval under section 203 of the Federal Power Act. See Illinois Power Co., 67 FERC ¶ 61,136 (1994); 16 U.S.C. § 824b.

"watchfully defer," where appropriate, to the substantive findings of another agency having concurrent jurisdiction over a transaction.[87]

[87] City of Holyoke v. SEC, note 39 above, at 363; see also Entergy Corp., note 42 above (SEC relied on hearing records and orders of FERC and state commissions in making its determinations).

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Chapter 3. Diversification[1]

A. Background

The problems associated with holding companies were not confined to their utility operations. Prior to 1935, holding companies acquired and held interests in nonutility businesses largely without restriction. In the years following the stock market crash in 1929, many holding companies experienced financial difficulties and several collapsed, due, among other things, to unsuccessful diversification.[2] The Holding Company Act sought to protect holding company system investors and utility consumers from the risks of nonutility ventures by limiting the extent to which registered holding companies and their subsidiaries could engage in these businesses. Thus, section 11(b)(1) of the Act limits the operations of a registered holding company system "to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system."

In the early years after adoption of the Act, the SEC's focus was primarily on compelling divestiture of businesses that did not satisfy the standards of section 11(b)(1). After the breakup of the massive holding companies was completed in the 1950s, this focus shifted to the review of new acquisitions of nonutility businesses.

As discussed elsewhere in this study, the utility industry has progressed through the years, from a period of extensive construction of new generating facilities (and related increased fuel requirements), through periods of change in the availability of fuel supply and investigation of energy alternatives, to an era of energy management, competition, deregulation and diversification. The types of nonutility businesses proposed to be acquired by registered holding companies and their subsidiaries have paralleled these developments, and the associated risks and the need for protection of investors and consumers have varied according to the type of business to be acquired and the other regulatory protections in place.

The SEC's administration and interpretation of section 11 has also progressed through the years to attempt to meet the needs of the changing utility industry, from strict construction of the statutory requirements in light of the original goals of the Act, to more flexible interpretation to reflect the increasing effectiveness of state regulation and the growing obsolescence of

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[1] This chapter deals with nonutility acquisitions by companies in a registered holding company system. Chapter 6 discusses acquisitions of nonutility interests by exempt holding companies.

[2] See Hawes, Utility Holding Companies, Section 2.04.

the concept of the utility as purely a local monopoly. The Division proposes further changes, both rulemaking and administrative, consistent with the statutory mandate, to meet the needs of the industry in the 1990s and beyond. The development of the SEC's administration of section 11(b)(1), and the proposals for further change, are summarized below.

1. The Functional Relationship Test

The SEC has interpreted the "other business" clauses of section 11(b)(1), read together, to require an operating or functional relationship between a proposed nonutility activity and a registered holding company's core utility operations.[3] The SEC has explained that section 11(b)(1) must be construed in "light of the statutory policy to achieve 'economy of management and operation' and the 'integration and coordination of related operating properties.'"[4] With respect to new acquisitions, the SEC has interpreted section 10(c)(1) to mean that "any property whose disposition would be required under section 11(b)(1) may not be acquired."[5] The phrase "any other interest in any business" in section 9(a)(1) has been read comprehensively to cover any arrangement that entails the acquisition of a substantial interest in a nonutility business undertaking.[6]

Beginning in 1965, nonutility acquisitions by registered holding companies consisted primarily of fuel and fuel-related interests and subsidiaries and generating plant construction subsidiaries.[7] These acquisitions increased as a result of the fuel crisis that later developed in the 1970s. Many of the larger electric utilities responded to uncertainties about reliability of delivery by acquiring their own supply sources for a substantial

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[3] See, e.g., North American Co., 11 S.E.C. 194 (1942), aff'd, 133 F.2d 148 (2d Cir. 1943), aff'd on constitutional issues, 327 U.S. 686 (1946) (requiring divestment of various nonutility interests).

[4] General Public Utilities Corp., 32 S.E.C. 807, 839 (1951) (citing section 1(b)(4) of the Act; Commonwealth & Southern Corp., 26 S.E.C. 464, 490 (1947); Cities Service Power & Light Co., 14 S.E.C. 28, 38 (1943)).

[5] Texas Utilities Co., 21 S.E.C. 827, 829 (1946) (denying approval to acquisition of transportation company by registered holding company).

[6] See Public Service Co. of Oklahoma, 45 S.E.C. 878, 882-83 (1975) (oil and gas venture). See also New York State Natural Gas Corp., 35 S.E.C. 480, 481 (1953) (gas leases); National Fuel Gas Co., Holding Co. Act Release Nos. 24175 (Aug. 28, 1986) and 24309 (Feb. 4, 1987) (gas pipeline).

[7] Fuel and fuel-related business ventures included exploration for gas and oil, research in coal gasification, acquisition of coal reserves and development of coal mines, and investments in transportation and storage facilities. See Report to the Congress by the Comptroller General of the United States, "The Force of the Public Utility Holding Company Act has been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies" (1977) at 34.

percentage of their fuel requirements and transport.[8] During the 11-year period 1971-1981, expenditures for fuel and related facilities by registered holding companies totalled approximately $4.2 billion.[9] Ownership of mines and related transportation facilities was not uncommon in 1935, and their retention was permitted under section 11(b)(1) of the Act.[10] Acquisitions of fuel and fuel-related interests by registered system companies were similarly approved under section 10(c)(1) on the basis of a functional relationship with core utility operations.[11]

In 1969, the SEC reexamined the general restraints on nonutility activities in the context of an acquisition by a utility subsidiary of a registered holding company of an interest in low-income housing construction. In an initial decision, the SEC found that the acquisition was within the language of the "other business" clauses of section 11(b)(1).[12] One year later, however, the SEC overruled its prior determination on the basis of a lack of functional relationship.[13] Thus, while exempt holding companies engaged in substantial diversification in the 1980s, with ventures into real estate, retail drug stores, financial institutions and insurance companies, among others, the requirement of a functional relationship continued to limit nonutility diversification by registered holding companies.[14]

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[8] For example, Middle South established System Fuels, Inc. in 1971 as a direct subsidiary of the system's four electric operating companies. In 1974, the New England Electric System organized New England Energy, Inc. to provide fuel for New England Power Company, the generating and transmission subsidiary for the New England Electric system. In 1978, Central and South West established Central and South West Fuels, Inc. to function as the procurement and exploration arm of the system. American Electric Power Company greatly expanded its own fuel sources through coal mining subsidiaries in West Virginia, Ohio and Utah.

[9] Annual Report of 1981, at 76-77.

[10] See, e.g., North American Co., note 3 above, at 225-26.

[11] See, e.g., System Fuels, Inc., Holding Co. Act Release No. 20441 (Mar. 9, 1978) (authorizing acquisition of leases and mineral rights with respect to uranium reserves, and related activities).

[12] Michigan Consolidated Gas Co., 43 S.E.C. 1108, 1114 (1969).

[13] Michigan Consolidated Gas Co., 44 S.E.C. 361 (1970), aff'd, 444 F.2d 913 (D.C.Cir. 1971).

[14] Some analysts have observed that utilities that diversified in the past decade did not fare as well economically as the registered holding companies, which were unable to diversify. See, e.g., Charles M. Studness, Earnings from Utility Diversification Ventures, Pub. Util. Fort., Sept. 1, 1992, at 28-29.

2. Limitations on Transactions with Nonassociates

In the 1980s, registered holding companies, with increasing frequency, sought SEC approval for nonutility activities that would serve nonassociates to some extent. A number of orders approved relatively small acquisitions arising from joint ventures and equity investments to promote research and development of energy-related technology.[15] The SEC also permitted system companies to engage in transactions with nonassociates using equipment or facilities obtained for the use of the core utility business.[16] In some instances, the SEC approved the disposition of such equipment or facilities to nonassociates.[17] In addition, the SEC authorized a number of registered holding companies to acquire subsidiaries that would offer energy-related consulting and other services to nonassociates.[18] These nonutility acquisitions were generally quite limited, involving no significant financing.[19] Certain

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[15] See, e.g., General Public Utilities Corp., Holding Co. Act Release No. 15184 (Feb. 9, 1965) (acquisition of temporary, five-year interest in company created to promote manufacture and national marketing of electric equipment using new type of fan); Southern Co., Holding Co. Act Release Nos. 23888 (Oct. 31, 1985) (investment in joint venture to manufacture and sell photovoltaic cells) and 23440 (Oct. 1, 1984) (equity investment in company developing two-way communication technology combining energy management and other services for use by residential and small commercial customers); and CNG Energy Co., Holding Co. Act Release No. 23734 (June 14, 1985) (investment in development of electronic meter reading devices).

[16] See, e.g., Indiana & Michigan Electric Co., Holding Co. Act Release No. 24039 (Mar. 4, 1986) (subsidiaries that had obtained equipment to transport coal used by system generating stations authorized to offer services to nonassociates during times of system nonutilization). Similar orders approved arrangements whereby equipment or services needed for utility operations could be offered to nonassociates "during brief periods when [utility] transportation needs have been met," Georgia Power Co., Holding Co. Act Release No. 22487 (May 3, 1982); on a temporary basis, System Fuels, Inc., Holding Co. Act No. 22556 (June 29, 1982); and during "slack periods of work," Cedar Coal Co., Holding Co. Act Release No. 23973 (Dec. 31, 1985).

[17] See, e.g., Consolidated Gas Transmission Corp., Holding Co. Act Release No. 23914 (Nov. 20, 1985) (authorizing subsidiaries to lease excess channels on a microwave communication system to nonassociates); Jersey Central Power & Light Co., Holding Co. Act Release No. 24348 (Mar. 18, 1987) (authorizing utility to license to nonassociates a series of computer programs developed by company personnel to detect the unauthorized taking of electric energy).

[18] See, e.g., New England Electric System, Holding Co. Act Release No. 22719 (Nov. 19, 1982) (energy management services); American Electric Power Co., Inc., Holding Co. Act Release No. 22468 (Apr. 21, 1982) (management, technical and training services); Southern Co., Holding Co. Act Release No. 22132 (July 17, 1981) (management, technical and training services).

[19] See, e.g., Jersey Central Power & Light Co., note 17 above (capital investment would not exceed $200,000); National Fuel Gas Co., Holding Co. Act Release No. 24081 (May 1, 1986) (initial investment of $200,000); and CNG Energy Co., note 15 above (initial expenses of $150,000 and advance purchase payments of $200,000).

proposals were self-limiting.[20] The volume of nonutility proposals, however, generated concern among the SEC staff about the limitations that should be placed upon transactions with nonassociates.

In the early days of its administration of the Act, the SEC had generally required divestment of a nonutility business that chiefly benefited nonassociate, rather than associate, companies. An early decision involving two coal mining businesses, for example, approved the continued ownership of the one that sold more than 80 percent of its production to associate utility companies, but required divestment of the other, which sold its output almost exclusively to nonaffiliated purchasers.[21] In keeping with this precedent, the SEC staff imposed a 50 percent limit upon transactions with nonassociates in some instances to ensure that the nonutility business would continue primarily to serve its associate companies.[22] The percentage limitation was an administrative measure intended to create a bright line in this area.

In practice, the 50 percent limit proved a source of concern for the SEC and applicants. Among other things, there was uncertainty as to when and how the percentage limitation should be applied.[23] In 1987, Central and South West Corporation and its subsidiary, CSW Credit, Inc., sought the removal of a limitation imposed upon CSW Credit's nonassociate factoring operations by a 1986 order of the SEC.[24] At issue was a proposed expansion

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[20] See, e.g., Entergy Corp., Holding Co. Act Release No. 25718 (Dec. 28, 1992) (four year investment); American Electric Power Co., Holding Co. Act Release No. 25424 (Dec. 11, 1991) (ten years); and General Public Utilities Corp., note 15 above (five years).

[21] North American Co., note 3 above, at 223-224, 225-26.

[22] See, e.g., Transok, Inc., Holding Co. Act Release No. 23859 (Oct. 8, 1985) (authorizing subsidiary of registered holding company to acquire gas pipeline capacity, of which 50 percent would be dedicated to system utility operations); National Fuel Gas Co., Holding Co. Act Release No. 24381 (May 1, 1987) (authorizing registered holding company to acquire subsidiary to provide pipeline construction and related services to associate and nonassociate companies, within certain limitations).

[23] In some instances, the SEC applied the 50 percent limitation to revenues derived from specified regions and activities. Compare Eastern Utilities Assocs., Holding Co. Act Release No. 24273 (Dec. 19, 1986) (applying 50 percent limitation to Massachusetts subsidiary of registered holding company and requiring that revenues from energy management services attributable to customers outside New England would remain less than revenues attributable to customers within that area) with EUA Cogenex Corp., Holding Co. Act Release No. 26135 (Sept. 30, 1994) (excluding revenues from consulting from the 50 percent limitation) and Eastern Utilities Assocs., Holding Co. Act Release No. 25636 (Sept. 17, 1992) (including revenues from energy management services in New York as revenues from New England for purposes of the 50 percent limitation).

[24] Specifically, the average amount of nonassociate company accounts receivable outstanding at the end of each month over the preceding twelve-month period could not exceed the average amount of associate company accounts receivable outstanding at the end of each

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of CSW Credit's operations on behalf of nonassociates, for which applicants sought related financing authority. Unlike many prior nonutility proposals, a sizeable investment was involved.[25] On appeal to the SEC from a favorable initial ruling by an administrative law judge, the SEC denied the application.[26] It reaffirmed the section 10(c)(1) requirement of a functional relationship and upheld the use of a bright-line percentage limitation generally.[27] The SEC expressed dissatisfaction, however, with the perceived strictures of the statute.

3. A New Approach

Recently, the SEC has indicated a willingness to consider a more flexible approach to diversification by registered holding companies into nonutility activities. At the end of 1994, the SEC approved a proposal by a registered holding company to develop, through a subsidiary, a wireless communications system to provide services to system companies and regional nonassociates. The SEC stated that an assessment of functional relationship that takes into consideration the relative investments for associate and nonassociate companies is consistent with the rationale underlying its decision

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[24](...continued)
month over that period. See CSW Credit, Inc., Holding Co. Act Release No. 24157 (July 31, 1986). The SEC authorized CSW to organize CSW Credit to factor the receivables of system companies in 1985. Central and South West Corp., Holding Co. Act Release No. 23767 (July 19, 1985). Subsequent orders authorized CSW Credit to purchase receivables of nonassociate companies and approved related financing. See CSW Credit, Inc., cited above; CSW Credit, Inc., Holding Co. Act Release No. 24575 (Feb. 8, 1988).

[25] At the time of the filing, total financing authority of up to $780 million was available for the financing activities of CSW Credit. If the total investment and borrowing authority requested were approved and exercised, nonassociate receivables would represent approximately 76.2 percent of total receivables owned. CSW Credit, with total capitalization of $1.68 billion, would rank among the largest captive finance companies in the United States. CSW Credit, Inc., Administrative Proceeding File No. 3-7027, Brief of the Division of Investment Management, filed Apr. 14, 1989, at 8-9.

[26] The administrative law judge found that the application, consistent with the 1986 order, was in accord with previous SEC decisions permitting the sale or lease of excess capacity or facilities to nonassociate companies. The decision relied in particular on the order of the SEC in Jersey Central Power & Light Co., note 17 above. See CSW Credit, Inc., Holding Co. Act Release No. 25995 (Mar. 2, 1994).

[27] The SEC, however, identified one type of factual situation in which a nonutility interest could be found to be primarily devoted to the core utility business even though transactions with nonassociates exceed those with associates. In this situation, as in Jersey Central, the nonutility business involves the sale or lease of products or skills of some complexity developed by the holding company at considerable expense for the benefit of its utility subsidiaries and not readily available to the rest of the public from other sources; moreover, these endeavors generally require little or no further investment by the holding company, and permitting the proposed activities would permit amortization of product development expenses with little or no risk. CSW Credit, Inc., note 26 above.

in CSW Credit.[28] In the alternative, the SEC indicated that the proposal was within the rationale of the order in Jersey Central Power & Light Co., as approved in CSW Credit.[29] In addition, the SEC suggested that the proposed acquisition could also be authorized under the plain meaning of the statute, as "reasonably incidental, or economically necessary or appropriate" on a finding that it is "necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental" to the proper functioning of the integrated public-utility system.

Shortly thereafter, the SEC approved the request of a registered holding company for an order amending prior orders to remove a percentage limitation upon its energy management services business.[30] Among other things, the SEC noted that unlike the factoring business considered in CSW Credit, the provision of energy management services, including conservation and demand-side management services, is closely related to the core utility business. The SEC also noted the strong national interest in promoting energy conservation and efficiency, which are promoted by the energy management services industry.[31]

B. Recommendations for Future Regulation of Diversification Activities

The SEC must continue to respond flexibly to change in the utility industry. Toward this end, the Division believes that the registered holding companies should be permitted to invest in diversified activities without unnecessary regulatory obstacles and recommends consideration of a rule that would exempt, subject to certain conditions, investments in specified energy-related activities from prior SEC approval. The Division also recommends that the SEC adopt a budget approach for registered holding companies to make de minimis investments in diversified activities and otherwise adopt a flexible approach toward other diversification activities. These

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[28] The holding company proposed to invest $159 million to meet the needs of its system companies, and represented that an additional investment of less than $20 million would facilitate nonassociate transactions. Although the majority of the revenues could ultimately come from nonassociate customers, the system would at all times remain available for unencumbered use by the system operating companies. See Southern Co., Holding Co. Act Release No. 26211 (Dec. 30, 1994).

[29] See note 26 above.

[30] Eastern Utilities Associates, Holding Co. Act Release No. 26232 (Feb. 15, 1995). The prior orders had limited the extent to which the business could conduct operations outside the region comprised by the New England states and New York. See note 23 above.

[31] The SEC cited, among other things, the principal purpose of the legislation underlying the Energy Policy Act "to improve our environment, economy and energy security by promoting the efficient use of energy." Eastern Utilities Associates, note 30 above (citing H.R. Rep. No. 474(I), 102d Cong., 2d Sess. 133 (1992)).

recommendations will greatly reduce the delays and costs of regulatory burdens with which registered holding companies must contend and make them more competitive.

The SEC should promulgate rules to reduce the regulatory burdens associated with energy-related diversification.

In recent years, there has been a dramatic increase in the volume of applications by registered holding companies seeking to engage in nonutility activities that complement, or are natural extensions of, the gas- and electric-utility businesses. These filings reflect an evolution of the registered holding companies away from traditional, regulated utility functions and towards broader energy-related businesses. Today, nearly all registered holding companies engage in a variety of energy-related activities that involve application of resources and capabilities developed in the conduct of utility operations. Many involve new uses of skills and experience gained in utility operations, or new uses of utility infrastructure and technology to provide services to utility as well as nonutility customers.

The Division recommends that the SEC seek comment on a rule that would exempt such energy-related diversification by registered holding companies from the requirement of prior approval under sections 9(a)(1) and 10 of the Act. Such a rule (to be designated rule 58) would deem the acquisition of securities of an "energy-related company" (as defined in the rule) to be "in the ordinary course of business" of a company in a registered system, subject to certain investment limitations and reporting requirements.[32] Under the proposed rule, an energy-related company is one that derives, or will derive, substantially all of its revenues from one or more activities specifically enumerated in the rule, and such other activities as the SEC may, by order upon application under sections 9(a)(1) and 10, designate as energy-related for purposes of the rule. The exemption provided by the rule would be available only if the aggregate investment by a registered holding company in such energy-related companies does not exceed the greater of $50 million or 15 percent of the holding company's consolidated capitalization.

Rule 58 would also exempt the acquisition by a gas registered holding company or any subsidiary of securities of a "gas-related company" (as defined in the rule) subject to certain reporting requirements. The proposed

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[32] The rule would be promulgated under section 9(c)(3) which provides that prior SEC approval is not required for:

> the acquisition by a registered holding company or subsidiary company thereof, of such commercial paper and other securities, within such limitations, as the Commission may by rules and regulations or order prescribe as appropriate in the ordinary course of business of a registered holding company or subsidiary company thereof and as not detrimental to the public interest or the interest of investors or consumers.

rule would define a gas-related company as one that derives, or will derive, substantially all of its revenues from one or more activities permitted under the GRAA,[33] and such other activities as the SEC may, from time to time, by order upon application under sections 9 and 10 and the GRAA, designate as gas-related for purposes of the rule.

In connection with proposed rule 58, the Division also recommends related amendments to rule 45(b) and rule 52(b), concerning financings by registered system companies: (1) to qualify the exception under rule 45(b) to the requirement of SEC approval under section 12(b) and rule 45(a) for capital contributions and open account advances, without interest, to a gas-related company; and (2) to qualify the exemption provided by rule 52(b) from the requirement of SEC approval under sections 6(a) and 7 for the issuance and sale of securities by energy-related subsidiary companies, in order to conform the rules to the investment limitations of proposed rule 58.

The proposed rulemaking would eliminate unnecessary regulatory burdens and paperwork associated with filings by a registered holding company for SEC approval to invest in nonutility businesses that are closely related to a system's core utility business. The limitation of aggregate investment in energy-related companies will help to ensure that the financial integrity of the registered system will not be impaired by investments pursuant to the rule. In addition, the proposed rule incorporates reporting requirements that should enable the SEC and other interested regulators to monitor the effects of these investments.

The SEC should approve a budget approach for de minimis investments in diversified activities.

Regulatory delay associated with the approval process for nonutility acquisitions has been a recurring complaint of companies in registered systems. The requests for authorization typically require extensive documentation of a proposed new business activity and its relationship to the system utility business. The proposed rule would address these concerns with respect to activities most closely related to the core utility business of a registered holding company.

Companies also have opportunities to make limited investments in activities that do not fit squarely within previous orders of the SEC, but nonetheless appear to be within the meaning of the "other business" clauses of section 11.[34] The Division believes that, within reasonable limitations, the

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[33] Pub. L. No. 101-572, 104 Stat. 2810 (codified at 15 U.S.C. § 79k note (1990)).

[34] Section 11 requires that the other business be "reasonably incidental, or economically necessary or appropriate" and "necessary or appropriate in the public interest or for the (continued...)

companies should be permitted to make such investments without undue regulatory delay and expense.

Some commenters suggest that the SEC adopt a safe harbor that would exempt de minimis investments from the requirement of prior SEC approval. To provide maximum flexibility, the Division instead recommends that the SEC endorse the use of a "budget approach," under which a registered holding company could invest minimal amounts in diversified activities without regard to the specific identity of each investment. This approach would permit SEC review while enabling registered holding companies, without delay, to make small investments or small initial investments in projects that may become large enough to require subsequent SEC approval by order upon application.

Specifically, the Division contemplates that a registered holding company would file an application under sections 9(a) and 10 requesting authorization to invest a stated dollar amount, on an "as-needed" basis over a specified period. This procedure would obviate the need to seek and obtain prior SEC approval of the individual transactions. The applicant would be required to take steps to ensure that potential losses would be limited to the amount of the investment, e.g., by making the investment nonrecourse to other system assets or by isolating the new activity in a separate subsidiary. A certificate would be filed pursuant to rule 24 for each transaction.

The Division believes that this approach would strike an appropriate balance between the SEC's responsibility to protect investors and consumers, on the one hand, and the companies' need to respond to opportunities on a timely basis and on a more equal footing with their competitors.

The SEC should adopt a more flexible approach in considering all other requests to enter into diversified activities.

It is likely that registered holding companies will continue to seek authority to engage in activities that do not qualify for the safe harbor of proposed rule 58 or for the budget approach for small investments outlined above. Among those activities are potentially significant investments in ventures that are not energy-related within the contemplation of rule 58. The comments diverged sharply on the appropriate regulation of these types of investments.

For example, the registered holding companies voice concern about the delays inherent in the approval process, and urge the SEC to modify its

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[34](...continued)
protection of investors or consumers and not detrimental to the proper functioning of such system".

precedent concerning the functional relationship requirement and the related "50 percent test," which limits transactions on behalf of nonassociate companies. Some suggest new tests, such as an investment cap, if any restriction is needed. Others favor no restrictions at all on diversification.

Conversely, regulators and consumer groups question the ability of ratemakers to protect consumers against risks that may be associated with diversified activities. Various commenters stress the need for ratemaking authorities to have access to information about diversified activities, the need for an overall cap on investments, and the continuing need for the functional relationship requirement. The commenters are not unanimous, however. The Virginia Commission and the Public Utility Commission of Texas ("Texas Commission"), for example, suggest that registered holding companies, as well as exempt holding companies, should have flexibility in this regard. In addition, the Michigan Commission Staff notes that the functional relationship requirement does not ensure the success of a nonutility venture.

Some commenters make specific suggestions to modify the regulation of diversification. For instance, the Ohio Commission suggests a three-part test based on the relationship of the activity to the system's core utility business, the impact on competition and the protections provided for ratepayers. Wisconsin Electric Power Company ("Wisconsin Electric") describes a Wisconsin statute that permits expansive diversified activities and provides for protection of consumers against cross-subsidization and the effects of potential losses.

The Division believes that the proposal of rule 58 and the recommendation of a budget approach for small investments address many of the commenters' concerns. With respect to the other diversified activities that will continue to require SEC approval on a case-by-case basis, the Division recommends a more flexible interpretation of the provisions of the Act concerning diversification. Specifically, the Division contemplates an interpretation of the language of section 11(b)(1) that would allow registered holding companies to engage in nonutility businesses that are economically appropriate and in the public interest, regardless of whether such activities are ancillary to the utility business.[35]

Further, the Division favors the abandonment of percentage limitations as an administrative measure. Such bright-line limitations were intended to ensure that nonutility activities remained consistent with the statutory requirements. They have primarily generated confusion and today appear

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[35] See, e.g., Southern Co., note 28 above (permitting investment in mobile communications business on alternative holding that such investment was economically appropriate and in the public interest). See also Comments of CSW (diversification should be permitted if it is economically appropriate, even if it is not reasonably incidental to the utility business).

outmoded. The Division believes that the current administration of section 11(b)(1) requires a flexible standard that takes into account the risks inherent in the particular venture and the specific protections provided for consumers. The Division is not recommending an overall cap on investment because the existing level of diversification should be a factor in considering whether a proposed transaction is in the public interest and whether adequate consumer protections are in place.

Chapter 4. Affiliate Transactions

A. Background

As discussed in Part I, service contracts between holding companies and their utility subsidiaries prior to 1935 were used as a means to enrich holding companies at the expense of utility ratepayers and investors, and the states were unable to regulate these activities adequately. Since there was no arms-length bargaining, the holding company dictated the terms of the contracts, and fees were often stated as a percentage of utility revenues.[1] The existence of these practices was an important factor leading to the enactment of comprehensive federal legislation.[2] The Holding Company Act contains a number of provisions designed to prevent companies in holding company systems from overcharging affiliates for goods and services, and then passing such charges on to utility ratepayers.[3]

Section 13 of the Holding Company Act governs service, sales and construction contracts among affiliates. In general, section 13(a) prohibits registered holding companies from entering into or performing any such contract with an associate utility or mutual service company, except in limited circumstances to be exempted by rule.[4] Section 13(b) permits registered holding company subsidiaries and mutual service companies to enter into or

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[1] Study of Operations at 981-82. These fees were often reflected on the utility's books as operating expenses ahead of interest, deductible in computing the fair rate of return, and were sometimes capitalized and included in rate base. The fees also diluted the earnings of the utility available to its other investors. Id.

[2] See § 1(b)(2) of the Holding Company Act. The SEC has stated that "[o]ne of the most serious of all the holding company abuses was the exploitation of their operating subsidiary companies through unwarranted service fees, commissions, and other charges." Annual Report of 1944, at 107.

[3] As originally introduced, both the House and Senate bills leading to the Act would have made regulation of affiliate transactions under the Act the responsibility of the FPC, the precursor to today's FERC. See H.R. 5423, 74th Cong., 1st Sess. (1935) §§ 12(a)-12(d); S. 1725, 74th Cong., 1st Sess. (1935), § 13(g). This provision was retained in the bill passed by the Senate, S. 2796, but the House substitute bill amended the Senate bill to place the regulatory authority over this provision of the Act in the SEC, rather than the FPC. See House Report at 7. The House and Senate conferees agreed to give this authority to the SEC, see H.R. Rep. No. 1903, 74th Cong., 1st Sess. 72 (1935), and the legislation was enacted in this form.

[4] Rule 13-11 was adopted for this purpose in 1936. Holding Co. Act Release No. 125 (Mar. 30, 1936). Under current rule 85 a registered holding company may sell goods to or perform services for associate companies when the holding company is primarily an operating company, in emergencies, when the transaction is for a small dollar amount, or when the goods to be sold were bought for the holding company's own use or are sold incidentally to a sale of a business or a sale of assets. 17 C.F.R. § 250.85.

perform a service, sales or construction contract with an associate company only in accordance with SEC rules and only if such contract is performed "economically and efficiently, for the benefit of [the companies serviced], at cost, fairly and equitably allocated among such companies."[5] The SEC has adopted numerous rules under section 13.[6]

1. Formation of Service Companies

In the early years, the SEC's regulation of transactions under section 13 consisted primarily of review and approval of applications to form mutual and subsidiary service companies[7] and examination of service company operations to assure that the goals of the Holding Company Act were being achieved. The two functions were interrelated to the extent that "[t]he cumulative experience obtained . . . in dealing with service companies [was] helpful in passing upon the organizational features of service companies."[8]

The organizational phase of regulation was most intensive in the first years after enactment of the Holding Company Act, when registered holding companies were establishing service companies to engage in transactions with associate companies, as permitted by section 13. The greatest difficulties

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[5] The legislative history of section 13(b) clearly indicates that Congress gave serious consideration to including the "at cost" language and did so to protect consumers from excessive rates. See, e.g., House Report at 52-53. The SEC is also required to "insure that such contracts are performed economically and efficiently," and, where interassociate transactions are not conducted economically and efficiently compared to arms-length, market-priced transactions, the SEC may lower the charges to associate companies below cost. See rules 90(a)(2) and 91(a) (requiring charges not "more than cost") and rule 92(b) (permitting disallowance of excessive costs based on a market comparison). 17 C.F.R. §§ 250.90-92. See also Ohio Power Co. v. FERC, 880 F.2d 1400, 1411 (D.C. Cir. 1989) (Mikva, J. concurring), rev'd and remanded, Arcadia, Ohio v. Ohio Power Co., 498 U.S. 73 (1990), on remand, Ohio Power Co. v. FERC, 954 F.2d 779 (D.C. Cir. 1992), cert. denied, 113 S. Ct. 483 (1992).

[6] The original rules under section 13 were adopted in Holding Co. Act Release No. 125 (Mar. 30, 1936). The current rules relating to section 13 provide limited exemptions from the requirement for SEC approval of affiliate transactions, specify certain matters relating to approval and operations of service companies, and provide that affiliate transactions generally must be performed at "cost," as defined. See, e.g., rule 81, 17 C.F.R. § 250.81 (exempting sales of goods or services that are subject to public regulation and are made on terms comparable to those applicable to other customers); rule 85, 17 C.F.R. § 250.85 (discussed above); rule 87, 17 C.F.R. § 250.87(exempting certain limited transactions and certain specified holding company subsidiaries from the requirement that they seek prior approval to engage in transactions under section 13); rule 88, 17 C.F.R. § 250.88 (relating to approval of service companies); and rules 90, 91 and 92, 17 C.F.R. §§ 250.90 -.92 ("at cost" rules).

[7] Subsidiary service companies are direct subsidiaries of the holding company, whereas mutual service companies are subsidiaries of the utilities they serve.

[8] Annual Report of 1940, at 46.

encountered in this phase were the lack of uniformity among the proposed service companies, the lack of specific description of their proposed functions, and the continued commingling of holding company and operating company functions in one organization.[9]

Because service companies were unique to registered holding company systems,[10] there was no standard against which to judge them. In 1936, the SEC adopted a uniform system of accounts for service companies[11] as an important step in establishing standards, and by 1940, the SEC reported that "[a] reasonable amount of standardization has been accomplished, particularly with respect to accounting and the elimination of investments and functions not related to the performance of service, sales and construction contracts."[12] By 1941, thirty applications to form service companies had been approved, and the SEC reported that the first phase of regulation "is now largely completed . . . [and t]here has accordingly been a shift in emphasis to the matter of supervising the actual operations of the arrangements previously passed on."[13]

2. Examination and Review

The second phase of regulation consisted of examination and review of the financial and operating information of service companies, to ensure on an ongoing basis that service companies were operating in compliance with the requirements of section 13.[14] To implement reporting requirements,[15] and to facilitate review, the SEC in 1937 adopted rule 13-60, requiring the filing of annual reports by service companies, and adopted Form U-13-60 to be used

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[9] See Annual Report of 1944, at 108-09.

[10] "[T]he utility service company is a device peculiar to the registered holding company system." Annual Report of 1951, at 112.

[11] Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies, 17 C.F.R. Part 256, adopted May 12, 1936 and amended in Holding Co. Act Release No. 20910 (Feb. 2, 1979). This system of accounts was described as "the first step in the development of uniformity in accounting in a field where quite diverse practices have prevailed." Annual Report of 1936, at 43.

[12] Annual Report of 1940, at 46.

[13] Annual Report of 1941, at 110.

[14] This review was accomplished by means of field examinations of service companies, and financial and statistical reporting. The SEC's audit function under the Holding Company Act is discussed in detail in Chapter 5 of Part II.

[15] See section 14 of the Holding Company Act.

for that purpose.[16] By 1939, the SEC reported that it was "well into the second and more important part of service company regulation," and that staff investigations had uncovered abuses that required correction and had supplied "a wealth of information and experience which will be of immeasurable benefit in the administration of [section 13] in the future."[17]

In connection with monitoring operations of service companies, the SEC also identified and corrected other, more indirect, affiliate abuses engaged in by holding companies to the detriment of utility ratepayers. The SEC was particularly concerned with the practice of shifting holding company expenses to operating utilities through the medium of a service company. This shifting was accomplished, for example, by sharing officers and employees between the holding company and the service company and charging some portion of their compensation to the utility customers of the service company. In a series of proceedings, the SEC established the principle that the compensation and expenses of holding company personnel must be borne by the holding company and not shared with an associated service company and passed on to utilities.[18]

By 1946, most of the abuses connected with affiliate service transactions had been eliminated.[19] Over the next thirty years, the SEC continued to examine the activities of service companies to detect irregularities and monitor compliance with section 13, as part of "the day-to-day surveillance of the . . . operations of [the] registered holding company groups."[20] Few cases of great import arose, but the SEC continued to

[16] Holding Co. Act Release No. 513 (Jan. 8, 1937). In the following year, the SEC began receiving and studying Forms U-13-60, and reported that "a study is being made of the operating methods of various service companies which will enable the [SEC] to make suggestions and if necessary to promulgate orders to insure an accurate distribution of costs for this class of service in accordance with the standards set forth in Section 13 of the Act." Annual Report of 1938, at 19. The current rule requiring service companies to file annual reports is rule 94, 17 C.F.R. § 250.94.

[17] Annual Report of 1939, at 76-77.

[18] Ebasco Services, Inc., Holding Co. Act Release No. 2255 (Aug. 27, 1940); United Light and Power Service Co., Holding Co. Act Release No. 2608 (Mar. 11, 1941); Middle West Service Co., Holding Co. Act Release No. 2696 (Apr. 16, 1941); and Columbia Engineering Corp., Holding Co. Act Release No. 4166 (Mar. 11, 1943). The SEC noted that these practices involved the performance of a service for a charge by a holding company in violation of section 13, and that the related proceedings "constituted a landmark in the administration of Section 13." Annual Report of 1941, at 112.

[19] Study of Operations at 989.

[20] Annual Report of 1951, at 63.

establish policies on a case-by-case basis to safeguard the interests of utility consumers[21] and otherwise improved its regulation of service companies.[22]

3. Special Purpose Subsidiaries

Beginning in the 1970s, largely as a result of the energy crisis, holding companies undertook fuel exploration and development programs through special purpose subsidiaries that procured fuel and sold it to associate utility companies.[23] In the context of fuel subsidiaries, complex questions concerning the calculation of "cost" arose[24] and registered holding companies sometimes sought authorization to deviate from the "at cost" rules.[25] From 1971 through 1983, the SEC authorized a total investment of approximately $6.6 billion in fuel programs.[26]

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[21] For example, in 1943, the SEC established the principle that service company activities must be limited to operating services that the operating utility companies cannot perform as economically and efficiently for themselves, as opposed to managerial, executive or policymaking functions, Columbia Engineering Corp., note 18 above, and required reorganization of one service arrangement to segregate service activities for foreign subsidiaries, which were not subject to section 13, from those for domestic subsidiaries, which were. Electric Bond and Share Co., Holding Co. Act Release No. 4070 (Jan. 25, 1943).

[22] For instance, in an effort to streamline regulation, Form U-13-60 was amended in 1954 to eliminate material that duplicated the information supplied in Form U-5-S. Holding Co. Act Release No. 12287 (Dec. 30, 1953).

[23] See, e.g., the various orders relating to System Fuels, Inc., the fuel subsidiary in the Entergy Corporation system, including Holding Co. Act Release Nos. 17400 (Dec. 17, 1971) (approving formation of subsidiary and initial operations, and requiring that "SFI will sell fuels to [its associate utility companies] at prices equal to cost determined in accordance with Rule 91"); 20363 (Jan. 4, 1978); 21277 (Nov. 1, 1979); 21367 (Dec. 28, 1979); 21871 (Dec. 31, 1980); and 23028 (Aug. 9, 1983) (authorizing entry into coal supply contracts, financing for procurement and exploration programs for gas, oil, uranium and coal, and fuel storage, handling and transportation). Other holding company systems also engaged in extensive fuel procurement and development programs to meet the fuel needs of significant additions to generating capacity constructed in the 1970s.

[24] Because fuel programs are capital intensive, cost of capital is a significant component of the price of fuel. The SEC calculated cost of capital for a wholly-owned fuel subsidiary on the basis of the imputed capital structure of the utilities that it serves. Total price of fuel is based on full pooling of costs, including amortization of exploration and development costs. Levy Testimony at 651.

[25] See, e.g., New England Electric System, Holding Co. Act Release No. 22309 (Dec. 9, 1981) (utility permitted to enter into lease with affiliated joint venture with lease payments based on market price).

[26] Annual Report of 1983, at page 46.

In the 1980s and 1990s, registered holding companies expanded their use of separate subsidiaries to engage in other activities,[27] including formation of exempt wholesale generators and foreign utility companies under the Energy Policy Act,[28] raising further issues of compliance with section 13 and the rules thereunder. As registered holding companies increased the use of special purpose subsidiaries that may supply goods and services to companies within the holding company system, the SEC's audit and examination function kept pace with these developments by increasing the surveillance of fuel and other nonutility subsidiaries. These reviews, together with continuing reviews of service company subsidiaries, saved consumers substantial amounts of money in possible overcharges and inefficiencies.[29]

4. The Ohio Power Problem

The current issue in the area of affiliate transactions is how Congress, the SEC or the FERC should deal with the implications of the Ohio Power case.[30] Beginning in 1971, the SEC authorized a fuel subsidiary of Ohio Power Company to sell coal to an associate utility company "at cost."[31] During the 1970s, the FERC applied a rate-of-return methodology that was similar to the SEC's cost-plus pricing methodology. In 1981, however, the FERC adopted a market-based standard for pricing coal produced by affiliates of the purchasing utility.[32] Under the market standard, a utility buying such captive coal can recover only the price it would have paid under a comparable coal supply contract with a nonaffiliate. In 1982, when Ohio

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[27] See, e.g., American Electric Power Co., Holding Co. Act Release No. 22468 (Apr. 21, 1982) (consulting subsidiary); Consolidated Natural Gas Co., Holding Co. Act Release No. 22582 (July 22, 1982) (subsidiary engaging in sale and service of fuel conversion equipment for natural gas vehicles and fueling stations); and Entergy Corp., Holding Co. Act Release No. 25718 (Dec. 28, 1992) (subsidiary engaging in energy management services and development of efficient lighting technologies).

[28] 42 U.S.C. §§ 13201 et seq.

[29] See, e.g., Annual Report of 1992, at 46 ("The SEC audits . . . fuel procurement activities, accounting policies, annual reports of service company subsidiaries and fuel procurement subsidiaries of registered holding companies, and quarterly reports filed by non-utility subsidiaries of registered holding companies. By uncovering misapplied expenses and inefficiencies, the agency's activities during 1992 resulted in savings to consumers of approximately $10.2 million."). For the period 1983-1994, SEC audits resulted in total savings to consumers of approximately $288 million.

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

[31] See Ohio Power Co., Holding Co. Act Release Nos. 17383 (Dec. 2, 1971); 20515 (Apr. 24, 1978); 21008 (Apr. 17, 1979); and 21537 (Apr. 25, 1980).

[32] See Opinion 133, Public Service Co. of New Mexico, 17 F.E.R.C. ¶ 61,123 (1981), reh'g denied, 18 F.E.R.C. ¶ 61,036 (1982), aff'd, 832 F.2d 1201 (10th Cir. 1987).

Power filed wholesale rate increases, the FERC challenged the pass-through of coal costs that did not satisfy a "comparable market" test.[33] The FERC determined that Ohio Power had paid substantially more than a comparable market price for coal supplied by Southern Ohio, and so ordered Ohio Power to establish lower wholesale rates and to refund previous overcharges.

In 1992, the D.C. Circuit held that the SEC's order authorizing the sale of coal "at cost" precluded the FERC from disallowing the cost of coal from the utility's rates.[34] Ohio Power has been viewed as interfering with the ratemaking jurisdiction of the FERC and, potentially, the states by preventing them from considering the reasonableness of costs of affiliate transactions that have been approved by the SEC.[35] The perception that the SEC's orders may be read to impair the ability of the FERC, and state and local regulators, to protect consumers through traditional ratemaking proceedings is troubling because, historically, the SEC did not believe that the exercise of its authority under section 13(b) preempted federal and state ratemaking authority.[36]

In addition to the present study, the SEC has undertaken several initiatives to address the issues raised by the Ohio Power decision. The SEC staff has met with staff members of the FERC and representatives of NARUC to discuss their concerns and possible solutions. In addition, in response to the concerns expressed by the FERC and the states, the SEC undertook an effort to arrive at a joint legislative solution with the FERC.[37] Finally, the

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[33] Ohio Power Co., 39 F.E.R.C. ¶ 61,098 (1987). Southern Ohio had begun mining operations in 1978.

[34] Ohio Power Co. v. FERC, note 30 above.

[35] See, e.g., Hearings on Regulatory Oversight of Registered Holding Company Transactions, before the Subcommittee on Energy and Power of the House Committee on Energy and Commerce, 103rd Cong., 2nd Sess. 1 (1994) (Testimony of The Honorable Craig A. Glazer, Chairman of the Public Utilities Commission of Ohio on Behalf of the National Association of Regulatory Utility Commissioners) ("While the [Ohio Power] decision only applied to FERC regulation of wholesale power sales, it clearly threatens State regulation of a far larger share of costs recovered in retail rates. With the FERC and State commissions precluded from reviewing the costs of affiliate contracts, the SEC will have exclusive but flawed authority to protect ratepayers.").

[36] Prior to the Ohio Power decision, the SEC had assumed that the FERC and the states would be free to reexamine such costs. See, e.g., New England Electric System, note 25 above (granting a deviation from the "at cost" rules in connection with lease payments between affiliates, and noting that the FERC would later consider the amount of costs allowable in wholesale rates under its standards).

[37] In 1994, the SEC approved a joint SEC-FERC staff proposal to amend section 318 of the FPA that would have expressly authorized the FERC to disallow costs incurred pursuant to section 13(b) "if it determines that recovery of such costs would be inconsistent with the requirements of sections 205 or 206 of the Federal Power Act." Under the proposal, there would have been a rebuttable presumption that such costs were just, reasonable and not unduly discriminatory or preferential within the meaning of the FPA.

SEC proposed for public comment an amendment to rule 90 that would apply a market standard to intrasystem service, sales and construction contracts in "special or unusual circumstances" in which the market price for comparable goods or services is lower than cost as determined pursuant to rule 91.[38]

B. Recommendations for Future Regulation of Affiliate Transactions

The most significant issues involving affiliate transactions are those raised by the Ohio Power case, discussed above. The Division continues to believe that a legislative remedy, rather than rulemaking, is necessary to address these issues.

The SEC should withdraw its proposal to amend rule 90 concerning affiliate service, sales and construction contracts, reaffirm its intention not to preempt the ratemaking authority of the FERC or the states, and continue to work closely with rate regulators and utilities to reach a satisfactory resolution to the Ohio Power problem.

As discussed above, the SEC in December 1994 issued notice of a proposed rulemaking that would have applied a lower-of-cost-or-market standard to affiliate transactions involving companies in a registered holding company system. The rulemaking was intended to prevent the situation in which a utility in a registered system could purchase goods and services at a cost above market price, to the detriment of consumers.

As the Division anticipated, the rule was very controversial. The SEC received comments from registered holding companies, state and local utility commissions and consumer groups.[39] The registered holding companies oppose the rule, arguing that a lower-of standard would discourage significant investment and undermine the centralized management of registered systems by eliminating the consistent pricing standard of the present rules.[40] The companies further represent that implementation of the rule would be burdensome, and could result in stranded costs to the detriment of investors. In addition, the rule could result in unintended consumer detriment where, for example, the utility is the seller or service provider.

Some commenters also question the need for the proposed rule. The pricing of seller-produced goods, which was at issue in Ohio Power, could be

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[38] See Intrasystem Service, Sales and Construction Contracts; Proposed Rule Amendment and Rule Rescission, Holding Co. Act Release No. 26198 (Dec. 22, 1994).

[39] The comments are available for public inspection in SEC Public File No. S7-37-94.

[40] See, e.g., Comments of New England Electric System ("NEES"), File No. S7-37-94 (a lower-of standard creates a "heads you lose, tails you break even" scenario).

readily accommodated under the existing regulatory framework of section 13(b)(2) and rule 92.[41] The companies recommend that the SEC instead consider less drastic adjustments that could be accomplished within the current regulatory framework by specific exemptive orders. The SEC's authority to adopt a rule of broad application under the exemptive language of section 13(b)(2) was also questioned. As NEES stated, "[i]t is irrational and contrary to Congress's express intent to treat all intrasystem contracts as presenting special or unusual circumstances."

While the state and local regulators uniformly agree that there is a need for increased attention to affiliate transactions, they are generally skeptical of the SEC's commitment in this area. As the Indiana Commission noted, "[t]he problem is not the standard, it is the enforcement of the standard." Many commenters question the SEC's willingness to conduct the fact-specific inquiries that would be required to implement the proposed rule.[42]

The consumer groups generally find the proposed rule amendment lacking and suggest various changes, including requirements that companies solicit competitive bids before entering into an affiliate contract, and that utilities demonstrate a least-cost basis for affiliate transactions. These commenters also question the SEC's commitment to perform the necessary fact-finding and monitoring procedures.

On balance, the Division believes that the SEC should withdraw the rule proposal. The underlying issue is the ability of states and the FERC to protect consumers through traditional ratemaking proceedings, free from the potential issue of SEC preemption. The rule does not address this jurisdictional concern,[43] and the sweeping revision contemplated by the rule

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[41] Although a subsidiary company generally must perform services or construction for, or sell goods to, an associate company at cost, section 13(b)(2) authorizes the SEC, by rule or order, to grant an exemption from the "at cost" requirement in "special or unusual" circumstances. The SEC relied upon section 13(b)(2) in adopting present rule 92, which applies a lower-of-cost-or-market standard to intrasystem transfers of seller-produced goods "to insure that the price of such sales shall be in line with competitive prices of independent sellers." In Ohio Power, the company, by requesting orders, effectively sought a variance from the lower-of-cost-or-market standard of rule 92 that would otherwise have applied to the intrasystem sales of coal. See orders cited in note 31 above.

[42] See Comments of Bierman and Stover, File No. S7-37-94 (the rule proposal will not achieve the consumer protection goals set for it because the real problem is a lack of administrative will to make the fact intensive inquiry needed to conduct market/cost comparisons); Comments of the Ohio Commission, File No. S7-37-94 (the affiliate pricing determination is too complex and fact-intensive for a simple rule administered by an agency without experience in this area).

[43] The SEC explained that "[t]he rule does not, however, purport to resolve the jurisdictional concerns raised by the [Ohio Power] decision." Holding Co. Act Release No. 26198 (Dec. 22, 1994).

may be too broad. States and the FERC should be able to assess the appropriate charges in conjunction with the facts and circumstances of each case, and to test different formulations of cost or price allowance.[44]

In the proposing release, the SEC noted that it does not intend to preempt the authority of state and federal ratemakers to disallow costs associated with transactions under section 13 of the Act. Nonetheless, whether a SEC action will preclude the FERC and state and local regulators in this regard remains for Congress or the courts to decide. As the proposing release also noted, the Court of Appeals, on remand, did not resolve the equitable cost-trapping concerns raised by the Supreme Court in Ohio Power. It is possible that this question may be the subject of future litigation. An SEC statement that it does not intend to preempt FERC or state ratemaking authority should undercut any argument of detrimental reliance on SEC approval of cost for all purposes.

The Division believes that the SEC should proceed on a case-by-case basis, in consultation with other regulators. This approach would offer needed flexibility to address pricing concerns and other new issues.[45] In appropriate circumstances, the SEC should also issue exemptive orders under section 13 allowing more nonutility subsidiaries to charge market rates to nonutility affiliates. A new standard of review for transactions between utility and nonutility associate companies may also be appropriate where the utility is the seller of goods or the service provider. Finally, increased diversification may raise new and different affiliate concerns. For example, the affiliate transactions procedures developed by the Federal Communications Commission may provide useful guidance as registered holding companies diversify into communications. The potential variety of affiliate transactions necessitates that the SEC maintain the ability to respond flexibly and effectively in this area.

The Division further recommends that the SEC continue to monitor developments in this area and, if the problems raised by the Ohio Power decision remain, that the SEC pursue other avenues to resolve them.

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[44] See, e.g., Comments of Virginia Commission ("Transactions should be regulated with the objectives of maximizing revenues and minimizing costs to the utility company"). We note that some states have imposed a five percent surcharge on charges by a utility to a nonutility associate company. See also Entergy Corp., Holding Company Release No. 26218 (Jan. 13, 1995) (proposal of certain transactions pursuant to a settlement entered into by Entergy Corporation and its regulators).

[45] See, e.g., Southern Co., Holding Co. Act Release No. 26211 (Dec. 30, 1994).

Chapter 5. The Audit Function

A. Background

As discussed in Chapter 4 of this part, service contracts between holding companies and their utility subsidiaries prior to 1935 were used as a means to enrich holding companies at the expense of utility ratepayers and investors, and the Holding Company Act contains a number of provisions designed to prevent companies in registered holding company systems from engaging in abusive affiliate transactions. In order for these provisions to be effective, however, it was also necessary to provide the SEC with the authority to monitor such transactions by requiring the making and keeping of holding company system records and mandating SEC access to those records, and the Act included provisions for that purpose.

Section 15 of the Act is the source of the SEC's authority in this area. This section requires registered holding companies and their subsidiaries, affiliates of the foregoing, and other persons whose principal business is performance of service, sales or construction contracts for utilities or holding companies, to keep such accounts and records as the SEC deems necessary or appropriate in the public interest or for the protection of investors or consumers or for the enforcement of the Act, and provides that such accounts and records are subject to examination by the SEC. The SEC's authority extends to both the types of books and records to be retained and the retrieval of records to facilitate the auditing function.

In the early years of the Holding Company Act's administration, the SEC's audit function was used primarily in connection with examination and review of the finances and operations of newly-formed mutual and subsidiary service companies to assure that the goals of the Act were being achieved. The SEC adopted rules to implement the Act's reporting requirements and to require uniformity in the keeping of service company accounts,[1] and the staff monitored operations through both field audits and review of the financial and statistical information filed under the Act by service companies and their holding company parents. By 1946, most of the abuses connected with affiliate service transactions had been eliminated,[2] and by 1952, the restructuring of the original holding company systems (including establishment of system service companies) was largely completed.[3]

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[1] See Chapter 4 of this part for further information on the adoption of rules implementing the Act's reporting requirements and a uniform system of accounts for service companies.

[2] Study of Operations at 989.

[3] Annual Report of 1952, at 82.

Thereafter, the SEC continued to monitor the activities of service companies for compliance with the requirements of the Act as part of its ongoing regulatory functions. In the early 1960s, registered holding companies had only a few nonutility subsidiaries, and affiliate transactions were limited primarily to a small number of transactions involving administrative, accounting and engineering services furnished to utilities by service companies. Such charges totaled approximately $300-400 million per year. Since that time, the auditing function has focused on the growth of these companies, and the oversight of accounting systems and cost allocations. Through the 1970s and 1980s, the electric utility industry developed specialized fuel procurement programs and engaged in extensive construction programs such that, by 1989, service company services had expanded to over $2 billion per year. Today, these service companies render over 100 different types of services to the operating utilities in their systems, with nonfuel transactions aggregating approximately $4 billion annually. Each of these activities affects the utility companies in holding company systems, directly or indirectly.[4]

Since 1980, the SEC has conducted over 42 field and desk audits of service company and fuel procurement subsidiaries, and has established accounting, cost allocation and use of proceeds policies in dozens of associate transactions authorized by the SEC. The SEC has also adopted and implemented formal auditing policies for service companies and for EWGs and foreign utility companies, and has developed a manual providing service company guidelines and procedures for accounting, cost determination and allocation based on over 30 years of auditing experience.[5]

The utility industry has undergone significant change in recent years,[6] and registered holding company systems have expanded into nonutility business activities other than that of a service company. Since the early 1980s, the number of such nonutility subsidiaries of registered holding companies has quadrupled to over 200. As a result, current regulation of affiliate transactions, and the SEC's audit function, focus on review of

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[4] Of the $4 billion of nonfuel affiliate transactions by the 15 registered holding company systems in 1994, approximately 95 percent, or $3.8 billion, affected utility operations.

[5] All service company subsidiaries have been required by the SEC to maintain a recordkeeping system that facilitates the retrieval of service company costs. See 17 C.F.R. Part 257. Within the structure of service company records, the SEC has mandated service order and personnel timecard systems that capture the initial cost of a service transaction. See 17 C.F.R. Part 256. The SEC has also required the use of budgeting to establish prospective cost of service, the use of budget and planning review groups by utilities to monitor service transactions, the use of internal auditing to oversee accounting, billing and allocation, and the cooperative review of service transactions by the parties to assess whether the service is competitive with the marketplace. See, e.g., Central and South West Corp., Holding Co. Act Release No. 26293 (May 18, 1995).

[6] See the discussion of recent trends in utility regulation in Part I.

transactions to which nonutility subsidiaries of holding companies (other than service companies) are a party. The growth in intrasystem transactions within the holding company systems makes it important for regulators to have access to books and records that correctly represent the cost of service for those transactions. A state commission's ability to control cross-subsidization through affiliate transactions, however, is dependent upon its statutory authority over such transactions, access (if any) to the information and records of the nonutility activities and the holding company and cooperation with regulators having such access.[7]

The SEC historically has worked with ratemaking authorities in the area of audits. In 1979, the SEC established with the FERC a cooperative program of auditing service company subsidiaries of registered holding companies. Over the last ten years, the SEC has also extended numerous invitations to state public service commissions to assist in the auditing of service company transactions. However, in light of the growth in intrasystem transactions noted above, more affirmative action by the SEC may be needed to assist state regulators in their consumer protection activities. While several registered holding companies believe that there is no need for continuation of the SEC's audit function, some state and local regulators disagree.[8]

The SEC's recent Central and South West Corp. decision[9] illustrates how the SEC employs its broad ranging authority over the books, records, procedures and operations of all holding company system companies to enhance the effectiveness of state regulation. In approving a restructuring intended to consolidate and centralize in the system service company certain service and management activities that were previously performed individually by the operating companies, the SEC required the implementation of extensive procedures to authorize, monitor and control the rendering of services. In addition, in order to assist state regulators to monitor affiliate charges, the service company must permit such regulators to examine all books, accounts, memoranda, contracts and records of the service company as appropriate to the effective discharge of state regulatory responsibilities.[10]

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[7] As discussed in Section B below, many states do not have adequate authority to obtain the information they need regarding affiliate transactions in holding company systems.

[8] See Comments of New Orleans at 5 and the Texas Commission at 9.

[9] See, e.g., Central and South West Corp., note 5 above.

[10] See also Entergy Corp., Holding Co. Act Release No. 26218 (Jan. 13, 1995) (proposal to implement settlement agreements between Entergy Corporation and its state and local regulators with regard to affiliate transactions).

B. Recommendations for Future Auditing and Access to Books and Records

Because of the difficulty states may have in monitoring the activities of subsidiaries of holding companies, the SEC should continue to cooperate with ratemaking authorities to assist them in protecting consumers. The cooperation will be critical as nonutility subsidiaries increase in number and size, and the electric utility industry responds to deregulation. The Division recommends that the SEC share its audit authority and access to books and records of registered holding company systems with ratemaking authorities, so as to achieve the consumer protection goals of the Act.

The SEC should (1) coordinate and cooperate with the FERC and state and local regulators to audit and review affiliate transactions among registered holding company system companies, and (2) assist the states in obtaining access to books and records, wherever located, if such examination is required for the effective discharge of the state commission's responsibilities.

Spurred by legislative and regulatory developments, portions of the electric and gas utility industries have become increasingly deregulated and increasingly competitive. This trend will continue as the industry further evolves.[11] Utilities are also engaging to a greater extent in energy-related nonutility businesses,[12] and are competing in these diversified activities.[13] The increasingly competitive atmosphere in utility and utility-related markets will likely result in functional reorganization of traditional utility operations, as companies seek to separate their various functions in order to compete more freely in the deregulated and unregulated segments of the industry, and centralization of support functions of the utility business, to reduce costs.[14]

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[11] See Part I for a discussion of recent developments, including the Energy Policy Act, FERC Order No. 636, and a recent FERC rulemaking initiative related to open transmission access in the electric utility industry.

[12] See Chapter 3 above for a discussion of the types of diversified activities in which these companies are engaging.

[13] As discussed above, the Division is recommending that the SEC seek comment on a rule that would exempt from the requirements of sections 9(a) and 10 investments in energy-related activities of a registered holding company system, and that the SEC approve, under a budget approach, certain de minimis investments in other diversified activities, without specific prior approval for each transaction.

[14] See, e.g., Central and South West Corp., Holding Co. Act Release No. 26293 (May 18, 1995) (authorizing transfer to the holding company's system service company subsidiary of administrative, technical and other support services previously rendered by each individual operating company). Note also the formation of nuclear management service companies, Southern Nuclear Operating Company, Entergy Operations, Inc. and GPU Nuclear Corporation, to centralize the nuclear operations of these registered systems.

These developments have the potential to increase significantly the number of affiliate transactions in registered holding company systems and correspondingly to increase the opportunities for cross-subsidization and the need for rate regulators to have access to information on these transactions.[15]

All of the 42 state regulators that responded to the state survey questionnaire stated that they have the authority to prescribe a uniform system of accounts and access to the books and records of their jurisdictional utility companies. However, it is unclear how many states have authority to access the books and records of holding companies and books and records of nonutility companies including service companies. It is also unclear how many states have statutory authority or cooperative agreements to obtain books and records of out-of-state companies.[16] The questionnaire thus reveals varying levels of states' ability to regulate transactions between jurisdictional utility affiliates and various affiliated and unaffiliated entities. The Division's recent experience in auditing nonutility subsidiaries in cooperation with state regulators also indicates that these regulators desire greater access than they currently enjoy.

One of the Division's legislative recommendations is the conditional repeal of the Act, with transfer of continued audit and oversight authority with respect to affiliate transactions and cost allocations to the FERC.[17] Pending repeal or transfer of the audit function to the FERC, the Division recommends increased cooperation with state and local regulators, and increased access for these regulatory authorities to holding company system books and records, in order to protect consumers, at least until state powers are supplemented and reach a more uniform and effective level.

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[15] In fact, at least one writer has asserted that the desire to escape regulatory scrutiny and control is a key factor in management's decision to diversify through the holding company structure. Knapp, Effective State Regulation of Energy Utility Diversification, 136 U.Pa.L.Rev. 1677, 1686 (1988). See also Comments of the Indiana Commission ("Until the transformation to primarily competitive industries is more pervasive and complete, competition will aggravate, rather than alleviate the tendencies of holding companies to earn monopoly profits by subsidizing nonregulated activities through overcharges and the misallocation of common costs, transferring intangible benefits from the regulated to the unregulated at no cost, and charging ratepayers for research and development that eventually benefits the unregulated.") (citation omitted).

[16] See Appendix A.

[17] There appears to be a general consensus among state regulators and registered holding companies that it would be preferable for the FERC to serve as the single federal overseer of intrasystem transactions. This would assure consistency in pricing and allocation methods. Arguably, conflicts such as those in the Ohio Power case could be avoided by such practices, resulting in savings for consumers and investors through increased certainty, predictability and coordinated regulation. Finally and most important, the Division views the FERC as the appropriate agency to monitor intrasystem utility transactions, due to its extensive expertise in utility operations, well-developed administrative process, greater resources, and institutional focus on consumer protection. See Part III.

Finally, the SEC should redirect the resources that are made available as a result of the administrative reforms discussed herein for the Division's audit program to monitor intrasystem transactions in coordination with state regulators and the FERC.

Chapter 6. Exemptions

A. Background

In the early years of its administration of the Act, the SEC anticipated that the statute would be "self-liquidating," as the divestiture of unrelated operations required by section 11 resulted in the loss of jurisdiction over the resulting companies.[1] This prediction has proven largely true. The SEC was successful in breaking up and reorganizing the vast holding company systems that predated the Act. At one time or another after 1938, there were 223 holding companies registered under the Act.[2] Today, there are only fifteen. The vast majority of utilities now operate as free-standing companies, or as subsidiaries of holding companies that are exempted from registration as being "either intrastate in character or else not essentially holding companies in the utility field."[3]

Congress made exemptions from registration available in these situations because such holding companies are susceptible to effective state regulation[4] or are otherwise not the type of holding company at which the Act is directed. Section 3 establishes five classes of holding company exemptions. The most commonly used exemptions are those provided in section 3(a)(1) for an intrastate holding company, and section 3(a)(2) for a holding company that is "predominantly a public-utility company." In addition, section 3(a)(3) provides an exemption for a company that is "only incidentally a holding company," being primarily engaged in another business; section 3(a)(4), for a company that is only "temporarily a holding company;" and section 3(a)(5), for a holding company with essentially foreign utility interests and no material domestic utility operations.

Section 3(a) directs the SEC to exempt from "any provision or provisions" of the Act any holding company that satisfies the objective requirements of section 3(a), "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers." The "unless and except" clause "was designed to prevent the

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[1] In 1946, the SEC believed it "hardly possible" that there would be any new holding companies. "[I]t would be quite rare that that would ever happen." Study of Operations at 998-99.

[2] Annual Report of 1962.

[3] Senate Report at 6.

[4] As discussed in Part I above, Congress subjected holding companies to the requirements of the Act because meaningful state regulation of their abuses was often obstructed by their control of subsidiaries in several states and by the constitutional doctrines limiting state economic regulation.

exemption of any holding company which, although it might meet the formal conditions under Section 3(a), is essentially the type of company at which the purposes of the Act were directed."[5] In addition, under section 3(c), the SEC can modify or revoke an exemption if it finds that the circumstances that gave rise to the exemption no longer exist.[6]

The SEC has adopted a number of rules under section 3(a). Rule 2 permits companies to claim exemption under section 3(a)(1) or 3(a)(2), without the need to apply for or receive SEC approval.[7] Rule 3 provides an exemption for a bank that holds utility securities as collateral for a bona fide debt, or in the ordinary course of business as a fiduciary.[8] Rule 4 similarly exempts brokers, dealers and underwriters.[9] Finally, rule 5 exempts wholly foreign holding companies.[10]

The SEC has noted that "the purposes of the Act are preventive as well as curative"[11] in interpreting the exemptions narrowly. In recent matters, however, more liberal interpretations have been adopted in instances in which

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[5] Cities Service Co., 8 S.E.C. 318, 335-36 (1940) ("By thus imposing a mandatory duty upon the Commission to exempt companies falling within defined categories except where such exemption is definitely detrimental to the basic purposes of the statute, the Committee has felt free to broaden the exemptions beyond what would be justified if the exemptions had been made unqualified and self-operative and beyond the power of the Commission to correct when abused or used to circumvent the purposes of the title.") (citing Senate Report at 24). See also House Report at 11.

[6] See also rule 6, 17 C.F.R. § 250.6 (setting forth the procedure whereby the SEC may terminate a claim of exemption). The SEC has rarely invoked its authority to challenge an exemption. See, e.g., Long Island Lighting Co., 18 S.E.C. 717 (1945) (changed circumstances in the company's financial structure found detrimental to the public interest). See also Pacific Lighting Corp., 45 S.E.C. 152 (1973), in which the SEC staff unsuccessfully challenged an exemption on the basis of diversification.

[7] 17 C.F.R. § 250.2. A company can claim exemption under sections 3(a)(1) or 3(a)(2) by filing an annual statement on Form U-3A-2. In addition, rule 10, 17 C.F.R. § 250.10, provides exemptions for certain "upstream" holding companies and rule 11, 17 C.F.R. § 250.11, exempts from the requirement of prior SEC approval acquisitions of the securities of such companies.

[8] 17 C.F.R. § 250.3. Rule 3 also provides an exemption from the requirements of section 9(a)(2) with respect to the acquisition of securities in accordance with the rule.

[9] 17 C.F.R. § 250.4.

[10] 17 C.F.R. § 250.5.

[11] Standard Oil Co., 10 S.E.C. 1122, 1129 (1942). In that case, the SEC stated that the "unless and except" clause would have required denial of the application for exemption even if the objective requirements had been satisfied because the record disclosed, among other things, intrasystem transactions, including intercompany advances and servicing arrangements, of the type Congress recognized as the subject of potential abuse. Id. at 1129-30.

there was no indication of potential detriment to the effectiveness of state regulation or of the existence of the type of abuses the Act was intended to prevent.[12]

1. Intrastate Holding Companies

The exemptions under sections 3(a)(1)[13] and 3(a)(2)[14] are based on the assumption that a state can effectively regulate a holding company that operates and is organized in one state,[15] or a holding company that is essentially an intrastate operating company with minor subsidiary operations.[16]

The SEC's decisions under these provisions have generally focused on size as a proxy for effective state regulation. The result has been a somewhat confusing array of decisions.[17] For example, a utility company that contributed 3.3 percent of a system's gross revenues was found not to be a

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[12] See, e.g., Kansas Power and Light Co., Holding Co. Act Release No. 25465 (Feb. 5, 1992); text accompanying note 24 below.

[13] Section 3(a)(1) provides an exemption where:

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

[14] Section 3(a)(2) exempts a holding company that is "predominantly a public-utility company whose operations as such do not extend beyond the State in which it is organized and States contiguous thereto."

[15] See generally Houston Natural Gas Corp., 3 S.E.C. 664 (1938), petition for review dismissed, 100 F.2d 5 (4th Cir. 1938).

[16] See Senate Report at 24. See also House Report at 10 (section 3(a)(2) is directed at a company which "is itself a utility, being a holding company only in form by reason of the fact that it has one or more minor subsidiary utilities").

[17] The SEC has weighed a variety of quantifiable factors. See, e.g., N.W. Electric Power Cooperative, Inc., Holding Co. Act Release No. 24497 (Nov. 10, 1987) (exemption granted where 4 percent of a system's 69 KV transmission lines located out of state); Wisconsin Energy Corp., Holding Co. Act Release No. 24267 (Dec. 18, 1986) (exemption granted where less than 3 percent of a system's service population, number of customers, generating capacity, sales, book value of net plant and operating income were attributable to out-of-state activities). The SEC has also considered such issues as the treatment of wholesale utility sales to out-of-state interests at the state line. See WPL Holdings, Inc., Holding Co. Act Release No. 24590 (Feb. 26, 1988), remanded on other grounds sub nom. Wisconsin's Environmental Decade, Inc. v. SEC, 882 F.2d 523 (D.C. Cir. 1989), on remand, WPL Holdings, Inc., Holding Co. Act Release No. 25377 (Sept. 18, 1991).[17]1222

material subsidiary,[18] while a contribution of between 9.45 percent and 11.92 percent of a holding company's net income was deemed material for purposes of section 3(a)(1).[19] Similarly, an exemption has been granted where out-of-state operations represented approximately 9.9 percent of the holding company's utility revenues,[20] but denied where a utility derived 11.13 percent of its operating revenues from out-of-state operations.[21] Under section 3(a)(2), the SEC has granted an exemption if the gross revenues of the utility subsidiaries aggregate no more than approximately 25 percent of those of the parent.[22]

In some instances, this approach has created practical difficulties unrelated to the abuses the Act was intended to address. In 1988, for example, Kentucky Utilities Company sought SEC approval for a restructuring that would establish a holding company over its utility operations. Under SEC precedent, it was unclear whether an out-of-state utility subsidiary that contributed approximately 7 percent of Kentucky Utilities' consolidated utility revenues could be disregarded as an immaterial subsidiary for purposes of section 3(a)(1). Before an exemption was granted, nearly three years later, the company was required to merge its operations into a single utility company that was then incorporated in two states.[23]

In other matters, however, the SEC has taken a more flexible approach. In 1992, for example, the SEC granted a temporary exemption to Kansas Power and Light Company, in connection with its acquisition of Kansas Gas & Electric Company.[24] The temporary exemption was intended to allow the resulting holding company to reorganize its corporate structure to

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[18] Commonwealth Edison Co., 28 S.E.C. 172, 173 (1948).

[19] Wisconsin Electric Power Co., 28 S.E.C. 906, 912 (1948).

[20] Sierra Pacific Resources, Holding Co. Act Release No. 24566 (Jan. 28, 1988).

[21] Washington Railway and Electric Co., 4 S.E.C. 191, 193-94 (1938).

[22] See Wisconsin Energy Corp., note 17 above, citing Northern States Power Co., Holding Co. Act Release No. 22334 (Dec. 23, 1981); Ohio Edison Co., Holding Co. Act Release No. 21019 (Apr. 26, 1979); Union Electric Co., 40 S.E.C. 1072, 1077 (1962). In Union Electric, the SEC noted that "in all prior cases where exemptions under Section 3(a)(2) have been denied, the gross utility revenues of the subsidiaries have exceeded 35 percent of those of the parent." 40 S.E.C. at 1077. Nonutility and wholesale electric revenues are generally excluded from the calculation. Id. at 1074-76.

[23] See KU Energy Corp., Holding Co. Act Release No. 25409 (Nov. 13, 1991). Kentucky Utilities Company, a Kentucky public-utility company and exempt holding company, merged with its Virginia subsidiary public-utility company, thereby mooting the materiality issue under section 3(a)(1). The company then incorporated in Virginia, as well as in Kentucky, in order to satisfy the requirements of Virginia law.

[24] Kansas Power and Light Co., note 12 above.

satisfy the requirements of SEC precedent under section 3(a)(2).[25] The exemption was consistent with the terms of an order of the state commission, which required restructuring by January 1, 1995.

2. Nonutility Holding Companies

The exemption under section 3(a)(3), for a company that is "only incidentally a holding company" was intended to reach, for example, a manufacturing concern generating power for its own use, which "has a little surplus power and sells it to the local community."[26] Although the legislative intent was narrowly defined, the SEC early recognized that the statute could be read broadly to exempt holding companies that Congress intended to be subject to regulation under the Act.[27]

To counter such a broad reading, the SEC interpreted section 3(a)(3) to require a functional or operational relationship between the utility operations and the holding company's primary nonutility business.[28] In addition, the SEC has required that the utility operations be small in an absolute sense,[29]

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[25] The companies were concerned that a direct merger could adversely affect contractual arrangements concerning a generating facility owned by Kansas Gas & Electric, and endanger the tax-free status of the acquisition.

[26] 79 Cong. Rec. 884 (1935) (statement of Sen. Wheeler). See also Hearings on H.R. 5423, before the House of Representatives Committee on Interstate and Foreign Commerce, 74th Cong., 1st Sess. 2226 (1935) (an industrial company with a power plant for its primary nonutility business, which distributes the excess power, should be exempt) (cited together with the statement of Sen. Wheeler in Electric Bond and Share Co., 33 S.E.C. 21, 41 (1952)).

[27] Section 3(a)(3) provides an exemption for a holding company that is:

> [O]nly incidentally a holding company, being primarily engaged or interested in one or more businesses other than the business of a public-utility company and (A) not deriving, directly or indirectly, any material part of its income from any one or more subsidiary companies, the principal business of which is that of a public-utility company, or (B) deriving a material part of its income from any one or more such subsidiary companies, if substantially all the outstanding securities of such companies are owned, directly or indirectly, by such holding company.

[28] See, e.g., Standard Oil Co., 10 S.E.C. 1122, 1128 (1942) (section 3(a)(3) requires "an incidental or accessory relationship" between the utility operations and the holding company's primary nonutility business). See also Castle and Cooke, Inc., Holding Co. Act Release No. 23928 (Dec. 2, 1985) (companies primarily engaged in manufacturing, which own or operate utility subsidiaries principally to supply power for manufacturing needs, and sell additional amounts to the general public); United States Steel Corporation, 1 S.E.C. 497 (1936); Milliken and Co., Holding Co. Act Release No. 23509 (Dec. 3, 1984).

[29] In an early matter, the SEC explained, "Certainly, the intention of Congress was not to exempt from the operations of the Act a company which would otherwise be subject thereto, solely by reason of its hybrid character." Standard Oil Co., note 28 above, at 1129.

and that the holding company derive only a small part of its income, generally less than ten percent, from its utility subsidiaries.[30]

Section 3(a)(4) establishes another type of nonutility exemption, for a holding company that is only "temporarily a holding company." [31] Although the legislative history does not reveal the specific rationale underlying section 3(a)(4), it appears that the exemption was intended to address a narrow set of circumstances in which holding company status was temporary, inadvertent and unaccompanied by the intent to exercise control, so that abuses were unlikely to occur. The exemption has been granted where utility stock is held as collateral for a debt on which the debtor defaults, and where an investment bank acquires utility stock that it agrees to distribute within one year.[32]

3. Foreign Holding Companies

Section 3(a)(5) provides an exemption for a holding company that:

> is not, and derives no material part of its income, directly or indirectly, from any one or more subsidiary companies which are, a company or companies the principal business of which within the United States is that of a public-utility company.

The legislative history indicates that the exemption under section 3(a)(5) was designed for United States holding companies that "hold all or substantially all of their operating companies outside the United States."[33] As originally

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[30] See, e.g., Consolidated Oil Corp., 2 S.E.C. 165, 167 (1937) (less than 1.1 percent of holding company's gross revenues and 0.75 percent of its income derived from utility operations); Standard Oil Company of California, 4 S.E.C. 626, 627-28 (1939) (utilities represented 2 percent of holding company's assets and between 1-2 percent of its gross revenues and income); Cities Service Co., 8 S.E.C. 318, 330-31, 334 (1940) (finding utility operations accounting for 47.3 percent of holding company's assets and 32.6 percent of its revenues too large to permit section 3(a)(3) exemption).

[31] Section 3(a)(4) exempts a holding company that is:

> temporarily a holding company solely by reason of the acquisition of securities for purposes of liquidation or distribution in connection with a bona fide debt previously contracted or in connection with a bona fide arrangement for the underwriting or distribution of securities.

[32] See Halsey, Stuart & Co., Inc., Holding Co. Act Release No. 132 (Mar. 27, 1936). See generally Hawes, Utility Holding Companies § 3.04[4a] (1987).

[33] Cities Service Co., 8 S.E.C. 318, 332 (1940). The legislative history indicates that Congress in 1935 did not contemplate ownership of a domestic utility by a holding company domiciled outside the United States. The Conference Report noted, among other things, with respect to the section 11 requirement that a holding company limit its utility properties to one integrated public-utility system:

(continued...)

proposed, section 3(a)(5) applied only to holding companies with exclusively foreign utility holdings.[34] The rationale for the exemption was that "the United States would not be interested in such companies at all except insofar as it was desired to regulate the sale of their securities in the United States."[35] The exemption was subsequently amended to accommodate companies whose utility holdings, while essentially foreign, also included some small domestic operations.[36]

The early cases under section 3(a)(5) involved holding companies with exclusively foreign utility operations.[37] In 1940, the SEC considered a matter in which a company with significant United States utility operations sought to rely on a literal reading of the statute to evade regulation under the Act.[38] The SEC rejected that argument, stating that the exemption was limited to

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[33](...continued)

> To this limitation the Senate bill, like the House bill, allows in section 3 exceptions in the case of a holding company whose interests are essentially intrastate and in the case of a holding company whose interests are essentially foreign.

H.R. Conf. Rep. No. 1903, 74th Cong., 1st Sess. at 70 (1935).

[34] See Senate Report at 24.

[35] 79 Cong. Rec. 8843 (1935) (statement of Sen. Wheeler).

[36] Senator Wheeler stated:

> It was contended before the committee that there might be companies, for instance, which were organized in the United States but held operating companies entirely outside the United States, and consequently that the United States would not be interested in such companies . . . . Then one of the Senators called my attention to the fact that some company of that kind might possibly hold another company, just a small company, in the United States and that it did not derive any material part of its income from that company. So this amendment is proposed as a substitute for the original exemption for foreign systems, and it enlarges the powers of the Commission with reference to such companies in the manner I have explained. 79 Cong. Rec. 8843 (1935).

Quoted in Cities Service Co., note 33 above, at 333 n.26.

[37] In 1940, the SEC noted that "in every case in which an exemption under Section 3(a)(5) has been applied for and granted, the applicant has been a holding company for a wholly foreign utility system." Cities Service Co., note 33 above, at 334 n.27.

[38] Id. at 332-34.

"essentially foreign holding company systems which include minor American utilities."[39]

In a recent matter, the SEC relied on this language in granting an exemption under section 3(a)(5) to a Canadian holding company with Vermont utility operations.[40] In Gaz Metropolitain, the SEC found that a foreign holding company with domestic utility operations that "account for no material part of the holding company's income" and are "small in size" may qualify for an exemption under section 3(a)(5).[41] It concluded that the requested exemption would not be detrimental to the public interest or the interests of investors or consumers.[42]

B. Regulation of Exempt Holding Companies

Under section 3(a), the SEC generally exempts qualifying holding companies from all provisions of the Act. Currently, there are 152 holding companies exempt under section 3(a). Under section 9(a)(2), however, exempt holding companies must obtain SEC approval under the standards of section 10 for subsequent utility acquisitions.[43] In addition, the SEC retains authority to modify or terminate an exemption for cause.[44]

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[39] Id. See also Electric Bond and Share Co., 33 S.E.C. 21, 51 (1952) (exemption "is applicable only where the utility operations conducted by a holding company are . . . 'essentially foreign,' and include at most only a small or minor domestic utility").

[40] Gaz Metropolitain, Inc., Holding Co. Act Release No. 26170 (Nov. 23, 1994). The SEC rejected the Division's argument that section 3(a)(5) was not intended to allow foreign companies to control domestic utilities.

[41] Id. (citing Electric Bond and Share, 33 S.E.C. at 51). The SEC also cited a previous order granting an exemption under section 3(a)(5), without discussion, to a Canadian holding company with both Canadian utility subsidiaries and a New York utility subsidiary. Consumers' Gas Co., Holding Co. Act Release No. 14956 (Oct. 17, 1963).

[42] The order noted that the Vermont Public Service Board, which regulates public utilities in Vermont, and the Vermont Department of Public Service, which represents the interests of Vermont ratepayers, supported the applications. The order also noted that the SEC could reconsider the exemptive order on the basis of changed circumstances. Gaz Metropolitain, Inc., Holding Company Act Release No. 26170 (Nov. 23, 1994).

[43] Section 9(a)(2) of the Act requires authorization, by order upon application, for the acquisition by "any person" that would result in the ownership of five percent or more of the voting securities of more than one public-utility company. Section 2(a)(1) defines "person" as "an individual or company."

[44] See sections 3(a) (the "unless and except" clause), 3(c) (and rule 6 thereunder), and 20(a).

1. Utility acquisitions

As with registered holding companies, the SEC must consider: whether the acquisition of a utility interest by an exempt holding company will unduly concentrate control of utility systems; whether the purchase price is reasonable; whether the purchase will unduly complicate the capitalization of the resulting system; and whether the transaction will serve the public interest by tending toward the economic and efficient development of an integrated public-utility system.

There was a question concerning the extent to which section 10(c)(1) and, by reference, section 11, apply to exempt holding companies. In 1974, the SEC stated that the provisions of section 11 "apply by analogy" to exempt companies.[45] In 1994, however, rather than apply the above described three part test, in the Gaz Metropolitain decision, the SEC modified this position, stating that the Act required only benefits to "an" integrated system.[46]

2. Diversification

The SEC has asserted authority under the "unless and except" clause to regulate the diversification activities of exempt holding companies where they are detrimental to the public interest or the interest of investors or consumers. The limits of permissible diversification, however, have never been defined or established. The objective tests under sections 3(a)(1) and 3(a)(2) consider only utility operations.[47] The statute does not prescribe any express limits on the nonutility activities of these companies. Indeed, although the Act expressly limits the nonutility activities of registered holding companies, it is silent concerning diversification by exempt holding companies.

In the early 1970s, concern over the nonutility activities of two exempt holding companies led the SEC to challenge their exemptions under the "unless and except" clause. The result was the inconclusive and non-binding Pacific Lighting decision, in which two commissioners held that the nonutility activities of exempt holding companies should complement the utility operations, and two other commissioners proposed guidelines under which utility activities would be separated from nonutility activities. Under these guidelines, contracts with or services rendered to or by the utility or associate companies would be subject to state regulatory supervision; utility management, funds or credit could not be diverted for nonutility purposes; and unrelated nonutility activities would be limited to a "relatively small"

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[45] Union Electric Co., 45 S.E.C. 489, 506 n.63 (1974).

[46] Gaz Metropolitain, Inc., Holding Co. Act Release No. 26170 (Nov. 23, 1994).

[47] See Texas Utilities Co., 31 S.E.C. 367, 370 (1950) (predominantly and substantially standard "relates to the business or management of electric or gas utilities as such").

component of system activities and would have an established and successful record or else complement the utility operations.[48] Thereafter, in 1978, the SEC stated that the "unless and except" clause "unquestionably authorized a limit upon diversification by a holding company exempt under Section 3(a)(1)."[49] The decision failed, however, to identify that limit.

In the 1980s, substantial diversification efforts by exempt holding companies prompted the SEC to address this issue by proposing rule 17.[50] Under the proposed rule, the SEC would not have challenged a company's exemption on the basis of such activities if (1) the state regulated a company's diversification, or (2) the diversification came within certain objective limits. The rule proposal met with general disfavor.[51]

The SEC has not taken action since 1978 to modify or revoke an exemption on the basis of a holding company's nonutility activities. It has given weight, in recent matters, to the state's judgment concerning the effect of diversification, as well as the state's ability to exercise effective regulatory control.[52] The D.C. Circuit has held that the SEC does not abdicate its duty in an exemption determination "by deciding to rely, watchfully, on the course of state regulation."[53]

C. Recommendations for the Future Use of Exemptions

The exemptions described above have, for the most part, been construed and applied conservatively. In the sixty years since the Act was passed, the effectiveness of state regulation of utility holding companies has

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[48] Pacific Lighting Corp., 45 S.E.C. 152 (1973).

[49] Lykes Bros., Inc., 46 S.E.C. 1196, 1198-99 (1978).

[50] Non-Utility Diversification by Intrastate Public-Utility Holding Companies, Holding Co. Act Release No. 24815 (Feb. 7, 1989).

[51] As discussed below, the Division recommends that the SEC withdraw proposed rule 17.

[52] See, e.g., Wisconsin Energy Corp., note 17 above ("the judgment of a state's legislature and public service commission as to what will benefit their constituents is entitled to considerable deference when not in conflict with the policies of the Act"). The SEC also looked to the affected states for assurances before issuing orders permitting exempt holding companies to acquire foreign utility operations prior to the Energy Policy Act of 1992. See, e.g., Dominion Resources, Holding Co. Act Release No. 25598 (Aug. 3, 1992); Houston Industries, Inc., Holding Co. Act Release No. 25590 (July 24, 1992); PSI Resources, Holding Co. Act Release No. 25570 (July 2, 1992); and SCEcorp, Holding Co. Act Release No. 25564 (June 29, 1992).

[53] Wisconsin's Environmental Decade, Inc., 882 F.2d 523, 527 (D.C. Cir. 1989) ("Nor has petitioner given any substantial reason why the SEC's watchful deference to the legislative and administrative judgment of a state regulating an intrastate holding company is not permissible under the Act.").

improved markedly. It is clear that the range of circumstances that can render a holding company susceptible of effective state regulation, or otherwise not the type of holding company at which the Act is directed, is substantially broader than that encompassed by the five specific exemptions contained in section 3(a).

As discussed below, if conditional or outright repeal are not feasible options, the Division recommends that Congress consider legislation to broaden the SEC's exemptive powers. Pending repeal or legislative reform, the Division believes that more flexibility is needed in the administration of section 3(a). The Division does not recommend the adoption of bright-line tests in this area. Instead, it favors close consultation and cooperation with state regulators to ensure that any liberalization of the exemption standards will not leave state regulators unable to protect the interests of utility consumers. The Division also recommends that the SEC withdraw proposed rule 17. These recommendations are discussed in detail below.

The SEC should apply more liberal standards for exemption, where the affected states agree.

Pending repeal or legislative reform, a number of commenters argue for interim administrative relief. CMS Energy Corporation ("CMS Energy"), for example, recommends that the SEC adopt policies that would permit exempt holding companies to engage in increased merger and acquisition activity and increased out-of-state sales of wholesale electricity without jeopardizing their exemptions. The commenter suggests that utilities could then merge to form more efficient structures, including cross-border electric transmission companies and combination gas and electric companies, to be more competitive.

Some commenters suggest that the SEC should define, or redefine, terms such as "predominantly intrastate," "material part of income," and "predominantly a public utility." Others recommend that the SEC adopt safe harbors with higher numerical limits than those approved under the precedent. The commenters say these changes would provide flexibility and regulatory certainty for companies as they respond to fundamental changes in the industry.

The Division agrees that more flexibility is needed in the administration of section 3(a). Rather than bright line tests, however, the determination of what is appropriate in the public interest necessarily turns on a consideration of the facts and circumstances of each situation.[54]

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[54] See Comments of the Public Utilities Commission of California ("California Commission") (it is difficult to recommend changes to the exemptions until it is clear how industry structure will change as a result of competition and the possible disaggregation of traditional vertically-integrated utilities).

In this regard, the Division believes it is important for the SEC to work in consultation and cooperation with the affected state regulators. As the Virginia Commission notes, some exemptions may be based on a faulty premise of effective state regulation. It explains that it may not have authority to approve all financing transactions of utility holding companies; regulatory powers over the holding company are derived from authority over its utility subsidiary. Such regulatory authority, the Virginia Commission concludes, is far from a complete substitute for the authority granted to the SEC under the Act.

In other contexts, the SEC has required assurances that the state can adequately protect utility consumers against any detriment that might be associated with certain activities of exempt holding companies.[55] The Division believes it would be appropriate to require similar assurances as a condition of any proposed liberalization of the exemption standards.

The SEC should continue to review utility acquisitions by exempt holding companies.

A number of commenters urge the SEC to adopt a rule to exempt utility acquisitions that are subject to approval by other regulatory authorities. A group of exempt companies, for example, asserts that SEC review under sections 9(a)(2) and 10 is not needed to protect the public interest and the interests of investors and consumers where all interested state regulatory bodies and the FERC have approved the acquisition and the resulting entity would meet the integration requirements of, and qualify for exemption under the Act.

While the Division agrees that the SEC's review in this area is largely redundant, it does not believe that it could readily make the findings to support a broad grant of exemption from section 9(a)(2).[56] Accordingly, the Division recommends that the SEC continue to administer the standards of section 10 flexibly, in consultation with the affected state and local regulators. The Division, however, will explore ways to further streamline the review process.

The SEC should withdraw proposed rule 17.

Another issue of concern to commenters is the possible regulation of diversification by exempt holding companies. As discussed above in Chapter 3, the SEC proposed for comment a rule that was intended to clarify the

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[55] See, e.g., SCEcorp, note 52 above.

[56] Among other things, the SEC would have to find that the standards of section 10 are satisfied in every instance.

circumstances in which diversification would not be a basis for challenge to a company's exemption. The SEC received seventy-nine comment letters in response to the proposal.[57] A majority of the commenters opposed the rule and urged its withdrawal. Few offered any support for the proposal; none supported it without qualification.

The criticisms were generally that the proposed rule exceeded the SEC's authority under the Act; it represented unwarranted federal intrusion into an area of primary state regulation; it was unnecessary absent empirical evidence of diversification-related detriment; and the SEC should instead police the diversification activities of individual exempt companies under the "unless and except" clause.

The Division does not agree in every instance with the commenters. Among other things, there is no provision in the Act for enjoining the diversification activities of an exempt company prior to a formal determination that the company is not entitled to an order of exemption.[58] While it is true that the prospect of SEC intervention will frequently cause an exempt holding company to reconsider a course of action that might jeopardize its exemption, there is no assurance that the staff will timely receive the relevant information.

On balance, the Division believes it is appropriate for the SEC to withdraw proposed rule 17. Diversification by exempt intrastate holding companies is not per se detrimental to the protected interests. Concerns can be addressed on a case-by-case basis under the SEC's "unless and except" powers.

The SEC should not limit its discretion under the "unless and except" clause.

A number of commenters seek assurance that the SEC will not seek to limit diversification by exempt holding companies. In this regard, CMS Energy, for example, recommends that the SEC minimize the extent to which

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[57] The individual comments on the proposed rule are in SEC Public File No. S7-2-89.

[58] Section 18(f) of the Act authorizes the SEC to institute suit in federal court to enjoin "any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule, regulation, or order thereunder." Improvident diversification by an intrastate exempt holding company does not, however, constitute a violation per se of any of the provisions of the Act. As the Second Circuit noted:

> [T]he Congress conferred upon the Commission . . . the power to invoke the aid of the courts only to prevent evasion of the Act and non-compliance with the orders of the Commission. There is concededly no power to restrain or discipline holding companies exempt from its provisions.

SEC v. Long Island Lighting Co., 148 F.2d 252, 256 (2d Cir. 1945).

the "unless and except" clause may be used to limit nonutility diversification by exempt holding companies. The commenter expresses concern that the uncertainty produced by the potential loss of an exemption acts as a significant restraint on the ability of exempt holding companies to diversify into nonutility businesses.

Instead, CMS Energy urges the SEC to adopt guidelines designed to insulate the utility from the activities and financial effects of the nonutility business. The CMS Energy guidelines would require mandatory separation of utility and nonutility activities into separate corporate entities, prohibitions against guarantees, loans, or other financial arrangements that shift financial risk to the utility from nonutility subsidiaries and limitations on parent company obligations to nonutility companies and creditors, and access for state regulators to the books and records of the utility and the parent holding company with appropriate protections for competitively sensitive proprietary information.

CMS Energy rejects any definitive limits on the size, geographical location or nature of non-utility business activities by exempt holding companies.[59] Instead, the company suggests that the "unless and except" clause should serve as "an enforcement backstop," with the SEC exercising its authority in this area only after a public hearing that finds actual injury to investors or utility customers as a direct result of non-utility activities.

Several state regulators, however, suggest that more intensive review may be appropriate. The Virginia Commission notes that it is inconsistent with the public interest, and incongruous with the restrictions placed on registered companies, that exempt holding companies need no approval from federal or state agencies to diversify in nonutility areas. The Michigan Commission Staff recommends that safeguards, such as limiting the amount of diversification, be assessed for all companies to minimize the risks to both investors and consumers.

While the Division does not recommend a heightened scrutiny of nonutility activities of exempt holding companies, neither does it believe that the SEC should limit its authority under the "unless and except" clause. The legislative history makes clear that the SEC's "unless and except" authority is the justification for any broad grant of exemption.[60] Particularly in view of the liberalization the Division recommends in this area, it is important that the SEC maintain flexibility to address problems that may arise.

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[59] See also Comments of Questar Corporation ("Questar") (the SEC should announce that it does not intend to adopt regulations to limit the diversification activities of exempt holding companies).

[60] See Senate Report at 24; House Report at 11 ("[T]he Committee felt free to broaden the exemptions beyond what would be justified if the exemptions had been made unqualified and self-operative and beyond the power of the Commission to correct.").

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Other administrative reforms suggested by the commenters include regulatory exemptions under section 3(d), modification of rule 5, an automatic exemption under section 3(b) for any foreign subsidiary of a holding company, and a rule providing for automatic approval if the SEC does not rule on a request for exemption under section 3(a) or 3(b) within 120 days. Apart from an amendment to section 3(a) to broaden the SEC's exemptive powers, the Division believes that it would be premature to recommend changes to the Act's exemption section until it is clear how the industry will react to and be affected by increased competition, advanced structural and technological innovation, and greater reliance on state regulation.

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Chapter 7. Other Recommendations

A. Investment Company Issues

Questions have arisen in recent years concerning acquisitions of securities of public-utility companies by investment companies and advisers, whether acting on behalf of collective investment vehicles, individual clients or their proprietary accounts. The SEC requested comment on whether these entities should be subject to regulation as utility affiliates[1] or holding companies.[2]

The SEC received comments on these issues from three members of the securities industry,[3] the Investment Company Institute ("ICI"), three registered holding companies,[4] two public-utility commissions,[5] the AGA and the New York Bar Committee.

The commenters from the securities industry, the AGA and the New York Bar Committee support a broad exemption of investment companies and advisers from regulation under the Holding Company Act. The ICI suggests that the SEC adopt an exemption for investment companies and advisers modeled on rule 16a-1 under the Securities Exchange Act of 1934.[6]

Those commenters urging a broad exemption contend that the activities of investment companies and advisers do not implicate the policy concerns of

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[1] See section 2(a)(11)(A) (any person owning 5 percent or more of the outstanding voting securities of a company). Among other things, an affiliate must seek prior SEC approval for the acquisition of five percent or more of the voting shares of any other utility or holding company. See section 9(a)(2).

[2] See section 2(a)(7). Among other things, a holding company may be required to divest any unrelated nonutility interests. See section 11(b)(1).

[3] Alliance Capital Management L.P. ("Alliance Capital"), Capital Research and Management Co., and Merrill Lynch, Pierce, Fenner & Smith Incorporated.

[4] Allegheny Power System, Inc. ("Allegheny"), NEES and Southern.

[5] The Michigan Commission Staff and New Orleans.

[6] Rule 16a-1 provides that the securities holdings of certain parties are not considered for purposes of determining whether an entity is a "ten percent holder" that may be subject to reporting requirements and short-swing profit restrictions under section 16 of the Exchange Act, under certain circumstances. Specifically, rule 16a-1 provides that certain parties are not considered the beneficial owners of securities "held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business . . . as long as such shares are acquired by such institutions or persons without the purpose or effect of changing or influencing control of the issuer." 17 C.F.R. § 240.16a-1(a)(1). The ICI notes that securities held as portfolio securities by investment companies are encompassed by the rule.

the Holding Company Act and, in particular, section 9(a)(2). One commenter notes that the Holding Company Act was intended to curb abusive practices that stemmed from control of public-utility companies. In this regard, the commenters state that neither investment companies nor advisers generally invest for the purpose of exercising control; rather, they purchase utility or holding company securities in the ordinary course of business as fiduciaries of the security holders of the investment company or the parties on whose account the purchases are made.[7]

Two commenters in this group also state that the application of the Holding Company Act to investment companies and advisers would discourage investment in the utility industry.[8] Other commenters in this group assert that limiting the investment flexibility of investment companies and advisers would be detrimental to their shareholders and clients.

Of the registered holding companies commenting on the issue, one stated that an investment company or adviser should be subject to regulation under the Holding Company Act if it comes within the definition of an affiliate.[9] Another stated that such regulation is warranted "to the extent that the investment company or adviser asserts independent voting and operational control over the public utility company."[10] A third suggested that a mutual fund or fund adviser would prefer divestment of its utility or holding company securities to regulation under the Holding Company Act. This commenter suggested the SEC consider "whether such divestitures could have materially adverse consequences to public-utilities and cause disruptions in the capital markets."[11]

The Division believes that there is merit to exempting investment companies and advisers from application of the Holding Company Act. Accordingly, the Division recommends that the SEC consider a rule on this matter.

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[7] Alliance Capital notes that it has general fiduciary obligations to clients over whose accounts it has investment and voting discretion, by virtue of state statutes, the Investment Company Act of 1940, the Investment Advisers Act of 1940 and, under certain circumstances, the Employee Retirement Income Security Act of 1974.

[8] Similarly, the Michigan Commission Staff questions whether the SEC would want to undertake the regulation of investment companies or advisers under the Holding Company Act.

[9] Comments of Allegheny.

[10] Comments of NEES.

[11] Comments of Southern.

B. Foreign Utility Company Rules

The Energy Policy Act amended the Act to create two new classes of exempt entities: exempt wholesale generators (governed by new section 32) and foreign utility companies (governed by new section 33). Section 33(c)(1) directs the SEC to adopt rules relating to foreign utility company acquisitions by registered holding companies that provide for the protection of the domestic customers of the registered system and the maintenance of the financial integrity of the system.[12]

In March 1993, the SEC requested public comment on rules designed to implement this directive. Proposed rule 55 defined the circumstances under which a registered holding company can acquire an interest in a foreign utility company without the need to apply for or receive SEC approval. The rule prescribed three conditions that related to the size of the registered system's investment in foreign utility companies, the SEC's access to books and records, and the provision of services by domestic utility personnel. Where these conditions were satisfied, the acquisition could proceed absent an event of bankruptcy or other evidence of financial or operating problems. Proposed rule 56 clarified the status of subsidiary companies of registered holding companies formed to hold interests in foreign utility companies.[13] Most commenters felt that the SEC should not adopt rules concerning foreign utility company acquisitions without additional study by the SEC and further opportunity for public comment. Accordingly, action was deferred on proposed rules 55 and 56, pending further consideration.

In response to the comments and on further consideration, the Division suggests several revisions to the proposed regulations. The modifications are generally intended to create additional protection for consumers of registered holding company systems.[14]

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[12] The legislation places no restrictions upon foreign utility company acquisitions by registered holding companies pending the adoption of such rules.

[13] These rules were part of a comprehensive set of proposed regulations intended to implement congressional directives pertaining to exempt wholesale generators ("EWGs") under section 32, as well as foreign utility companies under section 33. See Holding Co. Act Release No. 25757 (Mar. 8, 1993). On September 23, 1993, the SEC adopted rule 53 (17 C.F.R. § 250.53) which creates a safe harbor with respect to the issuance and sale of a security by a registered holding company to finance the acquisition of an EWG, or the guarantee by the parent of the securities of an EWG, rule 54 (17 C.F.R. § 250.54), which similarly creates a safe harbor for system transactions that do not involve EWGs or foreign utility companies, and rule 57 (17 C.F.R. § 250.57) and Forms U-57 and U-33-S, which address the notification and reporting requirements for foreign utility companies and their associate public-utility companies. See Holding Co. Act Release No. 25886 (Sept. 23, 1993).

[14] The Division has modified proposed rule 56 for technical reasons. See below.

First, the Division has incorporated a procedure in proposed rule 55 that allows consumer advocates, state and local regulators, and others to challenge a registered holding company's reliance upon the exemption of the rule. Under this procedure, the SEC may, in its discretion, preclude further reliance upon the exemption if it appears to the SEC that any question exists whether the exemption may be detrimental to the public interest or the interest of investors or consumers. The withdrawal of the safe harbor would be done by order of the SEC after an opportunity for hearing and could be based upon information filed with the SEC or otherwise developed by the SEC and its staff. The restriction would cease to apply if the SEC determines, following notice and opportunity for hearing, that such reliance does not appear to be detrimental to the protected interests. During the period in which the safe harbor is unavailable, a company would be required to obtain SEC approval by order, upon application, or FERC determination where relevant,[15] to invest in foreign utility companies.

Second, new proposed Form U-55 is intended to ensure that federal, state and local ratemaking authorities will receive timely information concerning foreign utility company acquisitions made in reliance upon rule 55. The proposed form should enhance the regulators' ability to monitor these investments and facilitate any inquiry as to whether a company's reliance upon the safe harbor of rule 55 is detrimental to interests of investors and consumers.

Third, the Division has revised proposed rule 56 to delete the provisions under which an intermediate subsidiary holding interests in EWGs or foreign utility companies or both would be treated as foreign utility companies. Few comments were received on the proposed rule.[16] Under the revised proposed rule, only a company that is engaged directly or indirectly, and exclusively, in the business of owning or operating, or both owning and operating, all or part of one or more foreign utility companies will be treated as a foreign utility company.

It is unlikely that the revised proposed rules, in particular, rule 55, will be viewed favorably by those commenters most dissatisfied with the rules as

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[15] Certain entities that own or operate foreign generating facilities may qualify for status as either EWGs or foreign utility companies. Although the SEC is directed to adopt rules concerning the acquisition of an interest in a foreign utility company, the acquisition of an EWG is unconditionally exempted from the requirement of pre-acquisition approval. See section 32(g).

[16] In view of the fact, however, that the Energy Policy Act treats the direct acquisition of foreign utility companies differently from that of EWGs, the Division believes it would be inappropriate to apply a uniform standard to indirect acquisitions of these mixed interests. Whereas section 32 unconditionally exempts the acquisition of an EWG by a registered holding company, section 33 subjects the acquisition of a foreign utility company to any conditions that the SEC adopts in rules under section 33.

originally proposed. The Division nonetheless believes that the proposed regulations, as modified, strike a reasonable balance between the competing concerns. Accordingly, the Division recommends that the SEC issue separate releases requesting public comment on revised proposed rule 55 and proposed Form U-55, and adopting proposed rule 56 as revised.

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PART III. LEGISLATIVE RECOMMENDATIONS

In Part II, the Division presented a number of administrative recommendations for reform of the Act. There are limits, however, to the scope of the SEC's authority in this regard. Although the SEC has attempted to interpret the Holding Company Act flexibly and responsively, there is an increasing tension between the model of regulation under the Act, and the rapidly evolving structure of the utility industry. It is time for Congress to consider repeal or fundamental reform of the statute.

The Division has developed three legislative recommendations for Congress' consideration. Congress could:

- repeal the Holding Company Act and strengthen the ability of the FERC and state regulators to obtain books and records, conduct audits and review affiliate transactions;

- repeal the Holding Company Act, without condition; or

- amend the Holding Company Act to give the SEC broader exemptive authority.

Because it would achieve the benefits of unconditional repeal, while preserving the ability of states to protect consumers, the Division prefers the conditional repeal option discussed below. Of course, the choice of legislative options is one that Congress must make.

A. Conditional Repeal

The Holding Company Act regulates and restricts, among other things, the ability of regulated holding companies to issue securities, to acquire other utilities, to acquire nonutility businesses and to engage in affiliate transactions. In the Division's judgment, many of these limits are no longer necessary. Certain provisions of the Holding Company Act, however, still serve a useful function. In particular, the SEC's ability to obtain books and records, to audit holding companies and subsidiaries and to review affiliate transactions, assists states in protecting utility consumers. The Division believes that former efforts to repeal the Act failed largely because they did not address concerns about the continuing importance of these consumer protection provisions.

The option discussed in this section would condition repeal of the Holding Company Act on the enactment of provisions ensuring access to books and records needed for the effective discharge of a state's regulatory responsibilities, and providing for federal audit authority and oversight of affiliate transactions. The task of enforcing such provisions should be entrusted to the FERC as the agency with direct responsibility for the protection of energy consumers. Any repeal legislation, however, should include a minimum one-year transition period to allow states, utilities and other affected parties to prepare for the new regulatory regime.

This section first explains why many of the major requirements of the Holding Company Act are no longer necessary. It then discusses the consumer protection issues that the Division believes should be addressed in any repeal legislation.

1. The Act's Securities Provisions

The Holding Company Act was enacted in large part because public-utility holding companies had misled and acted contrary to the interests of investors. The Act requires registered holding companies to obtain SEC approval before they or their subsidiaries issue any securities. Under section 7 of the Act, the SEC must consider such factors as whether the security is "reasonably adapted to the security structure" and "necessary or appropriate to the economical and efficient operation" of the holding company system. Other securities provisions authorize the SEC to regulate the terms of underwriting, the solicitation of proxies, annual and other reports and systems of accounts for registered holding companies and their subsidiaries.[1]

At least three developments since 1935 have rendered these provisions of the Holding Company Act unnecessary. First, as discussed previously, the SEC has developed a comprehensive system of disclosure regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934. These statutes were in their infancy and indeed under attack in the courts when Congress passed the Holding Company Act in 1935.[2] Moreover, the annual reporting requirements of the Exchange Act applied only to companies with securities listed on exchanges, and thus applied to few public utility holding companies. In 1964, Congress amended the Exchange Act so that its annual reporting and other requirements would apply to all companies with over $1 million in assets and more than 500 shareholders.[3] Today, the reporting

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[1] See Holding Company Act sections 12(d), 12(e), 14 and 15(i).

[2] See Oklahoma-Texas Trust v. SEC, 100 F.2d 888, 890 (10th Cir. 1939) (contesting constitutionality of Securities Act); Wright v. SEC, 112 F.2d 89, 94 (2d Cir. 1940) (contesting constitutionality of Exchange Act).

[3] See Exchange Act section 12, 15 U.S.C. § 78l.

requirements of the Exchange Act reach every widely held public-utility holding company.

The system of securities regulation under the Holding Company Act differs from the system of regulation under the Securities Act and the Exchange Act. While those statutes generally focus on disclosure, substituting "a philosophy of full disclosure for the philosophy of caveat emptor,"[4] the Holding Company Act requires the SEC to evaluate the merits of securities issuances. Many have argued that this type of review improperly limits the ability of investors to make their own investment decisions.[5]

Second, accounting standards have substantially improved and become more uniform since 1935. The FERC has established uniform systems of accounts for all electric and gas utility companies operating in interstate commerce. In addition, most states have developed their own uniform accounting systems for utilities, closely patterned, in general, on the FERC standards.[6] In recognition of these developments, the SEC in 1975 rescinded the uniform system of accounts it had previously developed for registered holding companies under section 15 of the Holding Company Act.[7]

Third, the financial industry has changed substantially since 1935. In part because of their liabilities under the Securities Act, underwriters now conduct substantial "due diligence" activities when they underwrite a securities offering. Rating agencies scrutinize the finances of utility holding companies; a favorable rating is generally considered essential for a public-utility debt offering. Institutional investors have become considerably better informed and more sophisticated. Individual investors have the benefit, whether directly or indirectly, of thorough analysis by industry experts.

The securities provisions of the Holding Company Act impose costs. Although the Division strives to process financing applications as

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[4] See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

[5] See Ad Hoc Subcommittee on Merit Regulation, Report on State Merit Regulation of Securities Offerings, 41 Bus. Law. 785 (1986); Campbell, An Open Attack on the Nonsense of Blue Sky Regulation, 10 J. Corp. L. 553 (1985); James S. Mofsky & Robert D. Tollison, Demerit in Merit Regulation, 60 Marq. L. Rev. 367 (1977).

[6] See Appendix A.

[7] See Adoption of Revised Rule 26 Under the Public Utility Holding Company Act of 1935 and Rescission of the Uniform System of Accounts for Holding Companies, Holding Co. Act Release No. 18963 (May 1, 1975). The SEC, however, has retained a uniform system of accounts for mutual service companies and subsidiary service companies. See 17 C.F.R. pt. 256.

quickly as possible, the process of seeking and obtaining SEC approval inevitably creates delays. While an application is pending, rapid changes in interest rates may moot an attractive opportunity to issue debt securities. Similarly, attractive opportunities to issue equity securities may disappear. Regulatory delay may also prevent a registered holding company from issuing such securities on the most favorable terms, thereby depriving customers and investors of the benefits of efficient financing.

As the SEC observed in 1982, "investors in registered public utility companies would remain adequately protected" if the Holding Company Act were repealed.[8] Since this remains true today, the securities provisions of the Holding Company Act should be repealed.

2. The Act's Restrictions on Utility Ownership

The Holding Company Act generally requires prior SEC approval of utility acquisitions.[9] In many instances, the SEC's review duplicates those of the FERC and state and local regulators. To the extent that the standards in the Act are not duplicative, they may be unduly restrictive, as in the case of the geographic integration requirement for registered holding companies.

The SEC's review of electric utility acquisitions and mergers under the Holding Company Act largely parallels the review by the FERC under the Federal Power Act. Under section 203 of the Federal Power Act, the FERC reviews transfers of "jurisdictional assets," including transfers involving holding companies. The FERC considers, among other factors, "the reasonableness of the purchase price," "the effect on competition," "the impact on the effectiveness of state and Federal regulation," and whether the merger is justified by cost savings.[10] Many of these issues are issues the SEC considers under the Holding Company Act, and in recent years the SEC generally has not held separate hearings on these issues.[11]

The SEC's review of utility acquisitions also often parallels reviews by the state regulators. Most state commissions have either direct or indirect jurisdiction over utility acquisitions, and some states

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[8] Chairman Shad Testimony at 397.

[9] For further discussion, see Part II, Chapter 2, above.

[10] See, e.g., El Paso Electric Co., 68 FERC ¶ 61,181 (1994).

[11] See, e.g., CINergy Corp., Holding Co. Act Release No. 26146 (Oct. 21, 1994); Entergy Corp., Holding Co. Act Release No. 25952 (Dec. 17, 1993); UNITIL, Holding Co. Act Release No. 25524 (Apr. 24, 1992); Kansas Power & Light Co., Holding Co. Act Release No. 25465 (Feb. 5, 1992).

extend this jurisdiction to acquisitions by utility holding companies.[12] Although the statutory standards differ from state to state, in general, state regulators review utility acquisitions to assure that they will not adversely affect consumers. The courts have approved the SEC's "watchful deference" to state regulatory review.[13]

Finally, the SEC's review of the potential anticompetitive effects of utility acquisitions parallels review by the Department of Justice and Federal Trade Commission under the federal antitrust laws.[14] The antitrust agencies receive detailed information regarding the potential effects of mergers or acquisitions under the Hart-Scott-Rodino Antitrust Improvements Act of 1976.[15] The antitrust agencies have developed detailed guidelines to guide their consideration of mergers and acquisitions and to reduce uncertainty for businesses.[16] Although the SEC considers antitrust issues under the Holding Company Act,[17] it cannot replicate the expertise of the antitrust agencies on these issues.

Many of the comment letters in response to the Concept Release urged that the Act be amended or interpreted to eliminate duplicative Commission review of utility acquisitions. These comments came not only from regulated holding companies but also, in some cases, from state regulators.[18] Other state regulators, however, urged that the SEC continue to review utility acquisitions to protect the existing customers of the holding companies' utility subsidiaries.[19]

One aspect of the Holding Company Act that is not duplicated by other regulatory regimes is the integration requirement of section 11. This provision has been interpreted to prohibit a domestic holding company from owning utility companies in distant states. The integration requirement was imposed, in part, because Congress believed that local utilities would be more efficient and susceptible to effective

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[12] See Appendix A.

[13] See Wisconsin's Environmental Decade v. SEC, 882 F.2d 523, 527 (D.C. Cir. 1989).

[14] Competitive issues are also considered by the FERC in its review of utility acquisitions. See Gulf States Utilities Co. v. FPC, 411 U.S. 747, 760 (1973).

[15] 15 U.S.C. § 18.

[16] See Merger Guidelines, 57 Fed. Reg. 41552 (Sept. 10, 1992).

[17] See Municipal Electric Association v. SEC, 413 F.2d 1052 (D.C. Cir. 1969); section 10(b)(1) of the Act.

[18] See Comments of the Michigan Commission Staff and of New Orleans.

[19] See Comments of Virginia Commission.

regulation than the existing holding companies. Today, however, efficiency considerations may argue in favor of allowing holding companies to own utilities in noncontiguous states. Consumers in different states often have different demands for energy, and a company serving several states may make more efficient use of its generation and transmission facilities. Also, there are often significant administrative cost savings from utility mergers, savings that have little to do with whether the utilities serve contiguous areas.

Another aspect of the Holding Company Act that has no parallel at the federal level is the restriction on ownership of both gas and electric utilities. The SEC has generally interpreted section 11 of the Act to preclude ownership of both gas and electric utility companies by a single registered holding company. In contrast, the SEC has routinely permitted the ownership of both gas and electric facilities by exempt holding companies.[20]

Although the Division recommends that the SEC relax its policy on ownership of both electric and gas facilities, the question for Congress is whether there is a need for any federal restriction. To the extent that combinations of gas and electric utilities reduce competition, and thereby threaten consumers, they can be addressed through the federal antitrust laws, like other combinations of competing firms. Moreover, to the extent that states desire as a matter of energy or antitrust policy to prohibit such combinations in particular states, they are free to do so.[21]

3. The Act's Restrictions on Diversification

The Holding Company Act limits the ability of the registered holding companies to diversify into nonutility businesses. The Act also limits the ability of nonutility companies to diversify into the utility business.

For registered holding companies seeking to diversify, the critical provision is section 11 which limits a registered holding company to businesses that are "reasonably incidental, or economically necessary or appropriate" to the operation of its integrated utility system. Although the SEC may be able to relax many of these restrictions without

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[20] See WPS Resources Corp., Holding Co. Act. Release No. 26101 (Aug. 10, 1994), Southern Indiana Gas and Electric Co., Holding Co. Act Release No. 26075 (June 30, 1994), and Illinova Corp., Holding Co. Act Release No. 26054 (May 18, 1994).

[21] See section 8 of the Act, discussed in Part II, Chapter 2, above.

legislation,[22] the question for Congress is whether to retain any federal restrictions on diversification into and out of the utility business.

The diversification restrictions have had several effects on the utility industry. First, they preclude registered holding companies from entering businesses that are deemed unrelated to the utility business. Other utilities, including exempt utility holding companies and telephone companies, are entering these businesses, resulting in increased competition for consumers.

Second, the diversification restrictions limit the ability of other companies to enter the utility business. There may be many companies involved in manufacturing, energy, finance, telecommunications or other businesses that would be interested in diversifying into the utility industry. There may be substantial economies to be achieved by allowing these companies to acquire and operate utilities. To the extent that the Holding Company Act discourages such acquisitions, the market cannot test whether such acquisitions would be sensible or profitable. In this regard, the Act is inconsistent with the carefully neutral attitude towards takeovers that Congress adopted in the 1975 amendments to the Exchange Act.[23]

Of course, not every investment by a registered holding company in a nonutility business, or by a nonutility company in a utility business, will prove profitable. Indeed, ventures by exempt holding companies into unrelated businesses such as banking, drug stores and real estate have proven largely unsuccessful. On balance, however, it would appear that, if consumers are protected by other federal and state statutes, as discussed below, benefits may be achieved by removing the Holding Company Act's diversification restrictions.[24] Investors are already protected by the disclosure required under the Securities Act and the Exchange Act. The disclosure requirements under these laws are designed to ensure that investors have the information they need regardless of how diverse and complex the operations of a company.

The extent to which the Act's restrictions on diversification benefit consumers is unclear. The SEC's regulation in this area affects only the small universe of registered holding companies; many exempt holding companies and other utilities are substantially diversified.

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[22] See Part II, Chapter 3, above.

[23] See Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58-59 (1975).

[24] One study submitted to the SEC estimates the net present value of allowing the registered holding companies to diversify into nonutility businesses at $2 billion to $4.5 billion. See comments of CSW (Carpenter-Graves Study). This study did not attempt to estimate the benefits of allowing nonutility companies to diversify into the utility business.

Further, the Gas Related Activities Act and the Energy Policy Act permit significant investments by registered holding companies in nonutility activities. In any event, the SEC's review evaluates a transaction under the standards of the Act --- it does not guarantee the financial success of a nonutility venture. As discussed below, it may make more sense to focus on transactions between regulated utilities and their diverse unregulated affiliates, so that these transactions are economically fair to the regulated utility.

4. Federal Protections Regarding Records, Audits and Affiliate Transactions

The comprehensive regulation of holding companies under the Act is intended to protect investors and consumers of these companies. Given the developments in the industry and in other regulatory regimes, a less structural, more targeted regulatory approach now seems appropriate. In particular, if Congress pursues conditional repeal, the Division suggests that Congress ensure state access to books and records, federal audits and federal review of affiliate transactions.

Books and Records. To assess whether a transaction between a regulated utility and an unregulated affiliate is economically fair to the utility, and thus to the utility's consumers, the FERC or the state regulator will need access to the books and records of the unregulated affiliate. The SEC has authority, under section 15 of the Holding Company Act, to obtain records from registered holding companies and their subsidiaries and affiliates. The FERC has similar authority to examine books and records not only of a utility, but also of a person who controls such a utility, and of any company controlled by such a person.[25] Moreover, the FERC has authority to "make available to the several State commissions such information and reports as may be of assistance in State regulation of public utilities."[26]

Many states, however, report that they cannot readily obtain the books and records of an out-of-state company.[27] In the Energy Policy Act, Congress created a federal right for a state regulator to examine books and records of a regulated electric utility, an exempt wholesale generator selling electricity to such a utility, and certain affiliates or

[25] "The books, accounts, memoranda, and records of any person who controls, directly or indirectly, a licensee or public utility subject to the jurisdiction of the Commission, and of any other company controlled by such person, insofar as they relate to transactions with or the business of such licensee or public utility, shall be subject to examination on order of the Commission." Federal Power Act section 301(c), 16 U.S.C. § 825(c); see Natural Gas Act section 8(c), 15 U.S.C. §§ 717g(c).

[26] Federal Power Act section 210(c), 16 U.S.C. § 824h(c).

[27] See Appendix A.

associates of such an EWG. State regulators may only examine books and records "if such examination is required for the effective discharge of the State commission's regulatory responsibilities affecting the provision of electric service." If state regulators obtain information under this provision, they may not disclose "trade secrets or sensitive commercial information."[28]

Although this provision of the Energy Policy Act provides useful access to state regulators, it is considerably more limited than the access of the SEC under the Holding Company Act, largely because it only applies when an EWG sells to a regulated utility. On the other hand, the provisions in the Holding Company Act and the FERC statutes do not explicitly allow the federal agencies to obtain books and records for the sole purpose of providing them to a state regulator.[29] What is needed, therefore, is a new provision that incorporates elements of both approaches.[30]

In developing such a provision, Congress would need to consider several subsidiary issues, including:

- Which companies should be subject to the records requirements? Should the records requirements reach only those companies that are currently registered holding companies?

- Which subsidiaries of holding companies should be subject to the requirements? The Holding Company Act reaches records of "affiliates," defined to include any company in which the holding company directly or indirectly owns more than 5 percent of the securities. The Federal Power Act and Natural Gas Act, by contrast, only reach records of companies "controlled by" the holding company.

- On what terms should federal authority be used to obtain records for state regulators? Should the state regulator be required, as under the Energy Policy Act provision, to certify that records are "required for the effective discharge" of its regulatory responsibilities? Should there

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[28] Federal Power Act section 210(g), 16 U.S.C. § 824(g).

[29] In practice, the SEC has, on occasion, used its ability to obtain books and records under the Holding Company Act to obtain information for state regulators.

[30] Section 21(a)(2) of the Exchange Act may provide another useful model. This provision was added in 1988 to allow the SEC to investigate potential violations of foreign securities laws, and to provide the resulting information to foreign securities authorities. 15 U.S.C. § 78u(a)(2).

be limits, similar to those in the Energy Policy Act provision, on disclosure of confidential information?[31]

Audits. To confirm that the books and records accurately reflect transactions between a regulated utility and its affiliates, the FERC will need authority to assist and coordinate with state regulators in audits of multistate utility systems.

The SEC has broad authority, under sections 15 and 21 of the Holding Company Act, to audit and investigate companies in a registered system. The FERC has authority to investigate whether there have been violations of the Federal Power Act or "to aid in the enforcement" of the FPA, with respect to jurisdictional utilities. Moreover, the FERC "may publish or make available to State commissions information concerning any such subject."[32] It would appear, however, that the FERC does not have authority under the Federal Power Act to investigate every company in a registered system, or to use its investigative powers solely for the purpose of assisting a state regulator in setting state rates or enforcing a state regulatory statute.

In developing an audit provision along these lines, Congress would need to consider issues similar to those outlined above:

- Which companies in a holding company system should be subject to the audit requirements?
- On what terms should state regulators be permitted to participate in and benefit from federal audits? One question, for example, is whether state regulators involved in an audit under federal authority would be subject to federal ethics and confidentiality restrictions.

Affiliate Transactions. The third condition Congress should consider is federal authority to ensure that transactions between a regulated utility and an affiliate are economically fair to the utility. Section 13(b) of the Holding Company Act directs the SEC to ensure that transactions between regulated utilities and other subsidiaries of holding companies are conducted "at cost, fairly and equitably allocated

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[31] Section 24(c) of the Exchange Act may also provide a useful model: "The Commission may, in its discretion and upon a showing that such information is needed, provide all 'records' (as defined in subsection (a)) and other information in its possession to such persons, both domestic and foreign, as the Commission by rule deems appropriate if the person receiving such records or information provides such assurances of confidentiality as the Commission deems appropriate." 15 U.S.C. § 78x(c).

[32] See Federal Power Act section 307(a), 16 U.S.C. § 825(f).

among such companies." The Federal Power Act addresses the issue more generally, through the requirement that wholesale electric rates be "just and reasonable."

Many states also have statutory provisions or practices that address transactions between regulated utilities and their affiliates. Some states require that regulated utilities obtain prior state approval for contracts with unregulated affiliates. Other states address these issues in rate proceedings, by disallowing unreasonable costs charged by unregulated affiliates to regulated utilities. In view of the changes in the industry, and corresponding increase in affiliate transactions discussed previously, many states would perceive a decision to repeal the Holding Company Act without strengthening the FERC's ability to review affiliate transactions as an unwelcome addition to their responsibilities.

The solution, however, is not simply to transfer the responsibility for administering section 13 to the FERC. As discussed previously, the D.C. Circuit has held in Ohio Power that, if there is a conflict between an SEC order approving a price under the Holding Company Act and a FERC order disapproving the price under the Federal Power Act, the SEC order prevails.[33] There are concerns that the decision can be read generally to impair the ability of the FERC and state and local regulators to protect consumers through traditional ratemaking proceedings. A simple transfer of section 13 would not resolve questions about whether federal review of affiliate transactions insulates them from state review. Moreover, section 13 would not work without many of the other provisions of the Holding Company Act, including the provisions defining registered holding companies and their subsidiaries. Finally, the "cost" standard of section 13 may not be the correct standard for reviewing affiliate transactions; it may make more sense to use market value, or some combination of cost and market value, in reviewing such transactions.

B. Unconditional Repeal

In the past, the SEC has recommended unconditional repeal of the Act. Because the difference between conditional and unconditional repeal lies only in the conditions, this section does not restate the arguments above but rather focuses on questions regarding the necessity for conditions.

In 1935, when the Holding Company Act was enacted, the ability of states to regulate interstate utility holding companies was quite limited. In particular, the Supreme Court had essentially prohibited any

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

state regulation of wholesale power transactions.[34] Today, however, states have the constitutional power to protect their consumers through regulation of utilities selling electricity and gas to these consumers, including regulation of transactions between such utilities and their unregulated affiliates.[35] The question for many states is one of resources. The growth of competition may ultimately moot this concern. At present, however, the Division believes that unconditional repeal may be ahead of its time and some limited conditions may still be necessary.

If Congress decides to pursue repeal, whether conditional or unconditional, an important subsidiary question is the timing of the repeal. Some state regulators are likely to argue for a delayed effective date to give them time to seek new legislation or added resources. The regulated holding companies, on the other hand, are likely to argue for a relatively rapid repeal, so that they can begin to achieve the benefits of geographic and business diversification. The Division believes that both positions have merit: it would not make sense to repeal the Holding Company Act without adequate time for transition; it would also not make sense to prolong unduly the transition period. For that reason, the Division recommends a transition period of at least one year.

C. Exemptive Authority

The Division recognizes that there would be political difficulties associated with any form of repeal legislation. In the alternative, Congress could achieve many of the benefits of repeal by providing the SEC with more flexible exemptive authority.

At present, the SEC has limited exemptive powers under the Act. Many commenters support legislation that would allow the SEC to exempt holding companies and transactions on a finding of adequate state regulation.[36] The commenters differ, however, as to the particulars of how such an exemption would operate. While the state and local

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[34] See Public Utilities Commission of Rhode Island v. Attleboro Steam & Electric Co., 273 U.S. 83 (1927); Public Utilities Commission of Kansas v. Landon, 249 U.S. 236, vacated on other grounds, 249 U.S. 590 (1919).

[35] See Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission, 461 U.S. 375 (1983).

[36] See Comments of Centerior Energy Corporation ("Centerior"), Cilcorp, Inc., Duke Power Co., MCN Corporation, MDU Resources Group, Inc., Minnesota Power & Light Co., NIPSCO Industries, Inc., Pacific Gas & Electric Co., Pennsylvania Power & Light Co., Pinnacle West Capital Corporation, Public Service Enterprise Group Inc., SCANA Corporation, SCEcorp, South Jersey Industries, Inc. and Utilicorp United Inc.

regulators would generally require state certification as a condition of exemption,[37] the registered holding companies favor an approach that would offer more regulatory certainty and so, would condition the exemption on some objective showing of state authority.[38]

Other federal securities laws give the Commission considerably broader exemptive power. For example, section 6(c) of the Investment Company Act of 1940 provides:

> The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or class of persons, securities or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.[39]

The Investment Advisers Act of 1940 includes identical exemptive authority.[40] The Exchange Act includes a number of more specific provisions that give the SEC substantial exemptive ability.[41] In 1980, in the Federal Securities Code, the American Law Institute proposed an exemptive provision patterned on Investment Company Act section 6(c) with respect to essentially all provisions of the federal securities laws.[42]

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[37] See, e.g., Comments of the Michigan Commission Staff and New Orleans.

[38] See, e.g., Comments of Questar (the Act should be amended to exempt a holding company that is the parent of a public utility subsidiary "regulated by a State commission or State commissions having jurisdiction over the acquisition and sale of utility assets."); Southern (exemption should be granted if each affected state has access to pertinent information regarding transactions between jurisdictional utilities and their affiliates); and Wisconsin Electric (a broad exemption should be adopted for any holding company whose utility subsidiaries are regulated by the applicable state commission regarding financial matters and safety and reliability of distribution systems.). See also Comments of Centerior (a state commission could "demonstrate to the SEC that it lacks the necessary regulatory authority.")

[39] Investment Company Act section 6(c), 15 U.S.C. § 80a-6(c).

[40] See Investment Advisers Act section 206A, 15 U.S.C. § 80b-6a.

[41] See Exchange Act section 5(2) (authority to exempt an exchange from registration); section 12(g)(3) (authority to exempt foreign issuers from registration) section 12(h) (authority to exempt issuers from registration and other provisions); section 15(a)(2) (authority to exempt brokers or dealers from registration). 15 U.S.C. §§ 78e(2), 78l(g)(3) and (h), and 78o(a)(2).

[42] See American Law Institute, Federal Securities Code § 303(a) (1980). For reasons that the ALI
(continued...)

Congress could consider amending the Holding Company Act to add a provision patterned on Investment Company Act section 6(c). Such a provision would allow the SEC to administer the Act far more flexibly, and thus to tailor the Act to today's legal, regulatory and technological situation.[43]

If the SEC received this type of exemptive authority, the Division would likely recommend that the SEC develop a policy of exempting a registered holding company from all requirements of the Act if the company could obtain the consent of the relevant state regulators for such an exemption. An SEC policy providing for this type of "conditional exemption" would likely lead to negotiations between the registered holding companies and their state regulators regarding the terms on which the state regulators would consent. Some state regulators would likely insist on strict conditions regarding diversification, affiliate transactions and books and records; other state regulators might be prepared to give their consent without conditions. The Division expects that many of the registered holding companies would be able to obtain the required state consents, and thus avoid the requirements of the Act, although at the price of stiffer state requirements.

Expanded exemptive authority would not, however, achieve all the benefits of conditional or unconditional repeal of the Holding Company Act. In particular, to decide whether and how to use its exemptive authority, the SEC would have to consider questions of energy policy, and work with other energy regulators at the federal and state level. The possibility of comprehensive federal regulation, if an exemption could not be obtained or was revoked, could cause some companies to structure their businesses more cautiously, and differently, than they would if the Act were repealed.

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[42](...continued)
did not explain, the exemption would not have covered the equivalent of section 11 of the Holding Company Act. Because section 11 is the source of many of the limits on diversification activities and acquisitions, the Division would not favor new exemptive authority that does not reach section 11.

[43] To avoid litigation about whether SEC exemptive rules or orders are consistent with the "policy and provisions" of the Holding Company Act, Congress should amend section 1, the statement of purposes of the Act, to reflect the grant of any new exemptive powers.

CONCLUSION

The Holding Company Act led to the most ambitious restructuring of an industry in American history. As Chairman Levitt noted at the Roundtable Discussion that inaugurated this study on July 18, 1994, the Act, despite its imperfections, has served our nation well for sixty years. America today is blessed with a strong and vibrant utility industry. Indeed, it is the very success of the Act, together with fundamental and sweeping changes in the industry, that have generated questions about the continuing need for, and the role of, a federal holding company statute.

The central purpose of the study was to develop options, both legislative and administrative, for constructive change. To the extent the study has realized this goal, the result is largely due to the thoughtful participation of representatives of the industry, federal and state regulators, consumer advocates, and other interested parties and observers. The involvement of these persons has made possible the comprehensive review that the Division hoped to achieve.

APPENDIX A

Summary of State Survey

OMB Number: 3235-0453
Expires: January 31, 1998
Estimated average burden
hours per response: 10

January 1995

U.S. Securities and Exchange Commission
Division of Investment Management
Office of Public Utility Regulation

U.S. SECURITIES AND EXCHANGE COMMISSION QUESTIONNAIRE

STATE UTILITY COMMISSIONS

In conjunction with the Securities and Exchange Commission's reevaluation of the regulation of public-utility holding companies under the Public Utility Holding Company Act of 1935, the Commission seeks to evaluate the current status of state regulation of public utilities. Answers to the following questions will enable the Commission better to assess the extent of state regulation in this area.

Your answers to these questions are appreciated. It would also be helpful for answers to include citations to relevant statutes, administrative regulations, and judicial or administrative decisions. If you have questions concerning the questionnaire, please contact Joanne Rutkowski, Assistant Director, Office of Legal & Policy Analysis, at (202) 942-0545.

Background

The Public Utility Holding Company Act of 1935 was intended to curb the abusive practices of public-utility holding companies by bringing these companies under effective control. The Securities and Exchange Commission, as an agency with expertise in financial transactions and corporate finance, was charged with regulation of the corporate structure and financings of public-utility holding companies and their affiliates.

The Holding Company Act is far-reaching. Under the statute, a holding company can be any company that owns 10 percent or more of the outstanding voting securities of a gas utility company (defined as "any company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power") or an electric utility company (defined as "any company which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale").

The burden of regulation under the Act falls most heavily on holding companies that have significant interstate utility operations, and are thereby not readily susceptible to effective state regulation. These companies must register and comply with the myriad requirements of the Act. At present there are fourteen active registered holding companies, operating in 26 states. 1/

Section 11, which the Supreme Court has described as the "very heart" of the Holding Company Act, generally limits registered holding companies to a single integrated public-utility system and such other businesses as are "reasonably incidental, or economically necessary or appropriate" to the operations of that system. Commission approval is also required for most financings, acquisitions and intrasystem transactions involving companies in a registered holding company system. The Act also imposes various accounting and reporting requirements.

1/ Allegheny Power System, Inc., American Electric Power Company, Inc., Central and South West Corporation, CINergy Corporation, Columbia Gas System, Inc., Consolidated Natural Gas Company, Eastern Utilities Associates, Entergy Corporation, General Public Utilities Corporation, National Fuel Gas Company, New England Electric System, Northeast Utilities, Southern Company, and Unitil Corporation.

Specific Topics

I. Utility Financings

A. Securities Issuances -- Under sections 6(a) and 7 of the Holding Company Act, prior Commission approval is generally required for the issuance and sale of securities by a company in a registered holding company system. The Commission can refuse to authorize the issuance of a security that is not reasonably adapted to the capital structure of the issuer and other companies in the holding company system, or to the earning power of the issuer, 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."

There are a number of exceptions to this requirement. Most notably, under rule 52, prior SEC approval is not required for a public-utility company to issue and sell securities to its parent for the purpose of financing its business provided that the relevant state commission has approved the transaction. The Commission has requested comment on a proposal to further expand the rule to exempt a broader range of securities issuances by utility and nonutility subsidiaries of registered holding companies. 2/

1. Does your commission regulate the issuance of securities by utilities?

   Yes ___ No ___

2. If so, what general standards are applied in such regulation?

   ____

   ____

   ____

2/ See Holding Company Act Release No. 25574, 51 SEC Dkt. 2006, 57 Fed. Reg. 31156 (July 14, 1992).

3. What is the procedure and timing of such regulation?

____

____

____

B. Other Financings -- The SEC has broad authority over other types of system financings. Section 12(a) prohibits a registered holding company from borrowing, or receiving any extension of credit or indemnity, from other system companies. Under section 12(b), a company in a registered system cannot lend or in any manner extend credit to or indemnify another company in the same system except in accordance with SEC rules, regulations or orders. Section 12(c) governs dividends and security redemptions.

1. What other types of financing operations (for example, loan, guarantees and hold-harmless agreements) does your commission regulate?

____

____

____

2. What standards, procedures and timing are involved in this regulation?

____

____

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II. Affiliate Transactions -- Under section 13 of the Act, the SEC has broad authority over service, sales and construction contracts between companies in a registered system. Under the Commission's rules, affiliate transactions must generally be conducted at cost, for the benefit of associate companies. There has, of course, been much controversy surrounding this section following Ohio Power. The Commission has proposed for comment a lower-of-cost-or-market rule that should help to address the consumer protection issues raised by the decision. 3/ The Commission's

3/ See Holding Company Act Release No. 26198, 59 Fed. Reg. 67248 (Dec. 29, 1994).

jurisdiction does not extend to affiliate transactions involving the sale of electricity or natural or manufactured gas.

A. What regulatory authority does your commission have over transactions (including, for example, contracts for sales, services, and construction) between a utility and the following entities:

1. its holding company (if any),

____
____
____

2. a utility with which it is affiliated through ownership or otherwise,

____
____
____

3. an unaffiliated utility,

____
____
____

4. an affiliated nonutility company, and

____
____
____

5. an unaffiliated nonutility company?

____
____
____

III. Accounting, Audits and Inspections

A. Uniform Systems of Accounts

1. Does the utility commission have authority to prescribe uniform systems of accounts and require specific account adjustments?

Yes ___ No ___

2. If Yes, have such uniform systems or guidelines for account adjustments been established? Please provide citations or copies of materials and guidelines published.

____

____

____

B. Audits and Inspections

1. Does the utility commission have authority to perform audits of public-utility companies?

Yes ___ No ___

2. Does the utility commission have statutory authority to obtain access to the books and records of public utilities?

Yes ___ No ___

3. Does the utility commission have <u>de facto</u> authority to obtain such access?

Yes ___ No ___

4. Does the utility commission have statutory or de facto authority to obtain access to the books and records of the following entities:

   a. public-utility holding companies or

      Yes ___ No ___

   b. non-utility companies (including system service companies) affiliated with public utilities?

      Yes ___ No ___

C. Cooperative Arrangements

1. Are there cooperative arrangements with other regulators for performing joint audits or allowing other regulators to attend such audits?

   Yes ___ No ___

2. Are there cooperative arrangements by which the utility commission may obtain access to books and records of out-of-state utilities, non-utility affiliates or holding companies?

   Yes ___ No ___

IV. Acquisition and Ownership Regulation -- The SEC has broad authority under sections 9 and 10 of the Holding Company Act over the acquisition of "any securities or utility assets or any other interest in any business." The standards of section 10 relate to the overall structure of the resulting system, and the effect of the acquisition upon the public interest and the interests of investors and consumers, the "protected interests" under the Act.

There have been suggestions that the Commission's work involving utility acquisitions has been largely superseded by the FERC's review of utility mergers. In recent matters, the Commission has relied upon the FERC's analysis of certain issues that are closely linked to operations, to avoid duplicative review.

Issuance of an order under section 10 is generally conditioned upon receipt of all necessary state approvals. In matters in which formal state approval is not required, the SEC has nonetheless encouraged the companies to work with their regulators to address any possible concerns.

A. Acquisition and Ownership by In-state and Out-of-state Persons

1. <u>In-state ownership of out-of-state facilities.</u> Does the utility commission or other state authority regulate acquisition or ownership by an in-state utility or other person of utility facilities located outside the state?

Yes ___ No ___

If Yes, please describe:

____

____

____

2. <u>Out-of-state ownership of in-state facilities.</u> Does the utility commission or other state authority regulate acquisition or ownership by an out-of-state utility or other person of in-state utility facilities?

Yes ___ No ___

If Yes, please describe:

____

____

____

3. <u>Foreign ownership of in-state facilities.</u> Does the utility commission or other state authority regulate acquisition or ownership by a foreign utility or other person of in-state utility facilities?

Yes ___ No ___

If Yes, please describe:

____

____

____

B. Acquisition of Utility Facilities

1. Does the utility commission regulate the acquisition by a utility of utility assets?

Yes ___ No ___

2. If so, what standards are applied?

____

____

____

C. Formation of Holding Companies

1. Do state laws or regulations prohibit or restrict the formation of utility holding companies?

   Yes ___ No ___

2. If Yes, please provide the citation for such prohibition or restrictions.

   ____
   ____
   ____

D. Diversification

1. Does the utility commission regulate the ability of utilities or utility holding companies to invest in nonutility operations or acquire nonutility assets?

   Yes ___ No ___

2. If so, what standards are applied?

   ____
   ____
   ____

E. Mergers

1. Does the utility commission or other state authority have special regulatory procedures for mergers that involve public utilities?

   Yes ___ No ___

2. If Yes, what standards are applied?

   ____
   ____
   ____

F. Combination Electric and Gas Systems

1. Does the utility commission or other state authority regulate ownership of both electric and gas facilities by a single public utility or other entity?

   Yes ___ No ___

2. If Yes, does the manner of regulation depend on whether the electric and gas facilities serve substantially the same territory? (See Section 8 of the Public Utility Holding Company Act of 1935 (15 U.S.C. § 79h))

   ____
   ____
   ____

V. Reporting Requirements

A. What types of reports are required to be filed by public utilities? Please describe briefly the information required in each report. Please attach one completed example of each type of report.

   ____
   ____
   ____

VI. Recent State Legislative Initiatives

A. What legislative proposals have been made in the last two years with respect to the regulation of public utilities?

   ____
   ____
   ____

B. Are any such legislative proposals expected in the near future?

   Yes ___ No ___

LIST OF FOLLOW UP QUESTIONS TO PUHCA STATE SURVEY[1]

Diversification

1. Do you have authority to approve or review diversification activities by utilities or holding companies, other than in the context of a ratemaking proceeding?

2. Do you have authority to approve or review, other than in the context of a ratemaking proceeding, the formation or capitalization of a holding company or affiliate established to engage in non-utility activities?

Affiliate Transactions

3. Do you have authority to approve or review contracts for or transactions involving the sale of goods or services between a utility subject to your jurisdiction and non-utility affiliates, other than in the context of a ratemaking proceeding?

4. Do you have authority to review or approve allocation of costs by a service company to non-jurisdictional affiliates of a utility subject to your jurisdiction?

5. Do you have authority to approve or review, tax allocation agreements entered into by utilities, other than in the context of a ratemaking proceeding?

Audits

6. Does the commission have authority to conduct audits of any nonutilities such as service companies? If so, do you conduct such audits?

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[1] Telephonic survey conducted by Investment Management staff during April and May 1995.

Survey of State Regulation of Public Utility Holding Companies 1/

	[I.A.1] Approval of Util. Financings	[I.B.1] Other Loans & Guarantees	[II.A.] Affiliate Trans. w/HC's
Alabama	yes	yes	no
Alaska	*	*	*
Arizona	*	*	*
Arkansas	yes	yes	no
California	yes	yes	no
Colorado	yes	yes	no
Connecticut	yes	yes	no
Delaware	yes	yes	unclear
Dist. of Columbia	yes	no	no
Florida	yes	yes	no
Georgia	yes	no	no
Hawaii	yes	no	no
Idaho	*	*	*
Illinois	yes	yes	yes
Indiana	yes	yes	yes
Iowa	no	no	no
Kansas	yes	yes	yes
Kentucky	yes	yes	no
Louisiana	yes	yes	no
Maine	yes	yes	yes
Maryland	yes	yes	no
Massachusetts	yes	yes	no
Michigan	yes	yes	no
Minnesota	yes	yes	yes
Mississippi	no	yes	no
Missouri	yes	yes	no
Montana	yes	yes	no
Nebraska	Nebraska PSC Doesn't Regulate Gas or Electric Util's.		
Nevada	yes	yes	no
New Hampshire	*	*	*
New Jersey	*	*	*
New Mexico	yes	yes	no
New York	yes	yes	yes
North Carolina	yes	yes	yes
North Dakota	yes	yes	unclear
Ohio	yes	yes	no
Oklahoma	yes	no	no
Oregon	yes	yes	yes
Pennylvania	yes	yes	yes
Rhode Island	yes	yes	no
South Carolina	yes	N/A	unclear
South Dakota	yes	yes	yes
Tennessee	yes	yes	no
Texas	no	yes	no
Utah	*	*	*
Vermont	yes	yes	no
Virginia	yes	yes	yes
Washington	*	*	*
West Virginia	yes	yes	yes
Wisconsin	yes	yes	yes
Wyoming	*	*	*

	[II.B.] Affiliate Trans. Aff. Util's.	[II.C.] Trans w/ Unaff. Util's	[II.D.] Affiliate Trans. Affil. Nonutil's	[II.E.] Trans w/ Unaffil. Nonutil's
Alabama	no	yes	yes	yes
Alaska	*	*	*	*
Arizona	*	*	*	*
Arkansas	no	no	no	no
California	no	no	no	no
Colorado	no	no	no	no
Connecticut	no	no	no	no
Delaware	unclear	yes	unclear	unclear
Dist. of Col.	no	no	no	no
Florida	no	no	no	no
Georgia	no	no	no	no
Hawaii	no	no	no	no
Idaho	*	*	*	*
Illinois	yes	yes	yes	no
Indiana	yes	no	yes	no
Iowa	no	no	no	no
Kansas	yes	no	yes	no
Kentucky	no	no	no	no
Louisiana	no	no	no	no
Maine	yes	no	yes	no
Maryland	no	no	no	no
Mass.	no	no	no	no
Michigan	no	no	yes	no
Minnesota	yes	no	yes	no
Mississippi	no	no	no	no
Missouri	no	no	no	no
Montana	no	unclear	unclear	unclear
Nebraska	Nebraska PSC Doesn't Regulate Gas or Electric Util's.			
Nevada	no	no	no	no
New Hampshire	*	*	*	*
New Jersey	*	*	*	*
New Mexico	no	no	no	no
New York	yes	no	yes	no
North Carolina	yes	no	yes	no
North Dakota	unclear	unclear	unclear	unclear
Ohio	yes	yes	no	no
Oklahoma	no	no	no	no
Oregon	yes	yes	yes	no
Pennsylvania	yes	no	yes	no
Rhode Island	yes	yes	yes	yes
South Carolina	unclear	no	unclear	no ans.
South Dakota	yes	no	yes	no
Tennessee	no	no	no	no
Texas	no	no	no	no
Utah	*	*	*	*
Vermont	no	no	no	no
Virginia	yes	yes	no	no
Washington	*	*	*	*
West Virginia	yes	yes	yes	yes
Wisconsin	no	no	yes	no
Wyoming	*	*	*	*

	[III.A.] Prescribe Uniform Accts/Established	[III.B.1] Authority to Audit Utilities	[III.B.2] Authority to Access Utility Bks & Recs.
Alabama	yes/N/Ans.	yes	yes
Alaska	*	*	*
Arizona	*	*	*
Arkansas	yes/yes	yes	yes
California	yes/yes	yes	yes
Colorado	yes/no	yes	yes
Connecticut	yes/yes	yes	yes
Delaware	yes/yes	yes	yes
Dist. of Col.	yes/yes	yes	yes
Florida	yes/yes	yes	yes
Georgia	yes/N/Ans.	yes	yes
Hawaii	yes/N/Ans.	yes	yes
Idaho	*	*	*
Illinois	yes/yes	yes	yes
Indiana	yes/yes	yes	yes
Iowa	yes/yes	yes	yes
Kansas	yes/yes	yes	yes
Kentucky	yes/yes	yes	yes
Louisiana	yes/yes	yes	yes
Maine	yes/yes	yes	yes
Maryland	yes/yes	yes	yes
Mass.	yes/yes	yes	yes
Michigan	yes/yes	yes	yes
Minnesota	yes/yes	yes	yes
Mississippi	yes/yes	yes	yes
Missouri	yes/yes	yes	yes
Montana	yes/yes	yes	yes
Nebraska	Nebraska PSC Doesn't Regulate Gas or Electric Util's.		
Nevada	yes/yes	yes	yes
New Hampshire	*	*	*
New Jersey	*	*	*
New Mexico	yes/yes	yes	yes
New York	yes/yes	yes	yes
North Carolina	yes/yes	yes	yes
North Dakota	yes/yes	yes	yes
Ohio	yes/yes	yes	yes
Oklahoma	yes/yes	yes	yes
Oregon	yes/yes	yes	yes
Pennsylvania	yes/yes	yes	yes
Rhode Island	yes/N/Ans.	yes	yes
South Carolina	yes/N/Ans.	yes	yes
South Dakota	yes/yes	yes	yes
Tennessee	yes/yes	yes	yes
Texas	yes/yes	yes	yes
Utah	*	*	*
Vermont	yes/no	yes	yes
Virginia	yes/yes	yes	yes
Washington	*	*	*
West Virginia	yes/yes	yes	yes
Wisconsin	yes/yes	yes	yes
Wyoming	*	*	*

	[III.B.4] Access to Util HC Bks & Recs 2/	[III.B.5] Access Affil. Nonutil. Bks & Recs	[III.C.1] Coop Arrngmt for Joint Utility Bks & Recs.
Alabama		no	no
Alaska		*	*
Arizona		*	*
Arkansas		yes	yes
California		yes	yes
Colorado		yes	yes
Connecticut		no	no
Delaware		no	yes
D.C.		no	no
Florida		yes	no
Georgia		no	no
Hawaii		no	no
Idaho		*	*
Illinois		yes	no
Indiana		yes	no
Iowa		yes	no
Kansas		yes	no
Kentucky		no	no
Louisiana		yes	yes
Maine		No/Ans.	yes
Maryland		no	yes
Mass.		yes	no
Michigan		yes	no
Minnesota		yes	no
Mississippi		yes	yes
Missouri		yes	no
Montana		yes	no
Nebraska	Nebraska PSC Doesn't Regulate Gas or Electric Util's.		
Nevada		no	no
New Hampshire		*	*
New Jersey		*	*
New Mexico		yes	yes
New York		yes	no
North Carolina		no	no
North Dakota		no	no
Ohio		no	no
Oklahoma		yes	no
Oregon		yes	yes
Pennsylvania		yes	yes
Rhode Island		yes	no
South Carolina		yes	yes
South Dakota		yes	no
Tennessee		yes	yes
Texas		yes	yes
Utah		*	*
Vermont		yes	yes
Virginia		yes	yes
Washington		*	*
West Virginia		yes	no
Wisconsin		yes	no
Wyoming		*	*

	[III.C.2] Coop - Access Out-of-St. B & R	[IV.A.1] In-State Util Acquis Out-of-St Util	[IV.A.2] Out-of-State Util Acquis of In-St Util	[IV.A.3] Foreign Util Acquis of In-St Util
Alabama	no	unclear	yes	yes
Alaska	*	*	*	*
Arizona	*	*	*	*
Arkansas	yes	yes	yes	yes
Califonia	yes	yes	yes	yes
Colorado	no	yes	yes	yes
Connecticut	no	yes	no	no
Delaware	no	no	yes	yes
Dist. of Col.	no	yes	yes	no
Florida	no	no	no	no
Georgia	no	yes	no	no
Hawaii	no	no	no	no
Idaho	*	*	*	*
Illinois	no	yes	yes	yes
Indiana	yes	no	yes	yes
Iowa	no	yes	yes	yes
Kansas	no	no	yes	yes
Kentucky	no	no	yes	yes
Louisiana	yes	no	yes	yes
Maine	yes	yes	yes	yes
Maryland	no	no	yes	yes
Mass.	no	yes	yes	yes
Michigan	no	no	no	no
Minnesota	no	yes	yes	yes
Mississippi	yes	yes	yes	yes
Missouri	no	yes	yes	yes
Montana	no	no	no	unclear
Nebraska	Nebraska PSC Doesn't Regulate Gas or Electric Util's.			
Nevada	no	yes	yes	yes
New Hampshire	*	*	*	*
New Jersey	*	*	*	*
New Mexico	yes	yes	yes	yes
New York	yes	yes	yes	yes
North Carolina	no	yes	yes	yes
North Dakota	no	no	yes	yes
Ohio	no	yes	yes	yes
Oklahoma	no	no	yes	yes
Oregon	no	yes	yes	yes
Pennsylvania	yes	yes	yes	yes
Rhode Island	yes	N/Ans	yes	no
South Carolina	yes	yes	yes	yes
South Dakota	no	yes	yes	yes
Tennessee	yes	yes	yes	yes
Texas	yes	yes	no	no
Utah	*	*	*	*
Vermont	no	yes	yes	yes
Virginia	no	yes	yes	yes
Washington	*	*	*	*
West Virginia	no	yes	yes	yes
Wisconsin	yes	yes	yes	yes
Wyoming	*	*	*	*

	[IV.B.] Regulate Utility Acq of Utility Assets	[IV.C.] State Laws/Regs Concerning Form. of HCs	[IV.D.] Rev./Approve Diversification
Alabama	yes	no	yes
Alaska	*	*	*
Arizona	*	*	*
Arkansas	yes	yes	no
California	yes	yes	no
Colorado	yes	no	no
Connecticut	yes	yes	yes
Delaware	yes	no	no
Dist. of Col.	yes	no	no
Florida	no	no	no
Georgia	no	no	no
Hawaii	yes	yes	yes
Idaho	*	*	*
Illinois	yes	yes	yes
Indiana	no	no	no
Iowa	yes	no	no
Kansas	no	no	no
Kentucky	no	yes	no
Louisana	yes	no	no
Maine	no	yes	yes
Maryland	yes	yes	no
Mass.	no	yes	yes
Michigan	no	no	no
Minnesota	yes	no	no
Misssippi	yes	no	no
Missouri	yes	no	no
Montana	no	no	no
Nebraska	Nebraska PSC Doesn't Regulate Gas or Electric Util's.		
Nevada	yes	no	yes
New Hampshire	*	*	*
New Jersey	*	*	*
New Mexico	yes	yes	yes
New York	yes	yes	yes
North Carolina	yes	no	no
North Dakota	yes	no	no
Ohio	yes	no	no
Oklahoma	no	yes	no
Oregon	yes	no	no
Pennsylvania	yes	no	yes
Rhode Island	yes	no	no
South Carolina	yes	no	yes
South Dakota	no	no	no
Tennessee	yes	no	no
Texas	no	no	no
Utah	*	*	*
Vermont	yes	no	no
Virginia	yes	yes	no
Washington	*	*	*
West Virginia	yes	no	no
Wisconsin	yes	yes	yes
Wyoming	*	*	*

	[IV.E.] Utility Mergers	[IV.F.] Combination Elec & Gas Util
Alabama	yes	yes
Alaska	*	*
Arizona	*	*
Arkansas	yes	yes
California	yes	yes
Colorado	yes	yes
Connecticut	yes	no
Delaware	yes	yes
D.C.	no	no
Florida	no	no
Georgia	no	no
Hawaii	yes	no
Idaho	*	*
Illinois	yes	yes
Indiana	yes	yes
Iowa	yes	yes
Kansas	yes	N/Ans.
Kentucky	N/Ans.	N/Ans.
Louisiana	yes	yes
Maine	yes	No
Maryland	yes	yes
Mass.	yes	yes
Michigan	no	N/Ans.
Minneosta	yes	no
Mississippi	no	yes
Missouri	yes	yes
Montana	yes	yes
Nebraska	Nebraska PSC Doesn't Regulate Gas Or Electric Util.'s	
Nevada	yes	yes
New Hampshire	*	*
New Jersey	*	*
New Mexico	yes	yes
New York	yes	yes
North Carolina	yes	no
North Dakota	no	yes
Ohio	no	no
Oklahoma	yes	yes
Oregon	yes	no
Pennsylvania	yes	yes
Rhode Island	yes	yes
South Carolina	yes	yes
South Dakota	yes	no
Tennessee	yes	yes
Texas	no	no
Utah	*	*
Vermont	yes	yes
Virginia	yes	yes
Washington	*	*
West Virginia	yes	yes
Wisconsin	yes	yes
Wyoming	*	*

1/ An asterisk marks the response for those states that did not respond to the State Survey.

2/ The responses to this question are inconclusive at this time. See attached letter from Charles D. Gray, Assistant General Counsel, NARUC, to William Weeden, Associate Director, Division of Investment Management, SEC.

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PAUL RODGERS
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GAILE ARGIRO
Treasurer

June 1, 1995

Mr. William Weeden
Office of Public Utility Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Weeden:

As the Commission continues its analysis of the Public Utility Holding Company Act of 1935, the staff of the National Association of Regulatory Utility Commissioners (NARUC) has been pleased to work with you and your staff in surveying State public utility commissions concerning their authority to regulate utility holding companies in the event that the '35 Act is amended or repealed. From our perspective, the survey process went very smoothly, with the exception of an apparent misunderstanding concerning the legal authority and practical ability of State commissions to obtain access to out-of-state books and records of holding companies that operate utility subsidiaries within their respective borders.

To clarify this issue, we are now conducting a brief follow-up survey of the State commission which focusses on their authority under State law to order holding companies to provide such access. However, given our understanding of the Commission's schedule, the results of this follow-up will not be available in time for inclusion in the upcoming report. Of course, we will provide this information to you and your staff as soon as its available.

Please contact me if I can be of further assistance on this matter. With best wishes, I am

Sincerely yours,

Charles D. Gray

Charles D. Gray
Assistant General Counsel

cc: The Honorable Robert Gee, Chair, NARUC Committee on Electricity