ONE HUNDRED EIGHTH CONGRESS

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

JOE BARTON, TEXAS
CHAIRMAN

August 18, 2004

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

Dear Mr. Walker:

We are writing with further reference to our letter of April 21, 2004, in which we asked the Government Accountability Office (GAO) to conduct a study and report to us on the administration and enforcement of the Public Utility Holding Company Act of 1935 (PUHCA) by the Securities and Exchange Commission (SEC), with particular attention to the exemptive provisions that appear to have been abused by Enron Corporation and possibly others to the detriment of investors, ratepayers, and the public interest.

That letter also asked the SEC to respond to 50 questions about the agency's implementation and enforcement of the Act. The resulting 40-page June 28, 2004, SEC staff memorandum (copy enclosed) defends the current system, without coming to grips with the fault lines exposed in the Enron debacle and in the agency's belated December 29, 2003, opinion denying Enron's applications for exemptions under Sections 3 (a) (1), 3 (a) (3) and 3 (a) (5) of PUHCA. We find this disconnect troublesome.

The SEC's December 29, 2003, Opinion Denying Enron's Exemptions Under PUHCA

- Enron is a public utility holding company and the sole owner of Portland General Electric Company (Portland General), a public electric utility company.

- In its December 29, 2003, opinion, the SEC, among other actions, denied Enron's application for an exemption under Section 3 (a) (1) of PUHCA, which requires that a holding company and every subsidiary public utility company from which it derives any material part of its income be "predominantly intrastate in character" and operate "substantially in a single state."

- Applying traditional quantitative factors, the SEC found that, in the period of 1999 through 2001, Portland General earned an average of approximately 34 percent of its gross utility operating revenue from interstate sales (SEC Opinion p. 11). The SEC also found that Portland General's out-of-state assets located in Colstrip, Montana, and the associated transmission lines represented 13.1 percent of the undepreciated book value of the utility's total physical plant and 14 percent of its owned generating capacity (p. 12). This combination led the SEC to conclude that Portland General's operations were not consistent with PUHCA's predominantly/substantially test.

- Looking beyond percentage tests, the SEC opinion noted that "when a public utility engages in a large amount of out-of-state activity, there is the potential for the utility to escape effective regulation even if a state regulator controls the utility's in-state activity." (p. 24) While the Public Utility Commission of Oregon (OPUC) supported Enron's 3 (a) (1) application, it did not assert that it could adequately regulate the holding company. The SEC therefore found that, given the extent of Portland General's out-of-state activities, "OPUC's ability to regulate Portland General's in-state activity is not sufficient in this case to justify an exemption pursuant to Section 3 (a) (1)." (p. 25)

- Consequently, the SEC concluded that, in light of all these factors, "granting Enron an exemption, even employing the most flexible approach, would risk robbing the statute of its meaning." (p. 25)

- An exemption under Section 3 (a) (3) is limited to a holding company that is "only incidentally a holding company" and is not deriving "any material part of its income" from a public utility company. Section 3 (a) (5) requires an applicant to demonstrate that its utility operations are small.

- The SEC opinion noted that "Enron admits that it cannot meet the requirements of either section" and "has failed to present any evidence" from which the SEC could draw a favorable conclusion (p. 32). The SEC noted that Portland General is the largest investor-owned utility in Oregon. "Indeed, the record evidence tends to show that Portland General is a material utility subsidiary and that it is not small in either a relative or an absolute sense," the SEC found (p. 32).

- Accordingly, the SEC concluded that Enron failed to establish that it met the statutory criteria for exemption under either Section 3 (a) (3) or 3 (a) (5), and denied Enron's application under those sections as well.

- It is difficult to conclude that Enron claimed these exemptions in good faith.

The June 29, 2004 SEC Staff Memorandum

- Rule 2 permits some holding companies to claim an exemption under Section 3 (a) (1) of PUHCA without seeking formal Commission grant of the exemption. The SEC staff memorandum notes at page 3 that the holding company self-certifying such an exemption must make an annual filing on Form U-3A-2. The memorandum also notes that this filing is designed to enable SEC staff and the Commission "to monitor" companies claiming exemption and, in appropriate situations, to seek further information about the facts underlying the claim of exemption or, as outlined in Rule 6, to challenge the exemption.

- In the case of Enron, the SEC staff memorandum acknowledges: "For a variety of reasons, between 1997 and 2003, Enron was not required to register under the Act." (p. 3) At the time of its 1997 merger with Portland General, Enron reincorporated in Oregon and began claiming an exemption under Section 3 (a) (1) pursuant to Section 2 by making annual filings on Form U-3A-2. In 2000, without withdrawing its Rule 2 claim, Enron filed applications under Section 3 (a) (3) and 3 (a) (5). Finally, in 2000, after it became unable to file the financial statements required by Form U-3A-2, Enron also filed an application for an order of exemption under Section 3 (a) (1) and began relying on the "good faith" filing provision of Section 3(c) of the Act. At the time, Enron was not entitled to any of these exemptions but was allowed to take advantage of exempt status for more than five years before the Commission took appropriate action. The memorandum advises on page 4 that "the staff vigorously opposed the granting of any of those exemptions in the hearing conducted by the Commission." This begs the question: Where was the staff in the interim? Did the SEC commit the right level of resources and perform the right level of work during 1997 through 2003 on PUHCA?

- The SEC staff memorandum passively notes on page 4 that, when it acquired Portland General in 1997, "Enron was a likely candidate for a Section 3 (a) (1) exemption," without coming to terms with the fact that this was later revealed not to be the case, and without coming to terms with the Commission's role in the matter. The memorandum also stunningly advises that "the question of whether the applications were filed in good faith was not addressed in the administrative proceeding."

- Notwithstanding these facts, the SEC staff memorandum maintains: "The staff does not believe that the current system under the Act and rules is inconsistent with the public interest or the interests of investors and consumers." (p. 2) The memorandum expresses the staff's belief that "this system strikes an appropriate balance by permitting a holding company that clearly qualifies for an exemption

to claim it without going through a formal process, thereby saving both company and Commission resources, while effectively requiring that more doubtful claims of exemption be reviewed" through a formal process and improperly claimed exemptions be challenged (p. 3). The memorandum reveals that Enron's annual filings on Form U-3A-2 "did not provide any information that suggested that it could not qualify for the Section 3 (a) (1) exemption." (p. 4) Incredibly, the memorandum goes on to state: "The staff continues to believe that it can adequately monitor exemptions claimed pursuant to Rule 2 by reviewing the annual filings that companies make on Form U-3A-2." The staff indicates a main concern is "conserving significant staff and Commission resources that can more valuably be used elsewhere." (p. 5) It appears that the only reform being proposed by SEC staff is non-specified changes to update Form U-3A-2 "to improve the usefulness of the form as well as reduce any unnecessary burdens imposed on the industry." (p. 35) The memorandum indicates on page 35 that "the staff is not aware of any recent filings on Form U-3A-2 that are intentionally false and misleading," but, after what Enron was able to pull off, we are not particularly comforted by that assurance. What changes to the annual form are proposed and how will they help the SEC spot and avoid future Enrons?

- The SEC staff memorandum also explains the benefits that Enron and Portland General improperly obtained as a result of Enron not registering under PUHCA (pp. 3-4). The memorandum notes that an exempt company "avoids the costs of complying with the Act and the costs of making required filings and applications under the Act." Most significantly, the memorandum explains: "The company also presumably benefits by not being subject to the Act's regulatory requirements, including the Act's restrictions on a registered holding company's ability to engage in other businesses, its restrictions on affiliate transactions, and the requirements regarding capital and corporate structures....Enron also presumably benefitted from its ownership of PGE, including the effect that ownership of PGE had on its income, profit and assets during this period." Whether any of these benefits could be considered inappropriate depends upon whether Enron's exempt status was wrongly obtained or whether any of its applications for exemption was not made in good faith, questions that we are advised were not addressed by the Commission proceedings. The memorandum notes on page 7 that "an analysis of whether to revoke an existing exemption does not occur on a predictable basis." We are compelled to ask: When does it occur? When should it occur?

- The SEC staff memorandum indicates on page 33 that the staff engaged in "particularly rigorous reviews" of holding companies claiming exemptions as intrastate holding companies pursuant to Rule 2 in 1998, 1999, 2002 and again this year, noting that: "We are currently addressing specific issues that have arisen

in the context of this year's review." What resources were committed to these reviews, what work was done, and what were the findings and outcomes? The memorandum states at page 35 that the staff "has not formally audited or inspected any exempt holding companies in recent years," indicating that the staff believes that "there are more appropriate ways to follow up our concerns than through an audit or inspection." How did this operate in the case of Enron and other companies? What resources were committed to these "more appropriate ways" and what were the outcomes?

- The SEC staff memorandum indicates at page 39 that, during the past five years, the staff has examined seventeen registered holding companies, and that the Branch of Auditing and Financial Policy is currently hiring additional staff for the office and will likely add at least two analysts or accountants. We commend these additions. Are they adequate? What resources were committed to the seventeen reviews, what level of work was performed, and what were the outcomes?

- The SEC staff memorandum discloses at page 14 that, between 1992 and 1999, SEC staff issued five no-action letters to Enron and/or its subsidiaries assuring it that the staff would not recommend enforcement action to the Commission regarding certain proposed transactions or activities based on the facts presented by Enron. These no-action letters allowed Enron to expand into electricity power marketing, vehicular natural gas activities, operation and maintenance of an electric power project in the Philippines, interconnection of individual consumers to electricity distribution facilities, and ownership of electric, gas, water, and wastewater systems at a military base in Brooklyn, New York. We believe that GAO should review how this office processes no-action requests as compared with other units within the SEC and with other similar government entities.

- "Absent special circumstances," explains the memorandum, SEC staff will not look at the implications of the totality of activities claimed in exemptions and no-action requests (p. 17). The SEC staff memorandum states at page 5 that "the staff has no reason to believe that Enron's bankruptcy was causally related to the current administration of the exemptive provisions of the Act. Rather, it appears that Enron's downfall was directly related to unlawful activities of the company and a number of its employees and certain third parties." However, we believe that, upon a full review of the public record, had Enron been required to comply with the diversification, capital, and corporate structure requirements of PUHCA, it would have been virtually impossible for the company to have engaged in accounting frauds involving the use of "special purpose entities" to shift assets or liabilities off its balance sheets, or to have engaged in the fraudulent or manipulative energy trading in the Western electricity markets in 2000 and 2001.

This situation was exacerbated by the failure of the SEC to review Enron's public disclosure filings for a number of years.

- The SEC staff memorandum indicates at pages 18 to 24 that the SEC continues to favor an expansive view of utility ownership structures that have allowed companies like Berkshire Hathaway to acquire utilities without having to register under PUHCA. In 2000, the SEC issued a no-action letter to Berkshire Hathaway, finding that it would not have to register under PUHCA so long as it only held 9.9 percent of the voting stock of MidAmerica, a public utility, even though Berkshire reports that it has an 80.5 percent interest in utility operations, through MidAmerica Holdings. We ask you to review whether the SEC should allow such investments to be exempted from PUHCA in light of earlier SEC decisions in *H.M. Byllesby & Company*, 6 S.E.C. 639 (1940) and *The United Corporation*, 13 S.E.C. 854 (1943).

- The SEC staff memorandum contends that "those cases are distinguishable from *Berkshire Hathaway*" because "there were no *prima facie* holding companies" within the meaning of the Act, "and the staff did not conclude that, based on the facts presented in the no-action request, Berkshire Hathaway and the other companies would exert the kind of control or controlling influence that would have warranted a recommendation to the Commission that they be found to be holding companies under the Act." (p. 18). While Berkshire Hathaway is a highly successful company with a well-respected leadership, we ask you to review whether the precedent established in this matter could be exploited in the future by other companies that might be less well-capitalized and might be tempted to exploit their control over a utility or utility holding company to engage in the type of abusive practices that PUHCA was enacted to address.

After you have had an opportunity to review the SEC response and our comments and concerns, please have GAO staff contact Consuela Washington and Sue Sheridan with the Committee Democratic staff at 202-225-3641 or Jeff Duncan with Representative Markey's office at 202-225-2836 to begin the design phase of this important investor and consumer protection project. Thank you for your cooperation and attention to our request.

Sincerely,

JOHN D. DINGELL
RANKING MEMBER

EDWARD J. MARKEY
MEMBER
SUBCOMMITTEE ON ENERGY AND AIR QUALITY

Enclosure

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

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

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