Testimony of

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before the

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The Public Utility Holding Company Act of 1935 and S.1766

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Executive Summary

I. Introduction: Is Competition Here?

Proponents of the Public Utility Holding Company Act (PUHCA) repeal assert that "competition is here," or that competition will be here once the Act is gone. These statements suffer from a lack of precision. Competition remains elusive, and those seeking to implement it struggle with a long list of unresolved issues, at both the federal and state levels.

In the areas of market pricing and regional transmission policy, the present Federal Energy Regulatory Commission (FERC) is grappling with the problems and alternative solutions, but no objective person can credibly pinpoint a date by which the defects will disappear. On multistate mergers, the industry consolidation is accelerating, while FERC still lacks an analytical method that distinguishes efficient mergers from inefficient ones. Until these defects are cured, protections are necessary at the national level.

At the state level, significant barriers remain to generation competition. Retail ratemaking techniques still induce utilities to favor self-construction over buying at wholesale, and there is a growing trend toward blocking construction by independent generation. Even perfect federal policies will not create wholesale competition if state policies discourage wholesale competitors.

II. PUHCA's Major Themes Remain Relevant Today

The central themes of PUHCA remain relevant today: preventing utility acquisitions that are not justified by operational efficiencies; limiting speculative investments; prohibiting interaffiliate transactions; and restricting unsound financial practices. In the absence of vigorous competition, and in the presence of frequent mergers, each of these concerns needs Congress' attention.

III. Congress Should Modernize Certain PUHCA Protections

There is a significant difference between financial entry and competitive entry. The acquisition of one monopolist by another is a change in control, not an increase in competition. To call this "entry," and thus to criticize PUHCA because it "blocks market entry," is to misuse the term. It is "entry into a new market" from the perspective of the acquirer seeking new captive customers. But it is not a "new competitive entrant" from the perspective of those captive customers, for the simple reason that there is no competition.

Therefore, acquisitions need to be conditioned upon findings that they (a) are the product of a competitive market, (b) produce measurable, guaranteed benefits for ratepayers of both the acquirer and acquiree, (c) do not weaken the financial strength of the acquirer or acquiree, and

(d) do not deprive existing utility customers of benefits associated with their past cost contributions.

Title 2 of S.1766 makes important contributions by clarifying the FERC's jurisdiction over mergers and by emphasizing care in the granting of sellers the right to charge market-based rates. But with the repeal of PUHCA, the Commission will need more substantial, affirmative authority so as to screen in those acquisitions which promote efficiency and competition, and screen out those acquisitions which do not. Statutory proposals to replace PUHCA therefore must (a) hold mergers to standards of economic efficiency and effective competition; (b) allow market-based pricing only where markets are truly competitive; and (c) condition utility financing on public interest showings.

IV. Congress Should Transfer the Regulatory Responsibilities to FERC

Although FERC has not always pleased all its constituents, and has in the past used methodologies for merger review and market pricing not based in economic logic, it has remained publicly committed to its statute.

The Public Utility Holding Company Act has not enjoyed comparable respect. Twenty years ago, the SEC took the position that the Act no longer was necessary because markets and other regulators protect the consumer and the investor. The agency has held to this position through the era of nuclear cost overruns, the savings and loan failures, the bankruptcies of several utilities, utility diversification, the "discovery" that transmission owners exercised market power in generation markets, and even through the California price spike troubles of Summer 2000.

At the same time, staffing problems (no engineers, no economists, only one accountant) and the statutory application problems (particularly in the area of the "intrastate exemption" and the application of the "integration" test) have left the nation without the protections Congress has ordered.

V. Enron

Proper application of PUHCA would have identified and prevented Enron's ill-fated activities. Specifically, had Enron, a global company, not had the "intrastate" exemption, it would have been subject to the Act's standards for issuances of debt and other forms of financing; creating or acquiring nonutility ventures; and interaffiliate transactions. Faithful application of these standards would have prevented many of the troubles.

VI. A World Without PUHCA

A world without PUHCA, or its modern replacement, would be a world of unreviewed acquisitions of generation companies, unlimited mixing of businesses which serve captive customers and businesses which take unmeasurable risks, and no advance reviews of the prudence of securities issuances to assure consistency of the public interest. Where most customers have no choice but to buy essential electricity from a single company, to authorize such behavior without limits is counterintuitive.

Conclusion

The electric industry lacks effective competition in many markets. Congress cannot nurture competition by giving free rein to companies which for a century have avoided competition. And Congress cannot protect consumers by confusing financial entry with competitive entry. To repeal PUHCA without establishing a modern regulatory regime -- one that conditions acquisitions on real competition and attentive regulation -- is to allow dominant incumbents to exploit unearned advantages. Calling the result "competition" is good fiction, but it is not good policy.

United States Senate
Committee on Energy and Natural Resources

Testimony of
Scott Hempling, Attorney at Law

February 6, 2002

Mr. Chairman and Members of the Committee:

My name is Scott Hempling. I am the principal in a law firm which advises public and private sector clients involved in regulated industries, particularly state regulatory commissions and organizations of consumers or consumer representatives. I have represented clients in many cases under the Public Utility Holding Company Act of 1935 (PUHCA), before the Securities and Exchange Commission (SEC) and the U.S. Court of Appeals. I have testified before this and other Congressional committees many times on PUHCA and other electric industry matters. My testimony today reflects my own views, and not necessarily those of any past or current client.

I. Introduction: Is Competition Here?

Proponents of PUHCA repeal assert that "competition is here," or, that competition will be here once the Act is gone. These statements suffer from a lack of precision. Competition remains elusive, and those seeking to implement it struggle with a long list of unresolved issues, at both the FERC and state levels.

A. Competition Remains Elusive

For most of the last century, the combined actions of federal and state policymakers have given a selected set of companies the exclusive power to own the strategic assets of the electric industry: generation, transmission and distribution.

In two major efforts, Congress tried to stimulate a substantial nonutility presence in the generation sector. The Public Utility Regulatory Policies Act of 1978, and the Energy Policy Act of 1992, created categories of wholesale generating companies that would avoid "electric utility" status under PUHCA. Avoiding PUHCA meant that anyone could acquire any number of these generating companies in any location, using any corporate structure, unaffected by the various PUHCA requirements.[1] The PUHCA repeal sought today, in the name of competition, was largely granted in 1978 and 1992 for the wholesale generating sector.

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[1] The exception is the limit on the share of a PURPA "qualifying facility" that can be owned by a utility.

PUHCA repeal at wholesale has not brought effective competition at wholesale. Despite some inroads by independent companies, most generation remains concentrated in traditional utilities or their affiliates. As discussed in Part I.B and C. below, we face a long struggle before electric generation looks like the competitive commodity markets that characterize wheat, soybean and pork bellies.

In the meantime, those who control generation are exploiting their advantages. Mergers of utilities with market power have become almost routine. These efforts at "strategic positioning" might be benign in a competitive environment. But in an industry infected with market power in every major asset and service segment, these mergers are biasing markets against competition for years to come.

Under these conditions, the repeal of PUHCA, on a standalone basis, can only make matters worse. Freeing dominant incumbents to acquire others may improve their own standing, but it will not improve the electric industry. It will burden further our regulators, and the customers they try to protect.

As discussed in Part I.B below, the Federal Power Act, in its design by Congress in 1935 and in its implementation by the Federal Energy Regulatory Commission (FERC) today, has serious gaps. Meanwhile, state regulators are striving to keep up with today's changes. But state regulation was a tool designed primarily to regulate local utilities and local transactions. The number and complexity of multistate transactions today pose real difficulties for State regulation. Many state commission staffs are struggling with the burdens of rate cases, intervention in FERC proceedings concerning mergers and transmission access, as well as the numerous changes in the gas and telecommunications industries.

B. The Implementation Struggle at FERC

On three key issues -- measuring competitiveness, regional transmission service and mergers -- the industry and its regulators lack a common understanding and commitment.

1. Measuring Competitiveness

The California price spikes of 2000 were the natural culmination of 20 years of carelessness in the (a) analysis of wholesale markets, (b) design of mechanisms to make those markets work and (c) design of consumer protections for when those markets do not work.

Consider the shifting rationales supporting FERC's departure from cost-based ratemaking since the late 1970's:

- -- desire to increase supplies
- -- increase performance in coordination services
- -- desire to compensate for new risks
- -- financial stabilization of weaker companies
- -- market pricing is justified by a competitive market
- -- market pricing is necessary to attract entry into a noncompetitive market

The sixth rationale was offered by many generators during the California summer and repeated by the then-FERC Chairman. Notice the 180 degree turn from the preceding rationale. Only one of those rationales can be lawful. Yet both rationales, and most others rationales offered by applicants over the past 20 years, were accepted by the Commission, although not without dissent.

To its credit, the present FERC is bringing these issues forward, openly and forthrightly. Recent issuances on market analysis and refunds reveal how significant were the past errors and how difficult is the work ahead.

a. Recent Actions on Market Measurement

There finally has been official recognition of the illogic plaguing the "hub and spoke" and "delivered price test" approaches to market measurement, and the need to replace them. On the subject of "hub and spokes" method, FERC itself has explained its deficiencies:

> An accurate assessment of the effect on markets depends on an accurate definition of the markets at issue. <u>The Commission's current analytic [hub-and-spoke] approach defines geographic markets in a manner that does not always reflect accurately the economic and physical ability of potential suppliers to access buyers in the market</u>....
>
> <u>A drawback of this method of defining geographic markets is that it does not account for the range of parameters that affect the scope of trade</u>: relative generation prices, transmission prices, losses, and transmission constraints. Taking these factors into account, markets could be broader or narrower than the first- or second-tier entities identified under the hub-and-spoke analysis....
>
> Another concern with the [hub-and-spoke] approach ... is its <u>analytic inconsistency</u>. It defines the scope of the market to include the directly interconnected utilities that are accessible due to the applicants' open access tariff, but does not expand the market to recognize the access afforded by other utilities' tariffs. This was acceptable before open access was established as an industry-wide requirement for public utilities.

Merger Policy Statement, Docket No. RM96-6-000, 61 Fed. Reg. 68595 at 68599 (Dec. 30, 1996)(emphasis added).

Yet FERC, until about two months ago (about five years after acknowledging its serious defects), continued to apply the "hub and spoke" test to all applications for market-based pricing.

Then, on November 20, 2001, FERC came to terms with the fact that market-based rates had been approved for entities able to exercise market power. AEP Power Marketing, Inc., 97 F.E.R.C. para. 61,219 (Nov. 20, 2001) (order on triennial market power updates and announcing new, interim generation market power screen and mitigation policy). That day the Commission issued an order replacing its "hub and spokes" test for market pricing with a new interim test called the Supply Margin Assessment (SMA). The Commission stated that it had concluded that, "because of significant structural changes and corporate realignments that have occurred and continue to occur in the electric industry, our hub-and-spoke analysis no longer adequately protects customers against generation market power in all circumstances."

Under the SMA, FERC will ask whether the applicant for market pricing has an amount of capacity which exceeds the supply margin (excess of supply over peak demand) in the prospective buyer's control area, taking into account transmission constraints. Where it finds that the seller controls supply resources exceeding the supply margin, FERC will conclude that the applicant seller is in a position to exercise market power and may limit the buyer to a "split savings" price rather than a market price.

FERC's November 20 order applied the new test in pending cases for renewal of market rate authority involving American Electric Power Co., Entergy Corp. and the Southern Cos. Within the control areas of each of the companies, the Commission found that the companies could exercise market power "because [their] generation is needed to meet the market's peak demand." The Commission therefore imposed mitigation measures.

b. Recent Actions on Refunds

Only in the last two months has the Commission moved to establish an express refund mechanism that protects consumers from market rates which, while perhaps just and reasonable at the time they were authorized, might become unjust and unreasonable later due to a decline in competitive forces. See Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations, 97 F.E.R.C. para. 61,220 (Nov. 20, 2001) (order establishing refund effective date and proposing to revise market-based rate tariffs and authorizations). The proposed order would amend all market rate tariffs to clarify that where FERC finds that a seller with market rate authority has acted anticompetitively, FERC may issue a refund order. The order indicates that in ordering refunds the Commission will focus on two types of anticompetitive behavior -- physical or economic withholding of supplies.

In short, the present FERC is struggling, openly and determinedly, to solve, on many fronts at once, a set of problems that has smoldered for years. But this very struggle is cause for

caution. As hardworking and determined as they are, the present FERC Commissioners, like any prudent regulators, likely would hesitate to name a date on which they expect to see effective competition in all wholesale markets.

2. Regional Transmission Service

As to regional transmission policy, anyone not recently freed from solitary confinement knows that after 30 years of discussion almost every issue remains on the table:

- -- Independence from market participants
- -- Geographic scope and configuration
- -- Operational authority
- -- Short-term reliability authority
- -- Tariff administration and design
- -- Congestion management
- -- Parallel path flow
- -- Ancillary services
- -- Market monitoring
- -- Transmission planning and expansion
- -- Interregional coordination

While the present FERC has made major progress in the past 7 months, this FERC would be the first to admit that the date on which all markets will be served by RTOs that are independently governed, efficiently priced, reliably operated and publicly accountable is known by no one.

3. Mergers

Under Section 203 of the Federal Power Act, the FERC must disapprove mergers that are not consistent with the public interest. 16 U.S.C. 824b. Beginning in 1985, a process of consolidation began and accelerated in the second half of the 1990s. Mergers are now routine; yet there has been neither consensus nor clarity concerning FERC's merger analysis. Merger review at FERC remains economically indefensible. This conclusion follows from four merger principles that have emerged from various FERC cases:

a. The public interest is protected if costs do not exceed benefits, even though there might be other mergers or other investments which can produce the same benefits at a lower cost.

b. In comparing costs to benefits, FERC disregards acquisition cost and counts only implementation cost.[2]

c. The FERC counts as "benefits" coordination savings which could be obtained without a merger.

d. The FERC counts as "benefits" elimination of pre-merger imprudence.

Put simply, the present merger review standards do not distinguish efficient mergers from inefficient mergers. In a competitive market, a merging partner employing this analytical casualness would lose its shirt; in a regulated monopoly setting, the shirts are the customers'. This policy, applied repeatedly for 16 years, has done long-term damage to the cause of competition. There remains no process, either competitive or regulatory, that distinguishes combinations based on efficiency from combinations based on market share maintenance or market dominance.

C. The Implementation Struggle at the State Level

The problem of wholesale competition is not FERC's alone. The most pro-competitive FERC policies will not produce wholesale competition if entry is blocked in other ways. Several clouds appear, not only on the horizon but directly overhead:

1. Accommodating utility preference for self-construction: Few states have policies mandating that retail utility monopolies purchase their needs on the wholesale market. Leaving the choice with the vertically integrated utility creates strong bias favoring vertical integration and disfavoring wholesale competition.

Only occasionally is it in a utility's interest to forego construction (which would add to its rate base and therefore add to its profit), in favor of purchasing power from others (which assigns the profit to the generator and makes the utility a mere cost conduit).

2. State concerns with independent generation: Most states work mightily to attract physical investment: investment which creates jobs, broadens the tax base and, in the case of exporting industries, increases the state's trade surplus. In the case of new nonutility generation, this practice does not seem to exist; in fact the trend is in the opposite direction. An increasing number of states are questioning the benefits of allowing generation construction by companies that do not have firm loads, or who have customers located outside the state. In some instances, legal and political opposition to such construction has come from the incumbent

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[2] One would not buy a rental property merely because the expected rent exceeded the costs necessary to rehabilitate and maintain the space for tenants. One would buy the property only if the expected rent exceeded these implementation costs plus the acquisition cost.

utilities, who do not want competitors to gain a beachhead in their home markets. In other instances, there is legitimate concern from citizens wishing to avoid excess construction. Some seek to limit construction of generation in a state to plants intending to serve load in that state, even though such "hoarding" of in-state benefits and obstruction of interstate trade is a per se violation of the Commerce Clause of the U.S. Constitution. See New England Power Co. v. New Hampshire, 455 U.S. 31 (1982) (invalidating state law, which preserved benefits of state hydroelectric power for in-state consumers, because the law was "designed to gain an economic advantage to in-state consumers" to the detriment of consumers out of state).

The opposition to new generation, whether strategic or citizen-based, legitimate or illegitimate, has similar effect: it discourages competitive entry.

These two examples -- utility preference for utility construction and state concerns with independent generation -- indicate that the interest in wholesale competition has limits, when the costs of that competition are felt close to home, or when the losing competitor might be the home team. The best RTO policies in the world will not bring us wholesale competition, if state policies obstruct new generators. RTOs without generation entry means highways without traffic.

D. Overview of this Testimony

The central facts discussed above -- that competition remains elusive and that its success depends on FERC and the states getting dozens of decisions right -- establish the proper context in which to consider change to PUHCA. This testimony does not argue against any change to PUHCA. Instead, it describes the conditions which must be in place before amendment or repeal, so that persistent market power does not harm the consumer or impede progress to effective competition.

This testimony has five remaining sections.

Part II describes how PUHCA's major themes remain relevant today.

Part III recommends that Congress modernize certain PUHCA protections, and transfer the regulatory responsibility to FERC.

Part IV shows the how the arguments for standalone repeal lack a factual basis.

Part V underscores the continuing relevance of PUHCA, and the need for a federal corporate structure statute, by explaining that proper application of PUHCA would have identified and prevented Enron's ill-fated activities.

Part VI concludes this testimony by describing the consequences of a world without a federal corporate structure statute for the electric industry.

II. PUHCA's Major Themes Remain Relevant Today

Congress passed PUHCA to protect the public, investors, and consumers from utility holding company abuses. Congress identified several categories of abuses and acted comprehensively to address them. Today we still have the risk of abuse, and we still have the public, investors and consumers to protect from abuse. Most of the themes of the Act remain relevant today, including:

a. Prevent acquisitions that are not justified by operational efficiencies
b. End abusive interaffiliate transactions
c. Restrict unsound financial practices

I discuss these main themes next. For each of the three themes, I will explain the original purpose, describe how the statute addresses it and show that the original purpose remains necessary.

A. Prevent Acquisitions Unrelated to Operational Efficiencies

Original Purpose: Congress was concerned about acquisitions motivated by acquisitiveness rather than operational efficiencies. These acquisitions produced complex holding companies structures aimed at milking the individual utilities and their customers, using techniques that state regulators could not police. Congress concluded that such holding company "activities extending over many States are not susceptible of effective control by any State and make difficult, if not impossible, effective State regulation of public-utility companies." Section 1(a). Congress saw a need to require holding companies to maintain a focus on the core business of utility service to captive consumers, limit financial risks to ratepayers, and protect businesses in unregulated industries from anti-competitive cross-subsidies.

Tools: Review of Utility Acquisitions: Congress adopted geographic restrictions on the growth and extension of holding companies by precluding utility holding company acquisitions where the acquired utility is not physically integrated (the "integration" requirement) and coordinated with existing utility properties. Section 2(a)(29)(A).

Congress further required that utility acquisitions create new operational and managerial efficiencies. Acquisitions under the Act must therefore create positive operational benefits. Section 10(c)(2).

Congress prohibited acquisitions of utility assets where the acquisition will"tend towards interlocking relations or the concentration of control of public-utility companies, of a kind or to

an extent detrimental to the public interest or the interest of investors or consumers." Section 10(b)(1).

Congress restricted registered holding companies to engaging in businesses "reasonably incidental, or appropriate to the operations" of the public utilities. Section 11(b)(1).

Non-registered or "exempt" holding companies may diversify into other businesses only to the extent that such diversification is not "detrimental to the public interest, or the interest of investors or consumers." Section 3(a).

Current Relevance: In most states retail electric and gas customers remain unable to shop. They are no less captive today than they were in 1935. Even in states where retail competition has been adopted, effective competition is largely absent. At the same time, the industry, after several decades of quiet following breakups mandated by PUHCA, has regained much of its pre-1935 concentration and complexity. Many holding companies have dozens of affiliates, many of them making investments worldwide. This growth in affiliates has had little to do with improving service to customers.

B. End Unreasonable or Abusive Interaffiliate Transactions

Original Purpose: Utility holding companies exploited utility operating companies through financial mismanagement, taking advantage of the inability of state regulators to analyze complex and multistate transactions.

Tools: Review of Interaffiliate Transactions: Congress sought to ensure that holding companies could not use service, management, construction, and other contracts to allocate charges among subsidiaries in different states so as to obstruct effective state regulation. In Section 13 Congress prohibited registered holding companies from entering into contracts for services and goods (other than power, which is regulated by FERC) without SEC approval.

In Section 12, Congress placed strict limits, and in some cases outright bans, on certain financial transactions between utilities, their holding companies and other subsidiaries. For example, a registered holding company cannot borrow from its subsidiary utilities. Sec. 12(a). Other limitations apply to a holding company's loans to its subsidiaries and payments of dividends. All transactions are covered by Commission rules concerning fair accounting treatment, maintenance of competitive conditions, disclosure of interests, and other "public interest" factors. Sec. 12(f).

Current Relevance: Industry consolidation, combined with an increase in use of "service" companies that provide non-power goods and services to the various utility operating companies of a holding company system, means that consumers continue to be at risk from their jurisdictional utility's transactions with affiliates. State regulators do not have the ability and resources, and in some cases may lack authority, to review the many transactions between affiliates of utility holding companies. Further, without federal intervention state regulators may

be unable to access the books and records necessary to review the costs of an interaffiliate transaction.

C. Restrict Unsound Financial Practices

Original Purpose: Congress in 1935 found public harm from speculative and unsound securities issuances. Prior to the Act, holding companies issued securities based on inflated capital structures, fictitious or unsound asset values, pyramidal structures, and other market manipulations. Congress thus intended PUHCA to address the adverse consequences to the public "when ... securities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies." Section 1(b)(1).

Tools: Review of Financing: Without SEC approval, a registered holding company or its subsidiary may not issue or sell any stock, or exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of the company. Sec. 6(a). (There are various exceptions, including for private offerings, short-term securities, and others.)

In reviewing a holding company or its subsidiary's filing for approval, the SEC must ensure, under Sec. 7(d), that:

- issuance or sale of the security does not jeopardize the security structure of the holding company system;
- the security is reasonably adapted to the issuer's earning power;
- the type of financing is necessary or appropriate to the economical and efficient operation of the issuer's business;
- the fees and commissions paid are reasonable;
- where the security is a guaranty of, or assumption of liability on, a security of another company, the declarant is not taking an improper risk; and
- the terms and conditions of the issuance or sale are not detrimental to the public interest or the interest of investors or consumers.

If a State informs the SEC that State laws applicable to the transaction have not been complied with, SEC must reject the transaction. (Section 6(g)).

For utility acquisitions, the SEC must find that the amount paid bears a fair relation to the sums invested in, and earning capacity of, the underlying utility assets. (Section 10(b)(2)).

Relevance of Financing in the Current Industry Structure: As the Enron events demonstrate, federal disclosure statutes do not prevent a holding company or its subsidiaries from undertaking securities transactions which conceal the underlying value of the company. PUHCA's financial reviews do more than disclose; they apply a reasonableness test to assure that financial commitments are commensurate with utility service needs.

III. Congress Should Modernize Certain PUHCA Protections, and Transfer the Regulatory Responsibilities to FERC

Although PUHCA's main themes remain relevant, the statutory devices do not fit the industry today as well as they did in 1935. Some of these devices can be eliminated, while others must be modernized. This section describes the challenges posed by utility restructuring today, and then presents prerequisites for PUHCA repeal, including conditions on mergers and acquisitions, and on the mixing of utility and nonutility businesses. I then argue that Congress should transfer responsibility for the modernized protections from the SEC to FERC. Finally, I analyze the provisions of Title 2 of S.1766.

A. The Challenge of Utility Restructuring Today

Mergers between monopolies are different from mergers in competitive industries. Competitive industries lack captive customers. Customers ill-served by an expensive merger can shop elsewhere. Customers of a regulated monopoly have no choice.

PUHCA addressed mergers with a bold stroke: only those mergers justified by improvement in physical operations would be permitted, and then only if those mergers did not cause a concentration of control, produce a complex capital structure or otherwise harm the public interest. See Section 10 of PUHCA. The effect of Section 10 was to block acquisitions or mergers involving companies that could not, because of physical separation, coordinate their electric operations after the merger.

The 1935 Congress blocked all non-integrating acquisitions because it saw no possible benefit from them. Neither wholesale competition nor retail competition was evident at the time. Today, we have a policy of promoting wholesale competition and, in some states, retail competition. Competition works best if there is a substantial number of entrants in each market. Especially when a market is dominated by the incumbent as many present markets are, a marked increase in the number of viable competitors is a prerequisite for real competition.

This need for new viable competitors raises a legitimate question about the value today of PUHCA's prohibition on non-integrated acquisitions. It is fair to say that until 1992, PUHCA's prohibition, if enforced, limited the number of new competitors in any market to those entities that operate physically only in that market. In 1992, Congress, intending to promote wholesale competition, removed this prohibition if the acquired company was an "exempt wholesale generator," that is, a company that owned a generator, which company's exclusive business was

the sale of electricity at wholesale. Thus, with respect to wholesale competition, PUHCA does not present any prohibition on entry, and has not for almost 10 years. Utilities and non-utilities own many wholesale generation companies throughout the nation, on a non-integrated basis.

That brings us to the question of retail competition. In those states where retail competition is legally authorized, PUHCA's prohibition on non-integrating acquisitions normally would limit the number of players in that market to those whose physical operations are integrated with that market. However, in 1997 the SEC promulgated Rule 58, 17 C.F.R. 250.58. Rule 58 allows registered holding companies to create or acquire retail electricity marketing and brokering companies as well as other energy-related companies, provided these companies do not own utility assets and provided the aggregate investment in such energy-related companies does not exceed the greater of $50 million or 15% of the consolidated capitalization of the registered holding company. Thus, market entry at retail already is accommodated by SEC rule. What is not accommodated is the non-integrated acquisition of utility assets. Such acquisition could not increase competition where the assets are monopoly assets, like transmission and distribution. In that noncompetitive context, PUHCA presents a barrier not to competitive entry, but to financial entry.

This distinction warrants emphasis. There is a dramatic difference between financial entry and competitive entry. The acquisition of one monopolist by another is a change in control, not an increase in competition. To call this "entry," and thus to criticize PUHCA because it "blocks market entry," is to misuse the term. It is "entry into a new market" from the perspective of the acquirer seeking new captive customers. But it is not a "new competitive entrant" from the perspective of those captive customers, for the simple reason that there is no competition.

There is one circumstance under which the acquisition of distant monopoly assets might benefit the public: when the acquisition is the result of a competitive auction process designed to identify the most efficient and innovative provider of monopoly services. For that circumstance, some relaxation of the integration requirement is worth considering, under the specific conditions discussed next.

B. Prerequisites for PUHCA Repeal

1. Conditions on Mergers and Acquisitions Involving Utilities

The many PUHCA protections can be distilled into 5 modern prerequisites to the approval of a merger or acquisition involving utilities. Each is discussed next.[3]

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[3] In all acquisition situations, including those in this subsection and the subsequent ones, the entity actually performing the acquisition may be a utility or an affiliate of the utility. If there is a utility with captive customers anywhere in the acquirer's corporate structure, these principles should apply. Corporate form should not create customer risk.

a. The acquisition must be the product of a competitive market; and must not reduce the effectiveness of competition in the acquirer's or acquiree's present or likely future markets.

The typical utility merger is not the product of real competitive forces; it is the product of two companies, each with 100% market share at retail, creating a combination which itself has 100% market share at retail; and then persuading regulators to accept it. True competitive market forces are not involved.

When the merging companies themselves, because of their retail franchises, are not subject to strong competitive forces, there is only one way for the merger itself to be the product of real competitive forces: create competition for the monopoly franchise. The regulators of the potential acquiree must host an auction, allowing multiple companies to bid for the right to acquire. Only through this bidding process can we identify the most efficient combination, the one most likely to lower costs and increase quality.

This bidding process would reverse the economic positions of the typical utility merger. In the typical utility merger, the acquiring company bids for the acquiree's shareholders, paying the price they demand. This process increases the cost of the merger to the acquirer. That increased cost either causes ratepayers to pay higher rates, or causes a decline in service quality due to the financial pressure. In contrast, bidding for the franchise means bidding for the favor of the ratepayers. That means the bidders are offering lower prices, better services and more accountability, relative to the status quo. And that is exactly what should happen in competition.

The requirement that the acquisition must be a product of a competitive market also means that both the acquiree and the acquirer should be subject to the maximum competitive forces allowed by law. Assuming no retail competition, wholesale competition must be vigorous in both the acquirer's and the acquiree's markets. Wholesale competition will be vigorous only if there is a functioning, independently governed regional transmission organization offering efficiently priced transmission and ancillary services; low barriers to entry for new generators and demand side management service companies; and clear market mechanisms for demand side options.

b. The acquisition should produce measurable, guaranteed benefits for ratepayers of both the acquirer and acquiree, by significantly increasing the quality of service or decreasing the cost to consumers of electric service.

Unlike an adjacent acquisition, which may produce operational efficiencies from joint operations, a distant acquisition free of PUHCA's integration requirement offers a less obvious

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Also, the regulator should be authorized to waive some or all of these prerequisites where the customers of the acquirer and acquiree participate in markets subject to vigorous retail competition. In that context, the protection can come from the market rather than regulators.

"upside" to existing ratepayers. The public does not benefit if the only reason or effect of a merger is to increase the monopoly territory controlled by a single company. If the acquirer can show that it will run the utility better, then replacing one franchisee with another can benefit the public. That standard applies in a competitive market; it is no less appropriate in a retail monopoly context.

c. The acquisition should not weaken the financial strength of the acquirer or acquiree.

Where an acquisition is motivated by acquisitiveness rather than customer service, there can be a tendency to overpay for the merger (that is, overcompensate the departing shareholders relative to the real savings produced by the merger). The result is a financially weakened company, less able to invest internally for innovation, and more likely to seek government assistance in the form of rate increases. The regulator therefore needs to assure that the purchase price bears a reasonable relationship to the underlying costs and benefits of the combination.

d. The acquirer should compensate its existing ratepayers, at a market price, for the use of any resources which facilitate the acquisition or assist the acquired business, to the extent such ratepayers have borne the economic burdens associated with such resources.

When acquiring a new company, a utility may use resources for which ratepayers have paid. These resources might include valuable employees and equipment. Although these assets are owned nominally by the utility, the ratepayers have borne the associated economic risk, at least where the cost of the asset has been included in rates even though the market value of the asset might be lower. If the utility were able to make use of these assets without compensating the ratepayers at market value, the utility would be obtaining a reward from assets for which ratepayers bore the risk. This mismatch of risk and reward harms not only the existing ratepayers (by causing them to bear costs without realizing benefits), but also the effectiveness of competition (since the utility's competitors would not have had captive ratepayers to bear the cost of the assets involved). Requiring the utility to pay market price ensures that the utility is held to a market standard.

e. The acquiring utility may recover its acquisition cost from its existing utility customers, to the extent of tangible, measurable savings created for those customers.

This commonsense financial management applies to traditional utility investments, as well as in competitive markets. It prevents the acquirer from paying an artificially high price and then recovering that high price from ratepayers. It subjects the utility to the type of cost discipline that is imposed by effective competition. Under effective competition, the competitive market sets the price. An acquirer can recover its acquisition premium only if its post-acquisition costs are low enough to leave a margin with which to pay off the premium.

2. Conditions on the Mixing of Utility and Non-Utility Businesses

a. The Problem: With real retail competition almost nonexistent and wholesale competition uneven, customers remain vulnerable to their suppliers' business risks. Prominent among these risks is the risk of nonutility diversification.

The business risks associated with utility diversification are well-known. Utility holding company diversification has fared poorly.[4] Among the prominent examples was the failed investment by Pinnacle West, the holding company for Arizona Public Service, in a savings and loan institution. The failure resulted in Pinnacle West having to borrow several hundred million dollars from insurance companies to pay off bank depositors. As collateral for the loan, Pinnacle West pledged its only significant asset: Arizona Public Service.

Absent regulatory review of diversification, utility management has the incentive and opportunity to use ratepayer resources for shareholder ends. In a competitive market, ratepayers can protect themselves from such management decisions by shopping elsewhere. Absent a competitive market, protection must come from a neutral regulator.

The other side of the coin, distinct from the ratepayer harm, is the harm to competition in the industries entered by utilities or their affiliates. Utilities (typically through unregulated affiliates or subsidiaries) now routinely sell appliances; provide plumbing, heating, and cooling equipment and service contracts; engage in insulation work and sales of storm windows and doors; and provide outdoor lighting and interior lighting fixtures. Utilities also have entered the real estate, security and alarm monitoring markets, telecommunications, and related energy markets such as energy management and energy monitoring.

Exacerbating the problem is the proliferation of multi-state operations in which utility affiliates are engaged. Consider a holding company system, based in State X, that operates mechanical and electrical contracting affiliates in several other states. A non-affiliated competitor based in State Y, and injured as a result of cross-subsidization, may lack standing to file a complaint with the commission in State X because he is not a ratepayer of the subsidizing utility; meanwhile, his own state commission would not likely have jurisdiction over a nonutility affiliate of an out-of-state utility.

Further, a public utility's monopoly franchise may impart an ability and a legal right to gather customer site information regarding energy use, including a complete profile of each customer with respect to billing and credit history. Such information can be accessed or made available to unregulated affiliates while being withheld from non-affiliated competitors.

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[4] According to one commentator, the results were "horrendous in the aggregate and ... satisfactory to disastrous for individual utilities." C. Studness, "Earnings From Utility Diversification Ventures," Public Utility Fortnightly 28-29 (September 1, 1992).

b. Solutions: The mixing of utility and non-utility business can occur in one of two ways: a utility acquires a nonutility business, or a nonutility business acquires a utility business. In each of these contexts, the diversification should be subject to standard regulatory techniques which anticipate and respond to the risks. Those techniques fall into five categories:

(i) Advance Review: Advance federal review of financing where effective State review does not exist, or where such review is requested by a State commission.

(ii) Financing Requirements: Required use of nonrecourse (i.e., nonrecourse to the holding company or any affiliate other than the affiliate undertaking the business) financing for all nonutility investment, and a ban on interaffiliate loans or guarantees from the utility to the nonutility business. Nonutility businesses should pass the market test: they should be financeable by the market on their own merits.

(iii) Protections Against Excess Business Risks: To protect against excess business risks, there should be caps on diversified investment, and type-of-business and place-of-business reviews.

(iv) Protections Against Cross-Subsidies: A cross-subsidy occurs when utility ratepayers incur costs which benefit the nonutility affiliate, and the nonutility affiliate does not compensate the utility adequately. The problem of cross-subsidy exists whenever a single corporation, or corporate family, operates in monopoly and competitive worlds.

- Where the utility purchases goods or services from its affiliate, the proper compensation rule is "the lower of market or fully allocated book."

- Where the utility sells goods or services to its affiliate, the proper rule is market price.

(v) Access to Information: The regulators should have

- access to books and records of the utility and all its affiliates, to the extent such access is relevant to the protection of ratepayers.

- access to the books and records of any third party who is or will become a joint venturer of the utility or any affiliate of the utility, to the extent such access is relevant to the protection of ratepayers.[5]

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[5] As with the merger review standards, the regulator should be authorized to waive some or all of these prerequisites where the customers of the acquirer and acquiree are subject to vigorous retail competition. In that context, the protection can come from the market rather than

3. Arguments Against Diversification Review

Some attack diversification review as "anti-business." This attack misperceives the purpose of regulation. The purpose is to assure that diversified investment pays its own way, and succeeds or fails on its merits, rather than by relying on ratepayer resources. This principle aligns completely with economic efficiency and business prudence.

Shareholders who view appropriate utility regulation as inconsistent with their overall financial objectives can pursue those objectives by investing in diversified enterprises separately from their utility investment. They do not need the option of investing in competitive businesses through their investment in the utility.

Some have argued that the diversification of a company's business portfolio strengthens the company and therefore produces ratepayer benefits. This reasoning misunderstands the nature of regulation. Regulation permits a prudent regulated monopoly to earn a fair rate of return. If a company is performing below par in its monopoly business, the solution is to improve its performance, not seek solace in other investments.

4. The Necessity for a Federal Role

Some have argued that PUHCA is no longer necessary -- and needs no modern federal replacement -- because state regulators can protect consumers. This argument fails for four real-world reasons.

a. Many states lack the authority to investigate the sources of risk: the investment practices or financial condition of affiliates which are not utilities or which are located out of state.

b. Some investment errors are too large to correct through ratemaking disallowance, because that disallowance could place the utility in financial jeopardy and endanger service.

c. A registered holding company can use its multistate status to avoid effective regulation of interaffiliate transactions. In Ohio Power v. FERC, 954 F.2d 779 (D.C. Cir.), cert. denied, 113 S.Ct. 483 (1992), the Court of Appeals for the D.C. Circuit held, among other things, that the FERC (and, by implication, States) could not disallow from rates the costs incurred by Ohio Power, a utility subsidiary of a registered holding company, in purchasing coal from its subsidiary, even though the costs exceeded the market price.

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regulators.

The types and magnitude of interaffiliate transactions are almost unlimited. Most registered holding companies already have one or more subsidiaries which provide goods and services to the utility subsidiaries. These arrangements have included coal mines and other fuel sources, computer services, billing, power supply planning, expert witnesses, legal services, buildings and land. More recently, some utility subsidiaries have transferred traditional functions -- such as nuclear plant operations -- to these companies.

d. The multistate nature of electricity markets requires a multistate review of the effect on competition. The policing of market power is not a single-state task because the exercise of market power is increasingly a multistate phenomenon. Market power obtained in one State, even legitimately, can be leveraged into market power in another State.

Moreover, in the acquisition by a multistate utility company of a new utility -- and almost all mergers are multistate – there often are one or more states lacking authority over the transaction. For example, when CSW proposed to acquire El Paso, the transaction certainly would have had an affect on the ratepayers of Arkansas, Mississippi and Louisiana, but these states did not have proceedings. Similarly, when Entergy acquired Gulf States, those states in which Gulf States did not operate did not have proceedings. Although the acquisition by the holding company serving Arkansas of a utility doing business elsewhere certainly could affect Arkansas ratepayers, there was no state statute making it clear that the Arkansas Commission would have jurisdiction to review the transaction to protect Arkansas ratepayers.

C. Responsibility for the Modernized Protections Should Lie With the FERC

1. The SEC's Staffing Situation

Although FERC has not always pleased all its constituents, and has in the past used methodologies for merger review and market pricing not based in economic logic (<u>see</u> Part I.B), it has remained publicly committed to its statute.

The Public Utility Holding Company Act has not enjoyed comparable respect. More than twenty years ago, the SEC took the position that the Act no longer was necessary because markets and other regulators protect the consumer and the investor. The agency has held to this position through the era of nuclear cost overruns, the savings and loan failures, the bankruptcies of several utilities, utility diversification, the "discovery" that transmission owners exercised market power in generation markets, and even through the California price spike troubles of Summer 2000. Untroubled by the facts on the ground, the SEC has held firm.

It is unclear which is the cause and which the effect. But roughly contemporaneous with its repeal position has been a staffing arrangement that is not commensurate with its statutory obligations. My focus is not on work ethic or dedication, but on professional expertise. Here are five concerns:

a. The analysis of large scale operational relationships requires expertise in engineering. The SEC's PUHCA office has no engineers; it has had none for years.

b. The analysis of the competitive effect of mergers on the many affected electric markets, both product markets and geographic markets, demands expertise in economics at the highest level. The SEC's PUHCA office has no economists; it has had none for years.

c. The analysis of the risks associated with diversification conducted by well over 100 utility holding companies demands expertise in business management, including risk assessment, business strategy assessment, and managerial organization and effectiveness. The SEC's PUHCA office has no business management specialists.

d. The review of interaffiliate sales of goods and services (Section 13) requires expertise in the pricing and procurement of a host of products -- fuels, accounting services, nuclear operations services, real estate costs -- literally any business activity affecting the production of electric service. The SEC's PUHCA office has no business procurement specialists.

e. The review of internal and external financial transactions of over 15 multibillion dollar registered holding company systems, some with global operations, would strain even a large staff. The SEC must review issuances of securities (Sections 6 and 7), interaffiliate loans (Section 12), and capital structure (Sections 10(b) and 11(b)). Literally thousands of transactions occur involving billions of dollars. The SEC's PUHCA office has one accountant.

2. The Statutory Application Problems

The SEC also has issued a series of opinions that vary dangerously from the intent and language of the statute. The most prominent example is the integration requirement.

The Act allows holding acquisitions of public utilities only if the acquisition produces a single "integrated public-utility system," see Sections 11(b)(1) and 2(a)(29)(A);[6] and only if the acquisition "serves the public interest by tending towards the economical and efficient development of an integrated public-utility system." Section 10(c)(2). As utilities have sought to expand their reach, the Commission has left behind these principles and accommodated their proposals. The Courts have sometimes upheld the Commission and other times reversed it; but

[6] There are exceptions to the "single system" rule in Section 11(b)(1)(A), (B) and (C) not relevant here.

the trend is unmistakably towards consolidation and away from the competition-protective and consumer-protective features of the statute. Some examples follow.

In WPL Holdings, Inc., 40 S.E.C. 634 (1988) the SEC disregarded the economical and efficient development test of Section 10(c)(2) when it approved an addition of a corporate holding company where there was no evidence of increased operational efficiencies resulting from the acquisition. The court of appeals reversed. Wisconsin's Environmental Decade v. S.E.C., 882 F.2d 523 (D.C. Cir. 1989)(finding that the SEC decision "plainly gives no effect to the express language of the statute, which permits the SEC to approve acquisition of a utility only when the Commission has found that the acquisition 'tend[s] towards' the economical and efficient development of an integrated system). The Commission on remand found financial efficiencies.

Furthermore, in 1988 the Commission found that a utility holding company's participation in power plant construction consortium met the statutory requirement for integration despite the minimal interactions the plant would have with the utility. Order Authorizing Acquisition of Common Stock of New Electric Generating Company, Release No. 35-24566 (Jan. 28, 1988), aff'd Environmental Action v. S.E.C., 895 F.2d 1255 (9th Cir. 1990). The Commission concluded that the facilities would be coordinated even though there was no certainty that the public utility would purchase power from the plant being acquired. The SEC based its Section 10(c)(2) finding that there would be new economies resulting from the acquisition on the utility's apparent need for power several years after the acquisition.

In WPL Holdings, Inc., 66 SEC Docket 2256 (Apr. 14, 1998), aff'd Madison Gas and Electric Co, v. S.E.C., 168 F.3d 1337 (D.C. 1999), the SEC approved under the integration standard the merger of several utility holding companies with utilities operating in Wisconsin, Minnesota, Iowa and Illinois. The commission found that the assets met the statutory requirement of interconnection even though the Iowa and Minnesota assets were separated from the Wisconsin and Illinois assets, with the only connection being a 3-year contract for transmission service and the companies' plan to build a transmission line in the future. The progression of the SEC's effort to deprive the statutory interconnection requirement of meaning is evident from a chronology of its decisions prior to WPL Holdings.[7]

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[7] Conectiv, Inc., Release Nos. 35-26832, 70-9069, 1998 SEC LEXIS 326, *29 (Feb. 25, 1998) (approving use of contractual rights to transmission "when the merging companies are members of a tight power pool"); New Century Energies, Inc., Holding Co. Act Release No. 35-26748, 1997 SEC LEXIS 1583, *41-42 (Aug. 1, 1997)(approving under interconnection standard a contract for transmission service pending the planned construction of a physical tie within five years of the merger); Unitil Corp., 50 S.E.C. 961, 1992 SEC LEXIS 1016 (April 24, 1992) (lines could be built to connect the facilities located eight miles apart, but were unnecessary for coordination given the third-party contractual arrangements); Northeast Utilities, 50 S.E.C. 427, 1990 SEC LEXIS 3898, *48 (Dec. 21, 1990)(finding integration requirement satisfied where transmission contract was for at least ten years, and where companies were

Most recently, on January 18, 2002, the U.S. Court of Appeals vacated and remanded the Commission's approval of a merger between American Electric Power and Central & South West Corporation. Nat. Rural Elec. Coop. Ass'n v. S.E.C., No. 00-1371 (D.C. Cir. Jan. 18, 2002).[8] The AEP merger created the nation's largest registered holding company, with utility properties extending from Virginia in the east, to Michigan in the north, to Texas in the southwest. The service territories of the operating utilities of AEP and CSW are separated by several hundred miles at their closest point. The only proposed "physical" connection between the two system was a one-way transmission contract for a token amount of electric capacity -- less than one percent of the combined systems' generating capacity. The Commission's approval of the AEP-CSW merger culminated more than 20 years of SEC decisions approving virtually any proposal placed before it by utility holding companies coming under its purview.

The Court vacated the SEC's approval of the AEP merger on two grounds. First, the Court ruled that the SEC failed to explain how a one-way transmission contract could meet the interconnection requirement of the Public Utility Holding Company Act. The Commission also said the agency had failed to explain how its interconnection ruling was consistent with prior agency decisions, calling the SEC's explanation of its prior decisions "peculiar." Second, the Court ruled that the SEC erred in finding that the merged company satisfied the "single area or region" requirement of PUHCA Section 2(a)(29)(A). The Court found that the SEC had failed to cite any evidence in support of its "single region" finding, and that the agency's method of analyzing the single region requirement was flawed. Given these errors, the Court said "the Commission's decision that New AEP meets the region requirement cannot withstand even the most deferential review." Slip Op. at 8.

B. Comments on S.1766

With this backdrop, I would like to comment on Title 2 of S.1766. Title 2 seeks to set forth the key prerequisites for competitive evolution and consumer protection. It is a solid beginning step. I offer some comments below on provisions relating to mergers and market-based rates.

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located within highly integrated power pool); Centerior Energy Corp., 49 S.E.C. 472, 1986 SEC LEXIS 1655, *16 (April 29, 1986)(merger partners owned the transmission facilities as tenants in common and the contract had "no termination date and remain[ed] in effect as long as the [generation facilities acquired] are in existence); Electric Energy, Inc., 38 S.E.C. 658, 668-671, 1958 SEC LEXIS 807, *25-29 (Nov. 28, 1958) (acquisition of a single power plant where applicants had contractual use of necessary transmission facilities for the entire life of the acquired plant); New England Electric System, 38 S.E.C. 193, 198, 1958 SEC LEXIS 620, *12 (Feb. 20, 1958) (finding that "the necessary interconnections would be constructed forthwith if the present [transmission contract] arrangements with the non-affiliate companies were terminated") (emphasis added).

[8] This law firm represented the petitioners in this case.

1. Electric Utility Mergers (Section 202 of S.1766)

a. Inclusion of important merger transactions: The bill correctly attempts to clarify the universe of transactions which require Commission approval. It appears, however, that several types of transactions are missing.

First, the language does not seem to address the type of acquisition where the acquiree is a retail seller but does not own generation. Such an acquisition can endanger the nascent retail competition efforts in some states. These acquisitions are likely to be multistate in nature, and one or more states might lack jurisdiction under state law. Moreover, some states that have reviewed retail mergers have said they will not look at the merger's effect on retail competition because they have not yet authorized competition, even where the very parties to the merger have defined their objective as "getting ready for retail competition."

Second, although the language does create FERC jurisdiction where the acquiree has generation, transmission and distribution facilities, it is not clear that FERC is obligated to assess the effect of the merger on retail competition. FERC's Merger Policy Statement establishes the odd principle that it will review such effect if the state commission requests. FERC's obligation to review the retail effects in all cases should be clear in the statute.

Third, concerning the phrase in new 203(a)(1)(C), "purchase, acquire, or take any security of any other public utility": consider amending it to add, after "security," the phrase "any indicia of ownership or control," since there may be forms of control like partnership shares, or leases, that do not come within the definition of "security."

Fourth, new section 203(a)(2) correctly clarifies FERC jurisdiction over mergers at the holding company level. But for purposes of this section, "holding company" should be defined to include structures, such as partnerships, in which the device by which ownership or control of companies or assets is achieved is not through stock but through other means.

b. Standards applicable to the merger: The amendments to Federal Power Act Section 203 should include standards applicable to the merger. Under PUHCA, an acquisition is allowed only after a finding that it produces operational efficiencies, and does not tend toward a concentration of control or create capital structure or corporate structure complexities. As discussed in Part I.B above, FERC's review of mergers does none of this, except for a review of competitive effects on generation and transmission, and that review has been uneven due to uncertainty of market concentration measures. Moreover, FERC's competition review does address the merger's effect on the incumbents' ability to protect their retail monopolies against future retail competition, even as merging companies often give as a reason for merging the need to "prepare for retail competition." FERC's approach, in short, fails to screen out mergers that are not the product of, and contributors to, real competition.

As explained above, moreover, FERC's review does not distinguish adequately efficient from inefficient mergers. The result has been an accelerated consolidation process in our

industries that has set back substantially the cause of wholesale competition that FERC is trying to achieve elsewhere.

2. Market-Based Rates (Section 203 of S.1766)

a. Prerequisites for market-based rates: Before authorizing market-based rates, the bill requires the Commission to "consider" various features of the market. These features are the correct features to consider. But the bill does not establish prerequisites to market-based rates. It does not equate "just and reasonable rates" with "rates which are the product of a fully competitive market." Under present law, some have argued that supracompetitive rates charged in a noncompetitive market are just and reasonable because they will attract new suppliers and thus make the market competitive. Under this formulation, consumers are not an interest to protect from the absence of competition, but a source of funds used to create competition. As discussed in Part I.B above, moreover, the Commission's past methodologies on determining market competitiveness are deeply flawed, by its own admission; and the Commission only now is beginning a new inquiry into the correct methodology. There is not a consensus about what are the minimum features of a competitive market, or about what prices should look like in such a market. Given this uncertainty, the legislation should be clear that vigorous competition is a prerequisite to market rates.

b. Demand response mechanisms: The bill deserves special praise for making clear that the adequacy of demand response is central to the effectiveness of competition. In the past 20 years, excess attention has been paid to creating incentives to suppliers, and insufficient attention to the demand side.

c. Refunds: The bill should codify FERC's recent policy of establishing, at the time it grants an applicant authorization for market rates, that the right to charge those rates lasts only as long as the rates are just and reasonable. With this approach, refunds can be made back to the date on which the rates became unjust and unreasonable, rather than the date on which someone filed a complaint alleging that the rates were unjust and unreasonable. There can be a significant time lapse between the time that (a) the market power is exercised to make the rates unjust and unreasonable, and (b) that exercise is noticed by someone and brought to the Commission's attention.

d. Litigation costs: It costs money to bring a complaint to the Commission. The complainant has the burden of proof, and it requires lawyers and market experts to create that proof and carry it through the litigation process. If successful complainants could recover their litigation costs it would reduce the large disincentive to bringing information to the Commission. Just and reasonable rates are the seller's obligation and the Commission's duty. The customer should not bear the cost of making the statute work. This feature could be eliminated later, when competitive markets are the norm.

IV. Arguments for Standalone Repeal Lack a Factual Basis

To construct a logical argument for repeal, one must assert that the conditions requiring these protections no longer exist; specifically, that (a) consumers are protected, either by effective competition or careful regulation; and that (b) investors are protected, by their knowledge and their sophistication. As explained throughout this testimony, these assertions are inaccurate.

A. There is virtually no retail competition; and wholesale competition is ineffective in many places and endangered in all places, due to:

- the absence of regional transmission pricing and planning;
- the absence of a coherent merger policy that distinguishes efficient from inefficient mergers and that stops mergers which would damage wholesale or retail competition; and
- the absence of any feasible way to identify a real date when reliable wholesale competition will exist.

B. Wholesale rate regulation is uncertain, due to the absence of a consensus methodology and procedure on market pricing

C. Retail rate regulation is burdened by understaffing and the inherent difficulties of regulating, state-by-state, multistate companies. Some argue that "States can use ratemaking disallowances and other devices to protect the consumer." Not when the company already is weakened by its errors. Not a year goes by when some investor group does not argue that a rate increase is necessary "to save the company." For example, when Pinnacle West had to borrow hundreds of millions of dollars to pay off depositors of its failed savings and loan affiliate, it had no choice but to pledge as collateral its only asset: the stock of Arizona Public Service. Had the State regulators tried to prevent this pledging, the outcome might have been worse. On the other hand, had the SEC acted on a timely basis to limit Pinnacle West's investments, the problems would not have occurred.

D. Securities regulation largely focuses on disclosure, not on prevention of abuse. On this subject, the following two statements appeared in the same testimony supporting repeal of PUHCA:

> "The SEC retains full authority over securities functions."
>
> "'Our securities laws are, in the main, nearly seventy years old, and reflect a time, and a state of technology, light years away from what we now confront daily.'" (quoting SEC Chairman-designate Harvey L. Pitt, Testimony before the Senate Banking Committee)

Testimony of David L. Sokol before the House Subcommittee on Energy and Air Quality, Committee on Energy and Commerce (July 27, 2001). Both views cannot be correct.

We need to assure the workability of our federal securities laws before we can rely on them as a basis for repealing PUHCA's reviews. In any event, as discussed in Part I, federal securities laws focus on disclosure only. PUHCA's protections are different: they focus on the quality of financial activities, and their appropriateness to an industry characterized by captive customers and unsophisticated, small investors seeking stable investments.

At the state level, state commissions generally review security issuances of utilities within their jurisdictions, but not issuances by holding companies or by nonutility companies associated with such utilities. The need for such review is underscored by the failures of exempt holding company diversification in the 1980s. Utilities are affected by such failures, both in their credit standing and in their access to capital.

Other factors argue for continued federal review. Some states lack authority to review financings by nonutility affiliates, and not all utilities have worked with State commissions and State legislatures to furnish this authority. Moreover, where utilities have mismanaged costs or taken risks with negative results, regulation tends to hesitate. The ultimate penalty in a competitive market, bankruptcy or takeover by a stronger company, causes regulatory uncertainty that regulators often prefer to avoid. There is a concern, for example, that the bankruptcy court will require payments to certain creditors, and then preempt state ratemaking to ensure that ratepayers are the source of these payments. The risk of this type of event can discourage state commissions from requiring companies to bear the costs of their own risks. Given this uncertainty of "back-end" accountability, "front-end" accountability in the form of advance review of financial risks is critical.

These factors support establishing federal minimum standards for the quality of financing, applied and monitored at the federal level.

Assuming there is a federal role in financial reviews, that role should be consolidated with the financial reviews conducted by FERC under the Federal Power Act.

E. Reliance on antitrust law is misplaced. Antitrust is aimed at markets that are competitive, protecting them from anticompetitive behavior. Antitrust does not address well markets that are monopolistic, where actions entrench the incumbents further. The purpose of advance regulatory review is to act as a "first line of defense," preventing market power problems before they infect a market.

Also: <u>Who</u> would address the problem through the federal antitrust laws? Antitrust lawsuits are expensive. An individual consumer lacks the resource, and attorneys general must reserve their resources for blockbuster cases like Microsoft and tobacco. They often can be brought only "after the fact."

V. Enron: Proper Application of PUHCA Would Have Identified and Prevented Enron's Ill-Fated Activities

Enron's acquisition of Portland General Electric, a utility, made Enron a "holding company" under PUHCA. Enron Corp., a global holding company, then obtained an "intrastate" exemption from the Act under Section 3(a)(1). Without that exemption, Enron's financial dealings and diversification efforts would have come under the full purview of the Act. More than likely, the Act, if conscientiously applied, would have limited or even prohibited the arrangements that apparently led to its bankruptcy. I explain here the process by which it obtained the exemption, and highlight the PUHCA provisions which the exemption allowed Enron to escape.[9]

A. The Exemption Process

Section 3 of the Act authorizes the SEC to exempt a holding company from provisions of the Act if the holding company satisfies one of the five exemptions described in Section 3(a)(1)-(5). The SEC has used this authority to exempt qualifying companies from all provisions of the Act except the pre-acquisition review standards of Sections 9 and 10. The key condition on a continued exemption is the "unless and except" clause of Section 3(a), which says an exemption is available

> ...unless and except insofar as [the SEC] finds the exemption detrimental to the public interest or the interest of investors or consumers ...

Section 3(c) also allows the Commission to revoke an exemption if it "finds that the circumstances which gave rise to the issuance of such order no longer exists."

The most common of the five exemptions is the "intrastate" exemption of Section 3(a)(1), which directs the SEC to issue an exemption if --

> such 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....

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[9] This discussion focuses on Enron's exemption from registration, obtained under Section 3 and Rule 2 of the Act, not on its receipt of "no-action letters" stating that its brokering and marketing activities do not make it a "gas utility company" or an "electric utility company" under the Act because those businesses do not involve electric or gas "facilities" as defined by the Act. Enron Power Marketing, Inc., SEC No-Action Letter (Jan 5, 1994).

Although Enron is a global holding company with worldwide businesses, hardly "intrastate in character" and clearly doing business "substantially" in more than a single state, it obtained exempt holding company status under the intrastate exemption of Section 3(a)(1). The process for obtaining an exemption is as follows: An intrastate holding company make seek a Section 3(a)(1) exemption in two ways. It may obtain an official Commission order upon application under section 3; or it may self-claim an exemption by filing under the SEC's Rule 2, 17 C.F.R. sec. 250.2. Rule 2(a)(1) allows a company to obtain the exemption afforded by section 3(a)(1) by filing annual claim of exemption on form U-3A-2. Form U-3A-2 is a 2-page form seeking basic information about the holding company and its operations. No Federal Register notice is given to the public and no opportunity to comment afforded. The claim must be renewed by annual filings on or before March 1 of each year.

A claim to an exemption under Rule 2 is subject to Rule 6, 17 C.F.R. sec. 250.6. Under Rule 6, the exemption may be terminated by a registered letter from the Commission stating that a question exists about the holding company's entitlement to the exemption. A company receiving a termination letter has 30 days to either register under the Act or file a formal application for an exemption which, if filed in good faith, exempts the company from the Act until the Commission issues a final order.

On rare occasion, and in the very distant past (decades ago), the Commission has questioned a Rule 2 claim of exemption. However, we found no modern decisions indicating any such Commission activity.

Moreover, the Commission has no procedure by which a customer can file a complaint for revocation of an exemption should it become "detrimental to the public interest, or the interest of investors or consumers," as forbidden by Section 3. In the two situations where such a complaint has been filed, both involving extraordinarily serious situations, the Commission has taken no action.

Specifically, in May 1990, the Arizona Corporation Commission filed a complaint asking the Commission to revoke the intrastate exemption of Pinnacle West, the holding company Arizona Public Service Company. Pinnacle West had invested in Merabank, a savings and loan institution. The failure of that institution in the late 1980s forced Pinnacle West to borrow several hundred million dollars to bail out the depositors. As collateral for that loan, Pinnacle West pledged its only asset: 100% of the stock of Arizona Public Service.[10] The Commission took no action on the complaint. Also, last July the California Attorney General filed a complaint seeking revocation of the intrastate exemption for Pacific Gas & Electric as a result of its financial troubles. The Commission again has not acted.

B. Should Enron Have Received "Exempt" Status Under the Act?

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[10] The witness was counsel to the Arizona Commission in that matter.

There are two avenues by which the SEC could have found that Enron should not have been an exempt holding company.

First, the SEC could have refused the exemption to begin with. Enron clearly did not meet the requirements of Section 3(a)(1). Enron Corp., the holding company, although organized in the state of Oregon (the state from which it derived a material part of its income from its Oregon public utility subsidiary, Portland General Electric), has holdings and business activities throughout the United States and abroad. The business of Enron Corp. is not "predominantly intrastate in character," and Enron Corp. does not "carry on [its] business substantially in a single State." Enron Corp. is global in character and does business substantially in many states.

Second, the SEC could have found Enron's exemption would be, or had become, detrimental to the public interest or the interests of investors or consumers. Had the SEC investigated Enron's business activities during the exemption period, either before granting the exemption or as part of a periodic review, it should have been able to identify business dealings causing the detriment. But Enron's exempt status, plus the absence of any SEC review of exempt holding companies for detriment, meant that the statutory protections were not operating.

C. Customer and Investor Protections From Which Enron Was Exempt

Had Enron been treated as a registered holding company, those activities leading to its present state would have been curbed or prohibited, assuming the Act were applied conscientiously. Specifically:

Limitations on Utility Diversification: The off-shore financial transactions reported to be responsible for Enron's collapse should not have occurred if Enron had been treated as a registered holding company, because:

> Section 11(b)(1) limits the operations of registered holding companies and their subsidiaries to "businesses [that] are reasonably incidental, or economically necessary or appropriate to the operations" of their public utility operations. The SEC has interpreted the section 11(b)(1) language to permit nonutility businesses that are only "functionally related" to the utility business.
>
> Section 11(b)(2) requires the elimination of unnecessary corporate complexities and inequitable voting power among security holders. Specifically, the section requires the Commission to "ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute

> voting power among security holders, of such holding-company system."

Regulatory Review of Accounting and Financing: Regardless of whether Enron's offshore transactions would been barred by the diversification provisions applicable to registered holding companies, Enron's excesses would have faced the prohibitions and limits of Sections 6 and 7:

> Sections 6 and 7 govern the issuances of securities of RHCs and their subsidiaries. Section 6 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.
>
> Section 7 prescribes standards for the type and amount of securities for the registered holding company and its subsidiaries. Section 7(d), for example, 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 acquiring any securities, utility assets, or any other interest in any business.

In sum, sections 6 and 7 demand much more than the accounting standards and private review standards that were applied to Enron's investments.

Regulatory Review of Interaffiliate Relations: PUHCA Sections 12 and 13 would have required the SEC to police transactions among the various Enron affiliates.

> Section 13 governs service, sales and construction contracts between system service companies and associate companies in the same holding company system.
>
> Section 12 polices interaffiliate transactions in loans and other securities, requiring arms length relations between affiliated companies.
>
> Section 12 also precludes registered holding companies from borrowing or receiving any extension of credit or indemnity from a public utility subsidiary. It also gives the SEC rulemaking authority over other types of affiliate transactions such as: intra-system loans; declaration and payment of dividends; acquisition, retirement or redemption of a company's own securities; disposal of assets and securities; solicitation of proxies in connection with holding company and subsidiary company

securities; books, records, disclosures of interest, duration of contracts; and similar matters concerning affiliate transactions. From press reports, it would appear that many of Enron's financial dealings would have fallen under these standards applicable to registered holding companies.

VI. Conclusion: The Consequences of a World Without a Federal Corporate Structure Statute

The repeal of the Public Utility Holding Company Act, with no change in other statutes, would allow:

A. Acquisitions by utilities of other utilities, undisciplined by market forces and without adequate review of

- -- the costs and benefits to present and future consumers,
- -- the effects on retail prices and retail competition, and
- -- the effects on wholesale prices and wholesale competition.

The risk of consolidation would be less if there were (1) comprehensive, nondiscriminatory and efficient retail competition; or (2) predictable, low-cost and efficient franchise competition. Both (1) and (2) are largely nonexistent, leaving the retail sector subject to utility market power. Unlimited and unreviewed retail acquisitions could increase this market power, thereby contradicting the claims that "competition is here."

B. Unlimited mixing of utility and nonutility businesses, where the risks of business failure are borne in part or in whole by consumers who are prohibited by law from shopping, subject only to post-failure regulatory devices of proven insufficiency; while ratepayer obtain none of the benefits.

C. Unlimited interaffiliate transactions between the utility serving captive customers, and affiliates needing utility resources paid for by those customers.

D. Unlimited use of corporate structures that transfer ratepayer-funded assets to deregulated companies.

E. Unlimited use of corporate structures that cause Federal Power Act preemption of state review of the prudence or economic value of utility historic investments.[11]

F. Entry by utilities with government-granted market power into potentially competitive industries, while continuing to use resources financed by customers who lack competitive options.

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[11] See Mississippi Power & Light v. Mississippi ex rel. Moore, 487 U.S. 354 (1988) (holding that where FERC issued an order allocating a specific portion of the costly Grand Gulf nuclear plant to a utility, the state could not regulate the utility as if it had bought a lesser portion); Nantahala Power & Light v. Thornburg, 476 U.S. 953 (1986) (holding that FERC order allocating a portion of a low-cost hydroelectric plant to a utility preempted the state from treating the utility as if it were entitled to a higher portion of the hydropower than FERC had assigned).

The electric industry lacks effective competition in many markets. Congress cannot nurture competition by giving free rein to companies which for a century have avoided competition. And Congress cannot protect consumers by confusing financial entry with competitive entry. To repeal PUHCA without establishing a modern regulatory regime -- one that conditions acquisitions on real competition and attentive regulation -- is to allow dominant incumbents to exploit unearned advantages. Calling the result "competition" is good fiction, but it is not good policy.

Thank you for the opportunity to present this testimony. I look forward to any questions from the Committee.