ONE HUNDRED NINTH CONGRESS

U.S. House of Representatives
Committee on Energy and Commerce
Washington, DC 20515–6115

JOE BARTON, TEXAS
CHAIRMAN

August 8, 2005

The Honorable David M. Walker
Comptroller General
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

The Honorable Joseph T. Kelliher
Chairman
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable Diane Munns
President, Executive Committee
National Association of Regulatory
Utility Commissioners
1101 Vermont Avenue, N.W., Suite 200
Washington, D.C. 20005

Dear Chairman Walker, Chairman Kelliher, Chairman Cox, and Commissioner Munn:

Congress enacted the Public Utility Holding Company Act of 1935 (PUHCA) to correct grave abuses "found in the use of the holding company device in the nation's electric and gas utility industries." North American Co. v. SEC, 327 U.S. 686, 689 (1946). At that time, public utility companies were often gerrymandered or scattered across the country in ways that bore "no relation to the economy of operation or to effective regulation," giving rise to the litany of abuses against ratepayers, consumers, and investors enumerated in Section 1 (b) of the Act. Id. at 701.

Several recent events, discussed herein, led to concerns about the Securities and Exchange Commission's (SEC) administration and enforcement of PUHCA. By letters dated April 21, 2004, and August 18, 2004, we asked the U.S. Government Accountability Office (GAO) to look into these matters. GAO found material weaknesses in the SEC's oversight of registered and exempt holding companies, and the July 8, 2005, GAO report, Public Utility Holding Company Act: Opportunities Exist to Strengthen SEC's Administration of the Act, GAO-05-617, that we are releasing today, made recommendations for improvements, "as long as SEC continues to have responsibility to administer PUHCA." GAO Report, pp. 35-36. We commend GAO's thorough review and agree with their recommendations. Today, however, the President signs into law the Energy Policy Act of 2005, which repeals PUHCA six months after date of enactment and transfers certain responsibilities to the Federal Energy Regulatory

Commission (FERC) and the States (see Title X, subtitle F). The SEC's misadventures with PUHCA, including the belated reversal of Enron's wrongly claimed exempt status, carry important lessons for FERC, and raise questions about the adequacy of the tools in subtitles F and G of the 2005 Act to adequately protect consumers against the kind of abuses that gave rise to the passage of PUHCA in the first instance.

A. SEC's Administration of PUHCA

GAO found that outdated forms and slowness in processing applications have undermined the efficiency of the SEC's administration of PUHCA. In 2003, the SEC Inspector General reported that many of the PUHCA forms were outdated, ineffective, or contained requirements that did not serve a useful regulatory purpose. GAO Report p. 19. The SEC Inspector General also reported that PUHCA applications were not processed in a timely fashion and recommended that the staff establish performance goals. GAO Report p. 24 and Table p. 24. GAO found that the SEC was slow to respond or nonresponsive to these shortcomings.

GAO found that the SEC has approved a series of mergers involving utility systems that are separated by hundreds of miles, and are connected by small connector lines or transmission systems owned by other utilities, despite PUHCA's requirement that utility systems be geographically integrated and operate in a single area or region. Such approvals "effectively end enforcement of the act and encourage the formation of vast holding companies that the act was designed to prevent from recurring." GAO Report p. 20. In May of this year, an SEC administrative law judge ruled that one such SEC-approved merger -- between American Electric Power, an Ohio-based holding company, and Central and Southwest Corporation, a Texas-based holding company -- did not satisfy PUHCA's single area or region requirement.

GAO also found that the SEC has not conducted a thorough review of all exempt holding companies to ensure that they continue to qualify for an exemption from PUHCA and do not need to be subject to SEC regulation under the act. GAO Report pp. 25-28. In 2004, SEC staff conducted a review of all 81 holding companies that claimed exemption by self-certification. This review was undertaken, in part, as a result of the December 29, 2003, SEC decision that belatedly denied Enron Corporation's questionable applications for exemption from PUHCA. Nevertheless, the 2004 SEC staff review did not evaluate the utility activities of holding companies that are exempt by SEC order. The SEC has no formal process to ensure that these companies still qualify for their exemption, and are not required to provide the SEC with periodic information showing that the circumstances giving rise to their exemptions continue to exist. In addition, GAO found that the SEC cannot provide reliable estimates of the number of companies that have received exemptive orders that continue to meet the statutory definition of a holding company.

While industry may have benefitted from this state of affairs, it is unclear whether or how the interests of consumers and investors have been served. And we hope these mistakes will not be repeated at FERC.

B. PUHCA Repeal and FERC Oversight of Utility Holding Companies

The SEC and many participants in the utility industry have been pushing for repeal of PUHCA for more than a decade, arguing that its restrictions are outdated. Nonetheless, it is clear from recent and ongoing accounting, corporate, insurance, and mutual fund scandals, that human nature has not changed one iota. Accordingly, we have consistently supported modernization of PUHCA but opposed its outright repeal.

The Energy Policy Act of 2005 (EPACT) repeals PUHCA. It attempts to address the downside of PUHCA repeal through a number of provisions that provide: Federal and State access to the books and records of public utilities and their holding and affiliate companies (sections 1264 and 1265); broad FERC authority over affiliate transactions, including just and reasonable rates, cross-subsidization, pass through and recovery of costs, and any rules necessary to protect utility consumers (section 1267); FERC authority to strengthen electricity market price transparency (section 1281); broad prohibition against market manipulation (section 1283); and merger review reform (section 1289). Given the history of this industry, we have reservations about the adequacy of these tools to prevent a repeat of the past or even more creative misadventures.

During the 1920s, ownership of U.S. public utilities became concentrated in a small number of multistate holding companies. This construct made effective oversight by State regulators virtually impossible. Complicated cross-ownership structure and opaque disclosure made analysis of financial condition extremely difficult. Pyramid-like ownership structures and abusive affiliate transactions resulted in highly leveraged companies, financial shenanigans, and a large number of utility bankruptcies.

For example, the merger review authority granted to FERC under section 1289 of EPACT allows the Commission to protect against mergers that result in cross-subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company. EPACT, however, does not explicitly direct FERC to adopt generic rules addressing the threat of cross-subsidization or encumbrance of assets outside of a merger context. We would respectfully suggest that FERC use its existing legal authority under the Federal Power Act, which section 1267(a) of EPACT expressly preserves, to adopt such general rules. We note that there is some precedent for such an action. Following enactment of the EPACT of 2002, which added a new section 211 and 212 to the Federal Power Act to facilitate wholesale

transmission access, the Commission used its general authorities under sections 205 and 206 of the Federal Power Act to issue its landmark Order 888 on wholesale competition.

In addition, we would strongly recommend that State utility commissions examine the need to strengthen their regulation of utilities subject to their regulation in order to protect against the risks that may now be possible with PUHCA's repeal. Particular attention should be paid to addressing the risk of utility holding company diversification into unregulated businesses, and the prospect for utility consumers to be placed at risk as the result of failed utility diversification efforts. In addition, State regulators should be wary of complex utility holding company structures and of affiliated party transactions within such structures.

Finally, for many years the SEC has argued that PUHCA could safely be repealed because of the development of the SEC's full disclosure program and the evolution of modern accounting practices made a repetition of the abuses that gave rise to PUHCA unlikely. The SEC therefore has a special responsibility to ensure that, in its administration of the Federal securities laws, it pays particular attention to the prospect of utility holding company malfeasance. We therefore urge the SEC to greatly increase the frequency of its review of all utility holding company filings.

In the recent case of Enron, the SEC did not review Enron's financial filings with the agency for four years, and only after a massive accounting fraud, did the SEC look into and deny Enron's wrongly-claimed PUHCA exemptions.

We ask that you provide us with a copy of your joint plan for the orderly transfer of responsibilities and books and records from the SEC to FERC. We will, at the appropriate time, be asking for an assessment of the adequacy of the regulatory tools in subtitles F and G of the new law in protecting ratepayers, consumers, and investors. Success is going to require a great deal of coordination between your agencies and the States, particularly if merger mania creates the same kind of concentration and complex structures that gave rise to rampant abuse in the past.

Thank you for your cooperation and assistance in this matter.

Sincerely,

JOHN D. DINGELL
RANKING MEMBER

EDWARD J. MARKEY
MEMBER
SUBCOMMITTEE ON ENERGY AND
AIR QUALITY

Attachment

cc The Honorable Joe Barton, Chairman
Committee on Energy and Commerce

The Honorable Ralph M. Hall, Chairman
Subcommittee on Energy and Air Quality

The Honorable Rick Boucher, Ranking Member
Subcommittee on Energy and Air Quality