BY THE COMPTROLLER GENERAL



Report To The
Honorable Tom Corcoran
House Of Representatives
OF THE UNITED STATES


# Analysis Of SEC's Recommendation To Repeal The Public Utility Holding Company Act

The Securities and Exchange Commission (SEC) recommended to the Congress in December 1981 that the Public Utility Holding Company Act of 1935 be repealed. The act is intended to protect the public, investors, and consumers from abuses associated with the control of electric and gas utility companies through holding companies. SEC believes that the act has accomplished its basic purpose, duplicates other Federal and State regulations, and is no longer needed to prevent recurrence of past abuses.

GAO identified regulatory gaps that would occur if the act is repealed and found that some State regulatory officials believe they are unprepared to deal with the consequences of the act's repeal.

GAO recommends that the Congress, in considering repealing or amending the act, address, through the appropriate congressional committees, the potential impacts that regulatory gaps at the Federal level would have on State regulation and ultimately on consumers.


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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-202342

The Honorable Tom Corcoran
House of Representatives

Dear Mr. Corcoran:

As requested in your August 17, 1982, letter, this report discusses the Securities and Exchange Commission's justification for recommending repeal of the Public Utility Holding Company Act of 1935. Specifically, this report addresses historical developments leading to passage of the act, the past and present effectiveness of the act, and the Commission's followup to our 1977 report on the act, and it identifies legislative gaps and their potential effect on ratepayers and State regulators if the act is repealed. This report contains a recommendation to the Congress that it, in considering repealing or amending the act, address, through the appropriate congressional committees, the potential impacts that regulatory gaps at the Federal level would have on State regulation and ultimately on consumers.

As arranged with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time, we will send copies of the report to the Director, Office of Management and Budget; the Chairman, Securities and Exchange Commission; interested congressional committees, subcommittees, and Members of Congress; and other interested parties. Copies will be made available to others on request.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE HONORABLE
TOM CORCORAN
HOUSE OF REPRESENTATIVES

# ANALYSIS OF SEC'S RECOMMENDATION TO REPEAL THE PUBLIC UTILITY HOLDING COMPANY ACT

## D I G E S T


At the request of Congressman Tom Corcoran, GAO reviewed the adequacy of the Securities and Exchange Commission's (SEC's) justification for recommending that the Public Utility Holding Company Act be repealed. In 1935, the Congress passed the act to control and regulate holding companies. The act defines a holding company as "* * * any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company or of a company which is a holding company * * *."

The act's provisions were intended to protect the public, investors, and consumers from abuses associated with the control of electric and gas utility companies through the holding company structure. The act directed SEC to reorganize these holding companies and to provide for continued surveillance of the corporate structure, financial transactions, and operational practices of public utility holding companies. (See p. 1.)

SEC now believes the act should be repealed. In June 1982 testimony before two congressional subcommittees, SEC said that the act should be repealed because SEC had completed the reorganization of the Nation's electric and retail gas utility holding companies, consistent with the act's intent. SEC further stated that the act's remaining provisions now, to a large extent, either duplicate other Federal or State regulation or are no longer necessary to prevent recurrence of the abuses that led to the act's enactment. (See p. 3.)

While GAO found that SEC, under the act, had moved to reorganize holding companies and that some provisions of the act are similar to other Federal disclosure laws, it also found that SEC's justification did not fully consider the potential effect that regulatory gaps at the Federal level, which would exist after repeal, would have on consumers and on States' abilities

to regulate utility holding companies and to protect consumers.

## THE ACT HAS BEEN AND MAY CONTINUE TO BE EFFECTIVE

During the 1920's and early 1930's, holding companies operated with numerous and widely scattered utility and nonutility properties, and controlled the overwhelming majority of the Nation's electric and gas utilities. These holding companies had complex structures, with up to 10 layers of holding companies between the controlling top company and the operating utility. A number of Federal and State studies prepared at the time showed that these holding companies were engaging in abusive practices. They were exploiting consumers by charging excessive rates and exploiting investors by selling securities without providing adequate information on the conditions surrounding the issuance. At the time, regulation or control of holding companies at the Federal or State level was limited. To extend Federal authority to the control and regulation of public utility holding companies and to eliminate the abusive practices that were occurring, the Congress enacted the Public Utility Holding Company Act on August 26, 1935. (See p. 7.)

SEC's administration of the act has been effective in correcting some of the abuses identified above by breaking up, reorganizing, and simplifying holding companies. SEC has forced holding companies to (1) divest properties unrelated to utility operations, (2) physically interconnect and coordinate utility properties in a single area, and (3) maintain simple operating structures. As a result, the number of holding companies directly regulated by the act (registered companies) has been reduced from over 200 to 12. (See p. 8.) Each of these 12 companies operates in more than one State.

The act, however, provided for much more in its regulation of holding companies than just reorganization. GAO found that the presence of the act and SEC's administration of the act may continue to serve useful purposes that were not fully considered by SEC staff and Commissioners when deciding to recommend repeal. For example, SEC continues to regulate security transactions of the registered companies and their 63 utility subsidiaries operating in 24 States. The Holding Company Act provides SEC with more authority over security issues than that provided to SEC under

other securities acts. While the other securities laws require certain financial reporting and information disclosure, they do not guarantee that securities issuances by holding companies are in the best interest of the public, investors, or consumers. Under the Holding Company Act, however, SEC must assure that a security issuance is not detrimental to the public interest, interests of investors or consumers, or the proper functioning of the holding company.

Electric utilities that are part of the registered holding companies represent 22 percent of the electric utility industry and, in 1981, had assets in excess of $51 billion and operating revenues of $20 billion. The act also deters the creation of holding companies and allows SEC to monitor the activities of companies exempt from the act's provisions--such as a holding company located within the boundaries of a single State--a service that State regulators view as a valuable resource. (See pp. 9-14.)

## FEDERAL AND STATE REGULATORY GAPS AND PROBLEMS COULD EXIST IF THE ACT IS REPEALED

While GAO agrees with SEC that some of the act's provisions are similar to other Federal regulations--specifically, the Securities Acts of 1933 and 1934, the Clayton Act, and the Federal Power Act--GAO identified some regulatory areas that would not be authorized by other laws. These areas include the approval of acquisitions and financing of holding companies and the review of cost allocations between holding companies and their service companies and utility subsidiaries. Although the consequences of these regulatory gaps are uncertain, some SEC and State regulatory officials said that the gaps could adversely affect ratepayers in particular. (See p. 15.) GAO's information from State regulatory officials is based on GAO's contact with officials from 15 States and information prepared by the National Association of Regulatory Utility Commissioners.

Although SEC believes that States in general can protect consumers if the act is repealed, the majority of State regulatory officials we contacted said that they may not be in an adequate position to protect ratepayers because of legal and practical problems that could occur, such as a State's ability to obtain necessary books and

records of a holding company located outside the State. A resolution passed by the National Association of Regulatory Utility Commissioners indicated that the majority of States oppose repeal or substantial modification to the act. Specifically, State regulatory officials believe that, if the act is repealed, they would not be able to directly regulate interstate electric utility holding companies. Furthermore, some State regulatory officials say that new laws, more resources, and additional staff with more diversified expertise may be needed to deal with the consequences of repeal. (See p. 18.)

## RECOMMENDATION TO THE CONGRESS

GAO recommends that the Congress, in considering repealing or amending the act, address, through the appropriate congressional committees, the potential impacts that regulatory gaps at the Federal level would have on State regulation and ultimately on consumers.

## AGENCY COMMENTS AND GAO EVALUATION

SEC was provided a draft of this report for comment. SEC disagreed with GAO's findings and conclusions presented in the draft report and continues to support its recommendation to repeal the Public Utility Holding Company Act.

In its draft report, GAO proposed that SEC reevaluate its repeal decision. Because SEC (1) disagreed with the proposal and (2) had not conducted a study GAO recommended in 1977[1] to determine the overall usefulness of the act, GAO changed its proposal from one recommending action by SEC to a recommendation to the Congress.

SEC believes that (1) the act is no longer necessary because it duplicates other Federal or State regulations and (2) the States can meet their regulatory objectives without the assistance of the act. Further, SEC believes that the act does little to safeguard investors and the public interest from the risks of improper sales practices and abusive corporate management and control in utility holding companies. SEC also believes that fears of harmful diversification are no

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[1]"The Force of the Public Utility Holding Company Act Has Been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies," (FGMSD-77-35, June 20, 1977).

longer valid because today's business environment no longer provides the same investment advantages that it had in the past and other Federal securities laws provide safeguards against irresponsible investments by holding company management. SEC believes that it carefully weighed such factors as the act's effectiveness, the usefulness of SEC's authority under the act, duplication of other requirements, and changes in utilities' economic environment to reach its recommendation.

GAO identified direct regulation of interstate electric utility holding companies as a major area of nonduplication between State authority, other Federal authority, and SEC's authority under the act. Neither States nor the Federal Energy Regulatory Commission possesses the same type of direct regulatory control over interstate holding companies that SEC has under the Holding Company Act. In addition, the Securities Acts of 1933 and 1934 do not provide the same type of investor protection as that afforded by the 1935 act. It is only the 1935 act that is designed to protect the consumers' interests, as well as investors' interests.

The Congress passed the 1935 act because both investors and consumers were being exploited by holding companies. State regulatory officials charged with providing consumers with reliable service at reasonable rates said that, in general, they are unprepared to deal with the potential ramifications of repeal. These officials provided examples of potentially harmful situations that could occur if the act is repealed. (See pp. 23-27.)

# Contents

## ABBREVIATIONS

| | |
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| DOE | Department of Energy |
| FERC | Federal Energy Regulatory Commission |
| GAO | General Accounting Office |
| NARUC | National Association of Regulatory Utility Commissioners |
| SEC | Securities and Exchange Commission |

# CHAPTER 1

## INTRODUCTION

In the last 2 years, a number of initiatives have been introduced to amend or repeal the Public Utility Holding Company Act of 1935 (15 U.S.C. 79 et seq.). For example, many bills to amend or repeal the act were introduced in both Houses of the 97th Congress. In addition, the Securities and Exchange Commission (SEC), which has primary enforcement responsibility for the act, and the Department of Energy (DOE) considered legislative changes to the act. In December 1981, SEC recommended to the Congress that the act be repealed, and in June 1982, DOE told the Congress it agreed with SEC's position.

In response to the interest to amend or repeal the act, Congressman Tom Corcoran, in an August 17, 1982, letter, requested that we examine the bases for SEC's and DOE's positions. (See app. I.) Since DOE's position was based largely on SEC's justification, our work focused on SEC's position. In a subsequent meeting with the Congressman's office, we specifically agreed to examine, among other things, the current usefulness of the act and the reasonableness of SEC's recommendation to repeal it. We agreed that our examination would focus primarily on electric utility holding companies because they represent the majority of companies that are subject to the act's regulations.

## PUBLIC UTILITY HOLDING COMPANY ACT

The Public Utility Holding Company Act was enacted to control and regulate public utility holding companies.[1] In passing the law, the Congress sought to protect the public, investors, and consumers from abuses associated with the control of electric and gas utility companies through the holding company structure. The act, in part, provides for surveillance of the corporate structure, financial transactions, and operational practices of public utility holding companies and, in part, is a specialized antitrust statute with the objective of reorganizing and constraining the operations of holding companies in the utility industry.

The act contains a number of substantive sections relating to SEC's regulatory responsibilities. For example, the act specifies several regulatory restrictions and controls related to the acquisition and sale of utility securities and assets. It also states that acquisition of certain types of utility interests must comply

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[1]The act defines a holding company as "* * * any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public utility company [electric utility or gas utility company] or of a company which is a holding company * * *."

with State laws. It provides conditions and requirements for (1) SEC approval of security transactions and sales of utility assets and (2) acquisitions of other utility securities and assets. Intercompany loans; proxy solicitations; and contracts for services, sales, and construction are also under SEC's regulatory surveillance.

The antitrust standards for constraining holding company operations are contained in section 11 of the act. This section limits a holding company, generally, to operating a single, integrated utility system and other businesses that are reasonably incidental or economically necessary to the utility system. Further, it requires the company and its subsidiaries to maintain simple corporate and financial structures. It authorizes SEC to require the reorganization of utility holding company systems and their divestment of properties where necessary to achieve the prescribed standards.

The act requires all companies meeting the statutory definition of a holding company to either register with (registered holding company) or seek exemption from (exempt holding company) SEC. Currently, nine electric and three gas utility holding companies are registered under and subject to the act's provisions. Currently, 91 public utility holding companies are exempt from registration and other provisions of the act because SEC has determined that certain standards specified in the act for exemptions have been met. The act states that an exemption may be withdrawn if circumstances change.

## FEDERAL AND STATE AGENCIES WITH OTHER REGULATORY OVERSIGHT

While SEC has responsibility for regulating public utility holding companies and their utility and utility-related subsidiaries, several other Federal agencies and State public service commissions have some other regulatory responsibility. For example, the Federal Energy Regulatory Commission (FERC), under the Federal Power Act, is responsible for regulating the transmission and sale of electricity at wholesale in interstate commerce. This includes fixing wholesale electric rates and approving financing of utility companies whose security issuances are not regulated by a State commission. The Federal Power Act, however, provides FERC with such authority over utilities only, not holding companies. In addition, the Department of Justice and the Federal Trade Commission enforce section 7 of the Clayton Act, which makes illegal the acquisition of any company, including an electric utility and holding company, on the basis of risk or harm to competition. Under the Holding Company Act, however, SEC is required to review and approve all acquisitions by holding companies.

In addition to the Holding Company Act, other acts also give SEC regulatory authority over holding companies. For example, the Securities Act of 1933 requires certain companies, including

utilities and holding companies, to disclose to SEC in a registration statement several different items of information when securities are sold to the public. Moreover, the Securities Exchange Act of 1934 requires certain companies to prepare and file annual, quarterly, and special reports with SEC. These two acts are similar to the Holding Company Act because they require disclosure of information, but they differ from the Holding Company Act because they do not require SEC's approval on securities transactions. Further, these two acts are designed to protect the interests of investors, whereas the Holding Company Act is designed to protect the interests of both investors and consumers. Neither the Federal Power Act, the Clayton Act, nor the two Securities Acts are specifically designed to regulate interstate holding companies; the Holding Company Act gives such authority to SEC.

States, while unable to directly regulate interstate electric utility holding companies, are able to regulate electric utilities within their States. States generally regulate utilities to determine the appropriateness of such things as rates, dividends, securities, contracts with affiliates, and uniform accounting systems. The extent of legislative and enforcement authority in place differs from State to State.

## LEGISLATION INTRODUCED TO AMEND OR REPEAL THE ACT

During the 97th Congress, eight bills were introduced in the Congress that would either amend or repeal the Holding Company Act. Three bills--S. 1977, H.R. 5465, and H.R. 6134--were proposed to repeal the act, and five bills--S. 1869, S. 1870, S. 1871, H.R. 5220, and H.R. 6581--were proposed to amend it. Of the amendment proposals, two bills would allow holding companies to diversify their activities and provide more ways for a holding company to be exempt from the act, one bill would reduce regulation of registered holding companies, and two bills would exempt gas utility holding companies from the act. (See appendix II for more details on these bills.) As of May 12, 1983, two bills to amend the act had been introduced in the 98th Congress.

## SEC'S REASONS FOR RECOMMENDING REPEAL OF THE ACT

On December 15, 1981, the five SEC Commissioners voted unanimously to recommend repeal of the act. They made the recommendation after considering four options: three legislative proposals pending at that time to amend the act--S. 1869, S. 1870, and S. 1871--and repeal of the act.

In a June 2, 1982, statement prepared for hearings before the Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, and the Subcommittee on Energy Conservation and Power, House Committee on Energy and Commerce, SEC stated that the act should be repealed because it:

"* * * had accomplished its basic purpose and that its remaining provisions now, to a large extent, either duplicate other Federal or State regulation or otherwise are no longer necessary to prevent recurrence of the abuses which led to its enactment."

According to SEC, its recommendation was based primarily on significant developments since 1935 in Federal and State regulation of electric and gas utilities, disclosure and financial reporting requirements now applicable to most publicly owned companies, and changes in the accounting profession and the investment banking industry.

Two other Federal agencies--the Department of Justice and DOE--have also taken a position favoring repeal of the act. Their positions were based largely on SEC's justification.

## OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of our review was to examine SEC's and DOE's bases for recommending the Public Utility Holding Company Act's repeal. In a meeting with the Congressman's office, we agreed that the evaluation would include an examination of (1) the basic purpose of the act, (2) the relevant regulatory and economic conditions prior to and since passage of the act, (3) the current effectiveness of the act's provisions, (4) SEC's current enforcement activities, (5) the relationship of SEC's enforcement of the act with other Federal and State regulatory agencies, and (6) SEC's actions taken on our prior report's[2] findings and recommendations.

We accomplished the first, second, and fourth objectives by reviewing the act; interviewing SEC officials in the Office of the General Counsel and the Division of Corporate Regulation; and reviewing SEC documents, annual reports, correspondence, and files pertaining to the act to determine the purpose of the act, the history that was instrumental to developing and passing the act, SEC's current role in carrying out the act's provisions, and the rationale and justification behind SEC's position calling for repeal of the act.

In addition to interviewing SEC officials to achieve the third objective, we interviewed and obtained documentation from State public utility commissioners and/or their staffs in Arkansas, California, Connecticut, Florida, Georgia, Idaho, Illinois, Indiana, Maine, Massachusetts, New York, Oregon, Pennsylvania, Virginia, and Wisconsin. In selecting States to contact, we chose

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[2]"The Force of the Public Utility Holding Company Act Has Been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies," FGMSD-77-35, June 20, 1977.

7 from a list of 13 whose electric utility laws and authorities SEC had reviewed. The other eight States were selected due to (1) a specific request by Congressman Corcoran's office and/or (2) a selection by us to establish some geographic balance. We sought State officials' opinions on the effectiveness of the act as well as their assessment of their ability to effectively regulate and monitor public utility holding companies and their electric utility subsidiaries if the act is repealed.

We accomplished the fifth objective by contacting officials at DOE, the Department of Justice, FERC, and the Federal Trade Commission to discuss their roles and specific statutory authorities to monitor and enforce functions relating to the activities and operations of electric utility holding companies. We also discussed with these officials what the impact would be on their agencies if the act is repealed.

To accomplish the sixth objective, we interviewed SEC officials to follow up on the recommendations of our earlier report.

To get a better perspective on all six objectives and SEC's and DOE's bases for recommending that the act be repealed, we attended congressional hearings on the act conducted by the Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, and the Subcommittee on Energy Conservation and Power, House Committee on Energy and Commerce, and reviewed all bills introduced during the 97th Congress to amend or repeal the act. In addition, we visited or talked with officials from one registered and two exempt holding companies, two utility operating companies, three utility associations, two expert consultants, and a group representing major industrial consumers of electric power, on the possible effects that repealing the act might have on the industry. Further, we discussed with private industry the issue of what, if any, Federal and/or State capabilities would exist should the act be repealed. From these interviews and discussions, we were able to determine some of the pros and cons concerning repeal of the act and the reasoning behind those industry positions.

Although the act addresses both electric and gas utility holding companies, we and the Congressman's office agreed to limit this review to electric utility holding companies. These represent the greater number of companies registered under the act. Moreover, in conducting our evaluation, we did not review the Holding Company Act or other legislation on a section-by-section basis nor did we draw our own conclusions on the continued need for the Holding Company Act. Our assessment was limited to reviewing SEC's justification recommending repeal and identifying concerns that the Congress should be aware of in considering the future of the act. Our review was performed in accordance with generally accepted government audit standards.

## CHAPTER 2

## THE ACT HAS BEEN AND MAY CONTINUE TO BE EFFECTIVE

SEC believes the Public Utility Holding Company Act should be repealed because the act's basic purpose, as identified by SEC, has been accomplished--the reorganization of public utility holding companies--and the abuses that existed before passage of the act have been eliminated and are not likely to recur. We agree that SEC has accomplished much to date in the reorganization of public utility holding companies. However, we believe the act provides much more in its regulation of holding companies than just reorganization. SEC's justification did not fully consider the effectiveness or usefulness of the act and SEC's administration of it. Based on our assessment of SEC's current activities and comments from State regulators, we believe that the presence of the act and SEC's current activities may continue to be effective.

### THE ACT CONTROLS AND REGULATES HOLDING COMPANIES

Before the act's passage, complex holding company organizations controlled the majority of the Nation's electric and gas utilities. Federal and State studies showed that these holding companies were not operating the utilities in the best interest of consumers or investors. Consequently, to eliminate the abuses that existed at the time, the Congress passed the Public Utility Holding Company Act. In the act, the Congress listed a number of problems that it found resulted from the use of the holding company device in the Nation's public utility industry, such as:

--The inability of investors to obtain information necessary to appraise the financial position or earning power of the issuers of securities because of the absence of uniform standard accounts.

--The issuance of securities without the approval of States having jurisdiction over subsidiary companies.

--The issuance of securities on the basis of fictitious or unsound asset values.

--The issuance of securities by subsidiary companies under circumstances such that the company must support an overcapitalized structure.

--An absence of arms-length bargaining, resulting in a subsidiary company having to pay excessive charges for services, construction work, equipment, and materials.

--The allocation of charges by the holding company among its subsidiaries in different States, so that the States cannot effectively regulate.

--The control a holding company has over its subsidiaries, affecting the policies of the subsidiaries in a manner that complicates and obstructs State regulation of the subsidiaries.

--The growth and extension of holding companies in such a manner as to have no relation to economy of management and operation or to the integration and coordination of related operating properties.

--A lack of economy of management and operation, efficiency and adequacy of service, effective public regulation, and economies in raising capital.

The Congress stated that when these types of problems become persistent and widespread, the holding company, unless regulated, is injurious to investors, consumers, and the general public. Therefore, it declared that the policy of the act is to meet and eliminate these problems. To effectuate this policy, the Congress established provisions for simplifying public utility holding company systems, eliminating from these systems property detrimental to the system's proper functioning, and eliminating most public utility holding companies. In passing the act, however, the Congress did not limit the regulation of holding companies to just reorganization. It also provided for registration of holding companies and the regulation of (1) the issuance of securities, (2) the acquisition of securities and utility assets, (3) service contracts and other intercompany transactions, and (4) reports and accounts.

## Conditions that led to the act's passage

During the 1920's, holding companies acquired numerous and widely scattered utility and nonutility properties throughout the United States. The vast size of public utility holding companies and the increased concentration of control they had over the Nation's electrical power system caused concern at the Federal and State levels. Responding to these concerns, the Congress, in 1928, ordered the Federal Trade Commission to study the public utility industry to determine the extent that holding companies controlled public utilities and the amount of regulation that existed over these holding companies. At the same time, several States and the former House Committee on Interstate and Foreign Commerce were conducting similar studies.

The results of these studies showed that holding companies had pervasive control over public utilities and that their corporate structures were very complex, with up to 10 layers of holding companies between the controlling top company and the operating utility companies. For example, in 1932, eight major holding company groups controlled more than 67 percent of the electric energy generated by privately owned plants.

These studies also found that the controlling holding company groups were exploiting both consumers and investors. They exploited consumers by charging excessive utility rates based on such things as (1) unreasonable fees to operating companies for services that were not needed and (2) excessive depreciation expenses resulting from artificially inflated asset values. Holding companies also exploited investors by (1) issuing special voting stock to a small number of trustees, rather than to most investors, thereby precluding the majority of investors from making decisions in the operations of the holding company systems and (2) selling securities without providing adequate information on the conditions surrounding the issuance.

Eliminating these abuses was a difficult task because before 1935 regulation or control of holding companies at the Federal or State level was limited. At the Federal level, SEC had been given, in 1933 and 1934, limited authority over disclosure of certain securities transactions, but SEC had not extensively exercised its authority in this area. States, on the other hand, were trying to control the interstate holding company and its utility subsidiaries by enacting their own laws. To extend Federal authority to the control and regulation of public utility holding companies, the Congress enacted the Public Utility Holding Company Act on August 26, 1935.

## SEC has reorganized and regulated public utility holding companies

In passing the act, the Congress directed SEC to emphasize reorganizing the electric utility industry's operating structure to simplify the holding company structure. SEC was to accomplish this task by eliminating the excessive layers of intermediate holding companies, forcing the holding companies to divest themselves of certain properties, and redistributing voting power. The mechanism SEC used to accomplish the reorganization was section 11 of the act, also known as the "heart of the statute."

Section 11 limits an electric utility holding company to a "single integrated public-utility system," i.e., a single electric utility or group of utilities, usually interconnected, within a single geographic region. This section also requires that voting power be equitably distributed among security holders. Further, the section limits holding companies to diversifying in functionally related enterprises that are "reasonably incidental, or economically necessary or appropriate to the operations" of a utility system. For example, a registered holding company with a utility-operating company that generates power by using coal could be allowed to own a barge line or a coal mine as this would provide the utility with an uninterrupted supply of fuel and the ability to transport it. However, the holding company would not

be allowed to own interests that were not directly related to the utility's operations, such as housing construction or textiles. Restricting public utility holding companies to geographically situated and interconnected utility systems that have utility-related subsidiaries has greatly simplified the holding company operational structure.

Another major regulatory area of the act deals with financings and securities. This is the area where, according to SEC, it currently puts most of its effort. The objective of this area is a simple, conservative, and prudent capitalization for both the operating utility and the holding company. Other provisions of the act deal with mergers and acquisitions, service contracts, and other intrasystem transactions that continue to require significant SEC attention.

According to SEC, reorganization of holding companies was substantially accomplished about 20 years ago. Many holding companies were liquidated, properties not related to utility system operations were divested from the registered systems, and operating utilities were merged. Some utilities were spun off and became independent utility companies. In 1935, nearly 85 percent of the gas and electric utility system was part of registered holding company systems, while currently, the 12 registered systems constitute about 21.5 percent of the electric industry and 8 percent of the gas industry. The number of registered systems has been reduced to 12, from a high of over 200 holding companies that existed at one time or another since 1938. The number of companies controlled by these holding companies has been reduced from a high of over 1,000 operating utilities and over 1,200 nonutilities to the current number of 66 operating utilities and 53 nonutility subsidiaries. The 12 registered systems generally have simplified operational structures consisting of a single integrated system with nonutility activities deemed by SEC to be utility related.

## SEC'S JUSTIFICATION FOR REPEAL DID NOT CONSIDER STATE REGULATORS' VIEWS

SEC, in its June 2, 1982, statement, recommended repeal of the act because it has "accomplished its basic purpose" and is "no longer necessary to prevent recurrence of the abuses which led to its enactment." As previously stated, SEC said the purpose of the act is to reorganize the public utility holding companies. While SEC has made significant accomplishments in reorganizing public utility holding companies, we believe the act may provide much more in its regulation of holding companies than just reorganization. For example, we found a number of areas where this act provided the only regulation of interstate holding companies. Additionally, State regulators told us there would be practical difficulties in assuming regulatory control if the act is repealed. We believe that, in deciding on the fate of the act, the Congress should consider these areas where there would be regulatory gaps if the act is repealed or amended and should solicit the views of State regulatory officials upon whom the major burden of regulatory responsibility would fall.

SEC's process for recommending repeal

During the fall of 1981, SEC's Division of Corporate Regulation and Office of the General Counsel reviewed three proposals to amend the act--S. 1869, S. 1870, and S. 1871--that were developed by industry. The staff sought to analyze the projected effects of these proposals on SEC's administration of the act and to consider what options may be available to SEC in responding to the three bills. As part of their review, the staff spoke with representatives from the groups making the proposals and with representatives from the financial community. While they did not contact any State regulators, the staff did review the regulatory statutes of a number of States. After analyzing the proposals and other pertinent data, the staff concluded in a December 1, 1981, memorandum to the Commissioners that they had serious reservations about the proposed amendments and suggested the following actions for the Commissioners' consideration.

--Transfer administration of the act to another agency. SEC has supported such a transfer many times in the past.

--Develop its own amendment. The staff reminded the Commission that it was not bound to consider only the existing amendment proposals and if the Commission decided the industry proposals were too sweeping in certain areas, it could develop its own amendment.

--Repeal the act. SEC staff pointed out that this position would probably be supported by most of the industry and be opposed by some States and consumer groups.

SEC's General Counsel's Office concluded that SEC should ask the Congress to repeal the act, while the Division of Corporate Regulation suggested amending the act without changing materially the financing standards and the antidiversification theme of the act. The overall recommendation from these two groups to the Commissioners was to discuss and consider SEC's positions on the three bills and consider whether SEC should prepare its own legislative proposal and what the nature of such a proposal should be.

SEC Commissioners and key staff met on December 15, 1981, and discussed four options: recommend one of the three industry proposals or repeal the act. Some of the Commissioners expressed concern about taking a position without having a better idea of how the utility industry and State regulators viewed the act. Doubts were raised about the ability of States to regulate in the absence of the act, particularly their regulation of interstate holding companies. The Commissioners considered the possibility of holding hearings to explore these concerns, but rejected the idea because the Congress would be holding hearings within a few months. In the final analysis, the Commissioners did not obtain additional input and voted unanimously on December 15 to recommend repeal of the act to the Congress.

SEC and industry views on the act

SEC's recommendation is based on developments in Federal and State regulation of electric utilities, disclosure and financial reporting requirements that are now applicable to most publicly owned utilities, and changes in the accounting and investment banking industry. For example, SEC identifies the Federal Power Act as establishing comprehensive schemes for Federal regulation of all aspects of the interstate transmission and sale of electrical energy, cites the increased practical experience and better resources at the State level, and notes the development and expansion of disclosure and financial reporting under the Securities Acts.

In addition, SEC believes that the electric utility industry has been so thoroughly reorganized under the act that it is not fair to subject the remaining nine electric and three gas utility systems to the act's "substantial regulatory requirements." SEC's 1984 budget submission shows that compliance with the act required the industry to file 823 applications and reports in fiscal year 1982 and projects 820 filings for fiscal year 1983. SEC estimated the annual reports to involve about 69,000 hours of preparation.

Electric utilities and holding companies generally agree with SEC that the act should be repealed or at least modified to allow for more diversification and to relieve utilities from the act's stringent financial restrictions. For example, the Edison Electric Institute, which represents investor-owned utilities, stated in testimony before the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs that it agrees with SEC's recommendation to repeal the act. The Institute also believes that the act has served its basic purpose and continued Federal regulation is not necessary. In its conclusion, the Institute stated that repeal of the act would accomplish the removal of what it perceives as an unnecessary "heavy regulatory burden."

A representative for seven of the nine registered electric utility holding companies stated in June 1982 that most of the act's controls are no longer necessary. According to the representative, any remaining controls are duplicated or more effectively achieved by other existing means of Federal and State regulation. The registered holding companies basically believe that repeal of the act would eliminate unnecessary regulation.

Similarly, the Duke Power Company, an electric utility company operating in North and South Carolina, agreed with the conclusions of SEC and the Institute about the act. However, a company official stated that it may be too far reaching at this time to expect total repeal and decided to favor proposals advocating increased diversification under a holding company concept. This official believes that increased diversification would (1) facilitate capital formation by making the holding company securities more attractive to investors and (2) reduce risk levels of utilities remaining only in the utility business. The Duke Power official said that, because of the act, Duke Power

has been reluctant to establish a holding company because it is uncertain whether SEC would force it to divest its operations.

## Continued SEC involvement may be warranted

While we agree that SEC, under the act, has reorganized electric utility holding companies, we believe that a more important question is whether SEC's administration of the act continues to be useful. In our June 20, 1977, report,[1] we assessed how SEC carries out its responsibilities under the act. We found that certain provisions of the act are durable standards worthy of enforcement so long as holding companies conduct gas or electric utility operations. However, we also stated that because of changed conditions the continued application of other provisions needs to be reviewed. Accordingly, we recommended that SEC authorize a thorough study of developments in the gas and electric utility industry to evaluate the individual standards and determine the continued overall usefulness of the act.

We addressed SEC's comments to that report in another report.[2] In its comments, SEC disagreed with many of our conclusions and assumptions and concluded that the recommended study was not necessary in light of the industry's substantial reorganization since the act's passage. We stated that SEC's comments did not justify any changes to our original recommendation and reiterated the recommendation. In a letter to Senator Howard Metzenbaum on November 13, 1980, SEC stated it still had not prepared any studies and continued to disagree with GAO's recommendations.

SEC never made the comprehensive study that we envisioned to determine whether all or some of the act's provisions are useful and whether continued SEC administration in the area is needed. SEC, however, told us that, in preparing its June 1982 justification for repeal, it considered the act's current effectiveness, its usefulness, and the potential impacts of legislative and administrative changes on consumers and States. SEC said its justification was the product of legal research rather than direct contacts with State utility regulators. State regulatory officials we contacted identified a number of practical problems that could occur if the act is repealed and these are discussed in the following chapter.

Additionally, we noted that SEC was regulating interstate holding companies over which no other Federal or State agencies

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[1]See footnote, p. 4.

[2]"The Securities and Exchange Commission's Regulation of the Public Utility Holding Companies: An Evaluation of Commission Comments on a Critical Report," FGMSD-78-7, Jan. 4, 1978.

have direct authority. For example, for electric utility holding companies alone, SEC continues to regulate nine registered companies that control (1) approximately 60 electric utility operating companies in 24 States and (2) over 38 nonutility subsidiaries. The most recent SEC data indicates that these 63 electric companies represent 21.5 percent of the Nation's electrical generation (in terms of operating revenues), with assets in 1981 in excess of over $51 billion and operating revenues of $20 billion. Although the actual number of registered holding company systems may seem small in relation to what existed before the act's passage, their geographic and financial coverage is large. Moreover, many public utility holding companies have received exemptions under the provisions of the act.

Currently, regulatory efforts by SEC are devoted to reviewing the financial activities of these utility holding companies to assure compliance with the act's requirements. The two primary kinds of financial transactions that SEC monitors are (1) security issuances for internal utility operations and (2) securities and assets acquisitions of other utilities and nonutility businesses. No other Federal or State agency has direct authority to regulate these interstate holding companies.

In addition, SEC serves as a valuable resource to State regulators by monitoring exempt holding companies, having access to an interstate holding company's records of affiliate transactions, and allowing the States to concentrate their efforts in other areas of regulation by relying on SEC for technical assistance on security issuances. A majority of State regulators we interviewed said that SEC oversight of registered and exempt public utility holding companies' activities continues to provide protection for investors and, perhaps more importantly, for consumers who depend on the utility industry for energy at a fair and reasonable cost. However, some other State regulators we contacted believe the act is no longer needed.

According to State and utility officials, the act deters the creation of holding companies because companies, in general, prefer to avoid regulation. Even if a holding company would be declared exempt under the act, the company would still be required to file papers applying for exempt status and would generally have to submit an annual status report to SEC. Exempt companies told us that they are constantly concerned about the possibility of their exemption being withdrawn by SEC, thereby placing them under the act's regulatory and antitrust provisions, a situation they would prefer to avoid.

One State commissioner compared the continued need and usefulness of the act to a stop sign. According to him,

> "The proponents of change would argue that the stop sign should come down because there have been no accidents at this interchange for the last 47 years. I would argue that there have been no accidents because the stop sign has been there."

He expands the point further by stating that:

> "Just because only a dozen cars choose to use a particular sidestreet does not change the need for the stop sign on that sidestreet, nor the impact on all of the other users of that road on the main street. I think that it is a red herring to suggest it applies only to a very few customers."

A representative of the public power industry compared the act and its effect to a dam:

> "We look out over the industry today, and we see calm waters, and perhaps we fail to realize that these calm waters are because back in 1935 we constructed a dam, which as a result has created those calm waters."

Another factor to be considered before taking action to repeal the legislation is the relatively small costs associated with SEC's enforcement activities. Since 1938, the cost of implementing the act's provisions has been steadily reduced. For example, in 1940, SEC had a staff of 234 devoted to carrying out the act's provisions. In fiscal year 1982, only 17.9 staffyears were devoted to carrying out the act's provisions, at a cost of $801,000. For this level of effort, during fiscal year 1982 SEC staff reviewed 772 filings of applications and reports required of the public utility holding companies. More importantly for the 12 registered systems, SEC staff approved more than $8 billion worth of securities in fiscal year 1982 and reviewed mergers and acquisitions, service contracts, and intrasystem transactions among affiliates such as common-cost allocations. For fiscal year 1983, SEC projects that 18.5 staffyears will be used to enforce and monitor compliance with the act, at an estimated cost of $892,000.

## CHAPTER 3

## FEDERAL AND STATE REGULATORY GAPS AND PROBLEMS WOULD EXIST IF THE ACT IS REPEALED

In its June 2, 1982, statement, another reason SEC gave for recommending repealing the act was that the act's provisions, to a large extent, duplicate other Federal and State regulations. We recognize that, similar to the 1935 act, other Federal statutes contain disclosure and financial reporting requirements and that significant changes have developed in the disclosure and financial reporting requirements of publicly owned companies. There remain a number of important areas that would no longer be regulated at the Federal or State level if the act is repealed. Additionally, the views of State regulatory officials should be expressly considered. Some of these officials believe that they may not be in an adequate position to protect ratepayers because of legal and practical problems that could occur if the act is repealed.

### OTHER FEDERAL REGULATIONS DO NOT DUPLICATE ALL OF THE ACT'S PROVISIONS

Since the 1930's there have been significant developments in Federal regulation of electric and gas utilities. In addition, disclosure and financial reporting requirements have significantly improved for publicly owned companies. Although these regulatory requirements might accomplish the same regulation as some of the Holding Company Act's provisions, we believe a number of regulatory gaps would be created at the Federal level if the act is repealed.

SEC believes that the majority of the act's regulatory requirements are duplicated by the provisions of three Federal laws. Specifically, SEC believes that the Securities Act of 1933 and the Securities Exchange Act of 1934 contain disclosure and financial reporting requirements that could be used in lieu of the Holding Company Act's disclosure requirements. The Federal Power Act, which establishes a system of Federal regulation for all aspects of the interstate transmission and sale of electric energy at wholesale, provides for regulation of acquisition or disposition of utility properties, issuance of utility securities not subject to State regulation, and affiliate transactions. Although not specifically mentioned by SEC in its June 2, 1982, statement, the Clayton Act prohibits acquisitions of assets and securities when the acquisition would tend to harm competition. Thus, according to the Department of Justice, most acquisitions by one company of securities and assets of an unrelated company would not violate the Clayton Act. Because the Holding Company Act seeks to control different types of problems, its focus is somewhat different. The properties and business of public utility holding companies are confined to those necessary or appropriate to the operations of a public utility system.

Although these four Federal laws have some comparability with the Holding Company Act's provisions, we found these acts to be more applicable to regulating electric utilities rather than to regulating electric utility holding companies. Further, we identified a number of areas that would not be regulated by other Federal legislation if the Holding Company Act is repealed. Although the consequences of these regulatory gaps are uncertain, Federal and State officials we interviewed mentioned that several potentially adverse situations could occur if the act is repealed. These potential problems would result from SEC's no longer having authority to:

(1) Approve the acquisition of assets and securities by utility holding companies.

(2) Approve the issuance of securities by utility holding companies.

(3) Review the allocation of costs between the holding company and its service company and its utility subsidiaries.

Approval of acquisitions would no longer be required

If the act is repealed, there will be no prior Federal approval for acquisitions of any securities or utility assets or any other interest in any business by registered holding companies or their subsidiaries. Currently, the act provides SEC with approval authority over such acquisitions and specifies the criteria such acquisitions must follow. For example, the act requires that utility acquisitions be confined to a single geographically defined area and that other acquisitions be related to the utility operations. An acquisition may not unduly complicate the capital structure of the holding company and its subsidiaries. In addition, an acquisition may not be detrimental to the public interest, interests of investors or consumers, or proper functioning of the holding company.

If the act is repealed, interstate holding companies could acquire, subject to the Clayton Act, any nonutility subsidiary. In its June 2, 1982, statement, SEC acknowledges the possibility of acquisitions of profitable companies and points out potentially beneficial effects. SEC points out that chances are good that the new business may prove less risky or more profitable than the utility. However, SEC's justification did not address the other side of the coin. According to some State regulatory officials we interviewed, in some instances, such acquisitions could adversely affect the rates that consumers pay for their electricity. For example, if an interstate holding company acquires a subsidiary that, in turn, becomes unprofitable, it could cause the bond rating for the utility to be lowered. Such an action could increase the utility's cost to borrow money, and this higher cost of capital could be passed on to the consumer through higher rates.

Another State official pointed out that if SEC no longer approved acquisitions by holding companies, it would be possible for a holding company to invest its money in an unlimited number of nonutility subsidiaries and not have money available to provide to the utility subsidiary when needed. (The holding company usually provides additional funds to the utility by purchasing additional common stock from the utility.) A delay in receiving funds could hurt the utility by delaying a utility's maintenance or other needed items. The lack of funds could also affect the ratepayers because the utility may be forced to not only go to the marketplace for funds at a higher cost, but also to get funds through debt financing instead of equity financing. Additional debt financing could result in an unbalanced and unhealthy debt/equity ratio for the utility subsidiary that, in turn, could increase its cost to borrow money. These increased costs could eventually be passed on to consumers in the form of higher rates.

Approval of securities would no longer be required

If the act is repealed, holding companies will still be required to disclose financial securities information, but SEC will no longer have authority to approve the issuance of securities by registered holding companies. Currently, the act requires SEC to approve most types of security[1] issuances by registered holding companies and their subsidiaries. Approval may be withheld if either the securities or the terms of their issuance fail to meet certain qualitative standards. SEC limits the type of securities issued by a holding company to common stock and short-term debt and limits an electric utility subsidiary's securities to long-term debt; preferred stock; and special debt, such as for pollution control. SEC's regulations limit the amount of the utility subsidiary's debt and equity. According to SEC, the limits on the type of financing and securities under the act assist States, which are presented with financing proposals fashioned by the policies and standards under the act.

SEC officials stated that, if the act is repealed, there will be no State or Federal agency to consider the consolidated effects of security issues of a holding company with utility subsidiaries in several States. SEC stated in its December 1, 1981, memorandum that:

> "* * * experience has taught us that the most serious financial abuses were those involving the securities issued by the holding company, not the operating subsidiaries."

If the parent company's financings are no longer approved by SEC, the utility ratepayers could be injured as they were before the act's passage.

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[1]Security includes any note, draft, stock, bond, debenture, or instrument commonly known as a security.

Both State and SEC officials pointed out that the number and variety of securities issued by both the holding company and the utility subsidiary could increase if the act is repealed. As one SEC official pointed out, States could be called upon to consider a vast assortment of security issues whose consequences in terms of soundness and rates to consumers may be difficult to evaluate for the particular utility and the holding company as a whole. Repeal could magnify and create complexities for the States.

### Review of allocations of service company costs would no longer be authorized

If the act is repealed, SEC will no longer have authority to review allocation of costs for service companies of registered electric utility holding companies. In accordance with the act, service companies exist to serve companies, principally the operating utility subsidiaries, in their system "at cost, fairly, and equitably allocated among such companies." Service company activities center on accounting, administrative, financing, engineering, data processing, budget, and support services. Currently, each of the registered electric utility holding companies has a service company subsidiary. Although SEC has not exercised its authority extensively, under the act SEC can examine the books of service companies to assure that costs are equitably allocated. In the absence of the act, both State and SEC officials noted that no other Federal or State agency could assure this. According to an SEC official:

> "The importance of periodic surveillance of the service companies cannot be overemphasized, because the Commission's jurisdiction in this area is exclusive, and it is apparent that State and local regulatory authorities having jurisdiction over the rates of operating utility companies are dependent upon this agency for effective supervision of service company operations."

The chance of a service company's overcharging a utility subsidiary would increase without such a review. Such charges could eventually mean higher rates.

## STATE REGULATORY OFFICIALS ANTICIPATE PROBLEMS IF THE ACT IS REPEALED

Another factor in SEC's recommendation to repeal the act is the increased effectiveness of State utility regulation since 1935. Although SEC recognizes that some shortcomings in State regulation of utilities would exist if the act is repealed, SEC generally believes that States will be able to provide continued protection to consumers without SEC fulfilling the functions it currently exercises under the act. In reaching its repeal recommendation, SEC only reviewed the extent and adequacy of regulatory laws in 13 States and did not directly contact or obtain input from State officials during the decision process.

State regulators we interviewed generally do not favor repeal of the act. The National Association of Regulatory Utility Commissioners (NARUC), a group representing all of the State public service commissioners in the country, has formally opposed repeal or substantial modification of the act. Also, many of the State officials we interviewed were not as confident as SEC concerning their ability to protect ratepayers if the act were repealed. States said they would not be able to regulate interstate holding companies and believed that adverse situations could affect consumers if interstate holding companies were not regulated at the Federal level. Further, States thought that new laws, additional resources, and expanded staff expertise may be needed at the State level to deal with the consequences of repeal. Even with this additional legislation and financial and technical support, States were unsure if enforcement of this legislation would hold up in their State courts.

States would not have jurisdiction over interstate operations of holding companies

The major area of nonduplication between State authority and SEC's authority under the act is regulation of interstate electric utility holding companies. States are unable to directly regulate interstate operations of electric utility holding companies. If the act is repealed, States are concerned that the lack of such regulation could hurt consumers.

Generally, State control and authority extend only to a company's operations within the State's boundaries; States have no authority to regulate activities outside their own jurisdiction. States do not have the same type of direct regulatory powers over out-of-State parent holding companies that SEC has under the 1935 act. Because State regulatory officials are concerned about their lack of authority, NARUC adopted a resolution by a vote of 12 to 6 that opposed repeal or substantial modification of the act. The NARUC executive committee said it could support modifications of the act only if, among other things, SEC continues to approve interstate utility holding companies' new financing plans, SEC provides periodic reviews of holding companies' diversification activities, and State commissions have an opportunity to comment on holding companies' financing plans and diversification activities.

State regulatory officials we interviewed are concerned about regulatory problems that could occur for them if the act is repealed. These concerns are generally based on similar problems they experienced in the past in regulating utility subsidiaries of holding companies. California regulatory officials, for example, are concerned that an interstate holding company could keep its books and records outside the State. This could cause practical problems for the State's regulators who have no legal authority to obtain needed information maintained outside of the State but who are responsible for auditing the holding companies' financial matters related to California utilities. In the past, California regulators experienced this problem with an east coast holding company that owns a telephone utility in California. The holding

company made its records available, but the records were physically located at the company's east coast headquarters. The problem was eventually resolved when the holding company agreed to pay travel costs for California's auditors. However, California regulatory officials are still concerned that repealing the act would result in more of their utilities coming under the control of out-of-State holding companies, thereby increasing the number of such situations. Regulatory officials from other States such as Massachusetts, Connecticut, and New York also expressed similar concerns.

Not all State regulatory officials are opposed to repeal of the act. Officials in Indiana and Virginia are confident that their States can adequately protect consumers if the act is repealed. They believe their regulatory authority is sufficient to prevent the recurrence of past abuses. Another State regulatory official cited that repeal of the act could lead to more diversification, which would make it easier for the investor who wants a diversified portfolio. Another State regulatory official favoring repeal doubts that an increase in the number of holding companies would occur if the act is repealed.

More laws, staff, and expertise needed

Some State regulatory officials are concerned that not all States have a thorough system of legislation and regulations to adequately protect consumers, nor do all States have the staff capability--in number or experience--to handle the consequences of repeal. Some State regulatory officials are unsure if they could pass sufficient legislation to protect consumers if their utility is part of a holding company. Some are concerned that repeal could result in States having less authority over utilities. Some State regulatory officials are apprehensive about trying to enforce their statutes because they fear their laws would not hold up in their State courts. Also, because of expected increases in the number and extent of holding companies and diversified utilities, State regulatory officials are concerned about obtaining the needed number of staff and staff with sufficient levels of experience to properly regulate these increased activities, particularly with the tight budget constraints many States already face.

In recommending repeal of the act, SEC identified four areas of legislation that States should have in place to establish a comprehensive utility regulatory system. These include laws that would give State regulators authority to review and approve major corporate structural changes, approve financings and capitalizations, approve transactions with affiliates, and require uniform systems of accounts and reporting systems. SEC believes that States could protect consumers through comprehensive regulatory authority over the operating utilities and their transactions with affiliates. SEC recognizes in its June 2, 1982, statement that not all States currently have in place comprehensive systems of utility regulation that include these four areas, but it believes that States have the authority to enact such systems.

State regulatory officials we contacted anticipate increased activity in diversified ventures by both holding companies and utilities, the establishment of new holding companies, and the takeover of utilities by holding companies. Although States are responsible for regulating intrastate holding companies and utilities, these companies in the States we contacted are, in general, limited in number and not highly diversified. Some State regulatory officials are hesitant about the comprehensiveness of their laws and their ability to pass and enforce such laws in order to handle the expected increased activity so as to protect their ratepayers.

Connecticut, Pennsylvania, and Massachusetts regulatory officials believe that repealing the act could diminish their regulatory authority over operating electric utilities. A typical electric utility is a single company with generation, transmission, and distribution functions regulated by the State. State regulatory officials believe that repeal of the act could result in an electric utility company's forming a holding company and separating these functions into three distinct companies, with the State's authority being greatly reduced to regulating only the distribution company.

Some State regulatory officials anticipate increased and more complex transactions between affiliates within a holding company. Massachusetts regulatory officials told us that they are currently experiencing access-to-records problems between the regulated utility subsidiary and the affiliated nonregulated subsidiary. These officials believe that repealing the act could make this situation more troublesome.

Because State regulatory officials are unsure of the activity that will occur if the act is repealed, they are uncertain about the specific wording and extent of legislation needed to protect consumers. Further, officials from two States we contacted were concerned that their State legislatures would be slow to pass needed laws until the negative affects of repeal are actually experienced. One State commissioner who opposes repeal told us that, as a minimum, SEC should develop model legislation for the States and give them a grace period of 2 years to enact it. The NARUC ad hoc diversification committee passed a resolution in July 1982 containing a similar suggestion.

Some States are unfamiliar with regulating holding companies or diversified entities. As a result, it may be necessary to expand the knowledge and expertise of their regulatory staffs. This would require hiring new staff and/or training existing staff to obtain the expertise needed to evaluate such areas as formation of holding companies, different types and effects of equity and debt securities issuances, and different accounting and auditing standards employed by nonregulated activities of holding companies and diversified utilities. However, according to some State regulatory officials, budgetary constraints at the State level could make it difficult to add people with needed expertise to their regulatory staffs.

# CHAPTER 4

# CONCLUSIONS, EVALUATION OF AGENCY COMMENTS, AND RECOMMENDATION

## CONCLUSIONS

SEC's justification for recommending that the Public Utility Holding Company Act be repealed does not fully weigh the possible effects on consumers or consider the views of State regulatory officials. We agree with SEC, however, that the act has served to reorganize public utility holding companies and that some of its remaining provisions are similar to other Federal or State regulations. SEC currently has many regulatory responsibilities under the act. For example, it regulates registered public utility holding companies, monitors exempt holding companies' financial and diversification activities, approves more than $11 billion worth of securities, and reviews and approves mergers and acquisitions and service contracts of the registered systems. SEC accomplishes these tasks at a relatively small cost to taxpayers--$801,000 in fiscal year 1982.

In a 1977 report, we recommended that SEC conduct a study to determine the continued overall usefulness of the act. SEC never made the comprehensive study that we envisioned. SEC told us that, in preparing its June 1982 justification for repeal, it considered the act's current effectiveness, its usefulness, and the potential impacts of legislative and administrative changes on consumers and States. SEC said that its justification, however, was the product of legal research rather than direct contacts with State regulators. State regulatory officials we contacted identified some practical problems that could occur if the act is repealed.

We believe that before the Congress takes action to repeal or amend the act, it should address the potential impacts that regulatory gaps at the Federal level would have on State regulation and ultimately on consumers. If the act is repealed, a number of Federal regulatory gaps for interstate public utility holding companies will be created. For example, the Federal Government will no longer be required to review and approve the acquisition of assets and securities and the issuance of securities of holding companies. Further, the Federal Government would not be authorized to review allocation of costs of service company subsidiaries. Although the actual consequences of these regulatory gaps are only speculative, Federal and State regulatory officials mentioned several potentially adverse situations that could occur to consumers if the act is repealed.

Further, the impact that repeal would have on States' abilities to regulate utility holding companies and to protect ratepayers is as yet still uncertain. Many State regulatory officials we interviewed were concerned about a number of legal

and practical problems that could adversely affect their ability to protect ratepayers. For example, States do not have authority to directly regulate interstate public utility holding companies. Also, many States are not legally prepared to deal with the additional regulatory problems that are anticipated if the act is repealed, such as the more complex nature of holding company structures, increased diversification activities, and increased affiliate transactions. In addition, many State regulatory officials anticipate that additional funds and staff would be needed to carry out the increased workload expected if the act is repealed. However, budget constraints may prevent States from obtaining the needed staff and funds.

Considering the past and present effectiveness of the act and the uncertainties and potential impact that may occur if the act is repealed, we believe further evaluation of the continued need for the act should be made, focusing on the potential effect that repeal or amendment could have on consumers and States.

## AGENCY COMMENTS AND OUR EVALUATION

SEC was provided with a draft of the report for comment. SEC continues to support its recommendation to repeal the Public Utility Holding Company Act and disagrees with the findings, conclusions, and proposal in our draft report. SEC believes that the major premises of our draft reflect an erroneous understanding of the nature of SEC's burden in supporting the act's repeal. SEC believes that the Congress, rather than SEC, is the proper forum for obtaining the views of State regulatory officials and other interested groups in deciding on the fate of the act. SEC stated that the Congress should review the Holding Company Act and hopes that our study will help focus attention on whether there is any rationale for the continued existence of the act.

Specifically, SEC took issue with the following points: (1) our conclusion that SEC has not adequately demonstrated that the act is no longer needed, (2) the point that SEC's oversight of registered system's securities issuances and acquisitions is vital because no other Federal or State agency has direct authority to regulate these companies, and (3) the point that regulatory gaps caused by repeal could result in harmful diversification and could result in cost overcharges, both eventually hurting consumers through higher rates. Further, SEC believes that we did not consider industry's costs in complying with the act. Finally, SEC questioned the appropriateness of our proposal.

SEC disagrees with a conclusion we made in the draft report that it has not adequately demonstrated that the act is no longer needed and that SEC should give greater consideration to the current effectiveness of the act, the current usefulness of SEC's authority under the act, and the potential impact of legislative and administrative changes on consumers and States. SEC stated in its written comments that it carefully weighed each of these factors in making its repeal recommendation and addressed these factors in its June 2, 1982, statement presented during two

Congressional hearings. According to SEC, the statement discusses SEC's views concerning the current role of the act and SEC's belief that many of the act's provisions are either duplicative of other requirements or have been reduced in importance as a result of changes in the economic environment in which utilities operate. Further, SEC continues to believe that, based on legal research, States could meet their regulatory objectives without the act. Based on SEC comments we have modified our conclusion to point out that SEC's justification for repeal did not address the views of State regulatory officials and this needs to be done before deciding on the fate of the legislation.

We continue to believe that there would be a major gap in regulation of interstate electric utility holding companies if the act is repealed. States are unable to directly regulate interstate operations of electric utility holding companies. Our report contains examples of potentially harmful situations that could occur if the act is repealed. For example, California regulatory officials were concerned about the practical problem of access to information maintained outside the State. Other State regulatory officials are concerned about obtaining the needed number of staff and staff with sufficient levels of experience to properly regulate expected increases in the number of holding companies and diversified activities. These examples were given to us by State regulators who are concerned about possible repeal of the act. We believe that these arguments are important aspects for considering the usefulness and effectiveness of the act.

SEC takes issue with a statement in our draft report that SEC's oversight of securities issuances and acquisitions by registered systems is vital because no other Federal or State agency has direct authority to regulate these companies. SEC questions the need for this, especially at the Federal level, since SEC does not possess similar authority for other holding companies (utility, nonutility, and exempt). It was not our intention to draw our own conclusion on the continued need for specific provisions of the act but rather to evaluate SEC's justification supporting repeal. Therefore, we have modified our report by eliminating the language that gives such an impression. Our point is that no other Federal or State agency has direct authority to regulate these registered companies. It is SEC's role under the act to protect both investors and consumers. SEC points out that the requirements of the 1933 and 1934 Securities Acts, the evolution of Federal securities laws on fraud, and the increased sophistication of the accounting profession have increased investor protection. We do not disagree with this latter point in our report. SEC's comments to our draft report, however, do not explain how these improvements protect the consumer.

Regulatory officials we contacted presented some potentially harmful situations that could occur to consumers if the act is repealed. Examples included a holding company's (1) acquiring a subsidiary that becomes unprofitable that could in turn cause the

utility's bond rating to be lowered resulting in a higher cost of capital to be passed on to consumers and (2) investing money in nonutility subsidiaries so that money is not available to the utility subsidiary when needed. Further, our work disclosed that States, which are charged with assuring reliable electric service at a reasonable rate, are in general unprepared to deal with the potential ramifications of the act's repeal.

As mentioned in our report, State control and authority generally extend only to a company's operations within the State's boundaries; States have no direct authority to regulate activities outside their own jurisdiction. States do not have the same type of direct regulatory powers over out-of-State holding companies that SEC has under the 1935 act. State regulatory officials are concerned that repeal of the act could adversely affect their ability to protect their electricity consumers. We recognize that SEC's authority over registered utility holding companies is more comprehensive than over other types of systems, i.e., exempt and nonutility holding company systems. This authority was given to SEC because of the numerous abuses that were occurring before 1935. Further, we wish to point out that there is a difference between these three types of holding company systems. The registered systems are interstate with operations extending into 24 States. The exempt companies are primarily intrastate systems or are companies that are predominantly public utility companies operating in their State of organization and contiguous States. The nonutility holding company systems do not have electric or gas utility companies--regulated monopolies--as subsidiaries.

SEC points out that in the event of repeal, the Federal Energy Regulatory Commission or States would provide regulatory scrutiny over securities issuances, utility acquisitions, and affiliate transactions by companies engaged in wholesale sales of electric energy in interstate commerce. Neither States nor FERC possesses the same type of direct regulatory control over interstate holding companies that SEC has under the Holding Company Act. FERC does possess certain authority over the operations of electric utilities that are part of holding companies, but FERC does not have authority to regulate a holding company's securities issuances, acquisitions, or transactions with affiliates. FERC has no direct authority over holding companies. Further, as pointed out in our report, States do not have direct control over interstate holding companies.

SEC also focused on potential problems that may result from regulatory gaps caused by repealing the act. We pointed out that, while SEC's justification addressed the potentially beneficial impacts of acquisitions of profitable companies, its justification did not address the other side of the coin. SEC commented that:

> "* * * fears of harmful diversification, however, apparently rest on a mistrust of holding company management's incentives and ability to make sound

> resource allocation decisions, and on a misunderstanding of today's business environment * * * thus the argument that any move by a utility into another business necessarily increases the risk of the total enterprise no longer has the same validity."

We did not mean to imply that we mistrust management's incentives or its ability to make sound resource allocation decisions. Further, we did not mean to imply that diversification by a holding company is always bad. Our point is that there is no guarantee that diversification will always be less risky or more profitable than the utility's operations. Some State regulatory officials that we contacted said that some acquisitions by holding companies could adversely affect consumers' electricity rates. State regulatory officials registered concern that an unprofitable nonutility subsidiary of a holding company could cause the utility's bond rating to be lowered. Further, State regulatory officials pointed out that a holding company could invest its funds in a nonutility subsidiary and not have funds available for investment in the utility.

SEC continued its point by saying that the financial reporting and disclosure requirements of the Securities Acts provide strong safeguards against irresponsible investments by holding company management. We agree that the 1933 and 1934 Securities Acts require certain financial reporting and information disclosure. These acts, however, do not guarantee that securities issues or investments by holding companies are in the best interest of the public, investors, or consumers. It is the responsibility of these affected parties to review the disclosed information and judge if these are responsible management investments. Under the 1935 act, however, SEC determines the soundness of a security. SEC is responsible for assuring that an issuance or acquisition by a registered holding company system is not detrimental to the public interest, interests of investors or consumers, or proper functioning of the holding company. The 1935 act provides more investor and consumer protection than do the Securities Acts of 1933 and 1934.

SEC continues its point on regulatory gaps by citing two possible situations contained in our report--(1) service company affiliates might overcharge a utility for their services and (2) interstate holding companies could keep books and records outside the State. SEC points out that its review indicates that States generally have the power to identify the costs that may be considered in establishing utility rate bases and if this authority does not currently exist, then constitutionally a State could enact such legislation. Thus, a State could disallow unjustified charges. We recognize that, from a legal aspect, States could, during a public utility commission rate hearing, require a utility to submit books, records, and other justification kept outside of the States. However, State regulatory officials told us that they are concerned with the practical problems of effectively protecting consumers that receive electricity from an interstate holding company.

State regulatory officials we contacted said that they would not be able to regulate interstate holding companies and believed that adverse situations could affect consumers if interstate holding companies were not regulated at the Federal level. Further, State regulatory officials thought that new laws, additional resources, and expanded staff expertise may be needed at the State level to deal with the consequences of repeal. Even with this additional legislation and financial and technical support, some State regulatory officials said that they were unsure if enforcement of this legislation would hold up in State courts.

SEC argues that we failed to consider the costs incurred by industry in complying with the act. We agree that cost is a factor that should be considered in determining the fate of this act. However, as we note in chapter 2, SEC's 1984 budget submission shows that compliance with the act required industry to file 823 applications and reports in fiscal year 1982, projects 820 filings for fiscal year 1983, and estimated the annual reports to involve about 69,000 hours of preparation. We did not convert these hours into dollars, nor did we judge the financial effect on these companies.

SEC's last comment deals with our proposal that SEC reevaluate its repeal recommendation, especially its effect on States and consumers. SEC strongly disagrees with this proposal. SEC continues to believe that the act has served its primary purpose and that the act may be repealed without jeopardizing the investors' interests. Further, SEC believes that the Congress, rather than SEC, is the proper forum in which to probe the reactions of State regulators, industry representatives, competitors, consumers, and other interested persons to SEC's repeal recommendation.

In followup to SEC's comment that repealing the act will not jeopardize the interests of investors, we wish to note that our report does not take issue with this position. Our report focuses on the fact that SEC's justification did not adequately address whether repeal may jeopardize the interests of consumers. The act was designed to protect investors, consumers, and the public interest, and SEC's comments do not explain adequately how the consumer is protected.

Further, as we note in chapter 2, our June 20, 1977, report on the Holding Company Act contained a recommendation that SEC authorize a thorough study of developments in the electric and gas utility industry to determine the continued overall usefulness of the act. In response to that recommendation, SEC concluded the study was not needed and has not performed such a study.

In light of SEC's response to both the current and the 1977 report and because we continue to believe that consideration should be given to (1) areas where there would be regulatory gaps if the act is repealed and (2) the views of State regulatory officials, we modified our proposal and now recommend that the Congress not repeal the Public Utility Holding Company Act until it, not SEC, studies and analyzes the impact of repealing or amending

the act, especially on States and consumers. A copy of SEC's comments is attached as appendix III to the report.

## RECOMMENDATION TO THE CONGRESS

We recommend that the Congress, in considering repealing or amending the act, address, through the appropriate congressional committees, the potential impacts that regulatory gaps at the Federal level would have on State regulation and ultimately on consumers.

APPENDIX I

TOM CORCORAN
15TH DISTRICT, ILLINOIS

ENERGY AND COMMERCE COMMITTEE
SUBCOMMITTEE ON ENERGY CONSERVATION AND POWER
SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS

POST OFFICE AND CIVIL SERVICE COMMITTEE
SUBCOMMITTEE ON HUMAN RESOURCES
SUBCOMMITTEE ON POSTAL OPERATIONS AND SERVICES

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House of Representatives
Washington, D.C. 20515

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ILLINOIS TOLL-FREE ACTION LINE:
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August 17, 1982

The Honorable Charles A. Bowsher
Comptroller General
General Accounting Office
Washington, DC 20548

Dear Mr. Bowsher:

During the 97th Congress, many bills have been introduced in both Houses of Congress to amend or repeal the Public Utility Holding Company Act of 1935. Within the past year, the Securities and Exchange Commission and the Administration through the Department of Energy have recommended that the Holding Company Act be repealed.

Specifically, on December 21, 1981, SEC stated in a letter to Senator Alfonse M. D'Amato, Chairman of the Securities Subcommittee of the Committee on Banking, Housing and Urban Affairs, its belief that "...this statute has served its basic purpose and that continued federal regulation of utility holding companies is unnecessary and inappropriate." In a June 10, 1982, statement, DOE stated that "...the Administration supports repeal of the 1935 Act because it is a regulatory anachronism and burden...." Both SEC and DOE went on to further elaborate their positions.

As the first House sponsor of legislation during the 97th Congress dealing with the Act (H.R. 5220, the "Public Utility Financial Reform Act", introduced on December 15, 1981), and as a member of the committee of jurisdiction in the House, I am particularly interested in the bases for the positions expressed by the Administration and SEC. Therefore, especially in view of GAO's previous interest in the Act and the resulting response from SEC (see June 20, 1977, GAO report FGMSD-77-35, "The Force of the Public Utility Holding Company Act has been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies"), I request the GAO to evaluate the bases for these statements as follows:

(1) To what extent have relevant regulatory and economic conditions changed since the early 1930's when the Holding Company Act, the 1933 Securities Act and the 1934 Securities Exchange Act, as well as other New Deal laws were enacted? I believe that it would be useful during our current consideration of the possibility of repealing or amending the Holding Company Act to understand the context in which the legislation was originally enacted and how these conditions may be different today.

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(2) With the information developed in question (1) in mind, has the Act "...served its basic purpose" as SEC stated in its December 21 letter? If not, what in your opinion is the Act's basic purpose? Are all of the Act's regulatory provisions still required? Does the information developed in question (1) support SEC's statement that "...continued federal regulation of utility holding companies is unnecessary and inappropriate."?

(3) Has SEC's administration and enforcement of the Act been effective? What are SEC's primary responsibilities under the Act at the present time? Is there any relationship between SEC's enforcement of the Act and Department of Justice enforcement of anti-trust statutes?

In pursuing this request, I would like you to work with the relevant federal agencies. Although of late GAO has not been soliciting agency comments on some of its energy related draft reports, I specifically request that you allow the relevant agencies the opportunity to comment in connection with this request.

Although there have been four Congressional legislative hearings this year on this issue, final Congressional action seems unlikely during the remainder of this Congress. Is such action does appear more likely, I may request an interim report or briefing. Otherwise, I would hope that your report could be completed by January 1983.

I am looking forward to your work on this issue. Please contact me or have your staff contact Al Cobb of my staff if we can be of any further assistance.

Sincerely,

Tom Corcoran
Representative in Congress

## LEGISLATION INTRODUCED IN THE 97th CONGRESS TO AMEND OR REPEAL THE PUBLIC UTILITY HOLDING COMPANY ACT

During the 97th Congress, a total of eight bills--four in the House of Representatives and four in the Senate--were introduced to amend or repeal the Public Utility Holding Company Act. Three bills--S. 1977, H.R. 5465, and H.R. 6134--proposed repeal of the act. Two bills--S. 1871 and H.R. 6581--proposed amending the act to exempt gas utility holding companies. Three other bills--S. 1869, S. 1870, and H.R. 5220--proposed other amendments to the act. The following sections briefly describe the major changes proposed by the three latter bills.

### S. 1870 and H.R. 5220

These two bills proposed amending section 3 of the act, which grants SEC the power to make particular exemptions regarding holding companies. These bills provided for two additional categories of exemptions: (1) a holding company with one utility subsidiary whose operations are within the State boundary in which it is organized or contiguous thereto and (2) a holding company over a holding company that is, for the most part, an operating utility as well as otherwise exempt. These bills also allowed for the granting of unconditional exemptions for all classes of companies from all of the act's provisions except section 9(a)(2) concerning acquisitions. It was believed by proponents of these two bills that revisions would have enhanced diversification in the utility industry.

Because bills S. 1870 and H.R. 5220 carried with them modifications believed to enhance diversification, the chief utility industry proponents were the exempt holding companies and electric utilities. Many utilities regard the act as a potential for regulation of their existing and future operations.

### S. 1869

S. 1869 would have amended sections 6, 7, 11, 12, and 13 of the act. These sections address the areas of security transactions, nonutility acquisitions, gas utility property retentions, and affiliate transactions. In the area of security transactions (sections 6 and 7), the bill would have limited SEC's authority over the (1) issuance of short-term debt and guarantees, (2) issuance of securities by a public utility subsidiary and a nonutility subsidiary, (3) issuance of securities pursuant to a 1-year plan filed under section 7, and (4) guarantee by a registered holding company of securities issued by nonutility subsidiaries. Sections 6 and 7 would have amended the act to allow for SEC regulation of registered holding companies' consolidated security structures to prevent unsound financial practices.

S. 1869 would also have amended sections 9, 10, and 11 to remove and restrict certain existing requirements of registered utility holding companies. As had been proposed, amendment to these sections would have removed any required SEC approvals for nonutility business acquisitions. Moreover, the proposal restricted prior SEC approval of utility asset acquisitions to those assets directly related to traditional utility business. Finally, the bill's amendments to these sections would have modified the test involving retainability of nonutility investments.

S. 1869 would have further amended section 11 to assure the retention of gas utility properties by registered holding companies with combination gas and electric utilities in existence as of May 1, 1981. These holding company systems would be required to meet the standards outlined in clauses B and C of section 11 (b)(1) of the act. Currently, at least three registered electric utility holding companies could hold minor gas operations.

Finally, S. 1869 advocated revisions to sections 12 and 13. These revisions eliminated SEC's jurisdiction over loan transactions within holding companies and the sale of utility assets by holding companies if such transactions are authorized by State commissions. This proposal added another subsection to section 13, which forbade SEC from requiring profits acquired through subsidiary transactions with nonholding company system companies to be credited to the holding company's cost-of-service to affiliate companies. In addition, this new subsection granted SEC discretion to allow a subsidiary company to charge associate companies at market prices instead of at cost for sales, service (other than managerial), or construction contracts.

S. 1869, as was proposed, primarily limited SEC regulation of registered holding companies. These companies were the chief utility industry advocates for this bill. Also, a spokesman for a group of registered electric utility holding companies expressed support for repeal of the act.

APPENDIX III

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL
6-6

April 29, 1983

Wilbur D. Campbell
Acting Director
Accounting and Financial
Management Division
United States General Accounting
Office
Washington, D.C. 20548

Dear Mr. Campbell:

The Securities and Exchange Commission appreciates the opportunity to comment on the General Accounting Office's draft report "The Securities and Exchange Commission Needs to Reevaluate Its Position Recommending Repeal of the Public Utility Holding Company Act of 1935" (GAO/RCED 83-118). The Commission continues to believe that Congress should revisit the regulatory framework it established nearly fifty years ago in the 1935 Act and hopes that GAO's study will serve to focus added attention on the issue of whether there is any rationale for the continued existence of the Act. Nonetheless, the Commission believes that the major premises of the draft reflect an erroneous understanding of the nature of the Commission's burden in supporting repeal of the 1935 Act. Accordingly, the Commission has authorized me to submit to you this response to GAO's draft comments.

The main conclusion of the draft report is that the Commission has not "adequately demonstrat[ed] that the act is no longer needed." Report at page 22. Essentially, the report states that the Commission should give greater consideration to the "current effectiveness" of the Act, id. at 23, the "current usefulness" of the Commission's authority under the Act, id., and the "potential impacts of legislative and administrative changes on consumers and states." Id. at 23. In fact, the Commission, in making its recommendation that the Act be repealed, carefully weighed each of these factors.

GAO note: Page references in appendix III have been changed to reflect their location in this final report.

The points which the draft report commends for further study are addressed in the statement which accompanied the Commission's repeal recommendation. Statement of the U.S. Securities and Exchange Commission Concerning Proposals to Amend or Repeal the Public Utility Holding Company Act of 1935 (June 2, 1982). The statement discusses the Commission's views concerning the current role of the 1935 Act and the Commission's belief that many of its provisions are either duplicative of other requirements or have been reduced in importance as a result of changes in the economic environment in which utility companies operate. The Commission continues to adhere to these views. The statement also includes a discussion indicating the Commission's belief that the states could meet their regulatory objectives without the assistance of the Act; that view is, as the draft report points out, the product of legal research rather than direct contacts with state utility regulators. Nevertheless, the Commission was fully aware that a repeal recommendation could face opposition from some state officials.

It is not the purpose of this letter to repeat the reasoning in the Commission's statement supporting repeal. Three assertions in GAO's draft report do, however, merit a specific response. First, the draft report states that the Commission's oversight of securities issuances and acquisitions by registered systems is vital for "no other Federal or State agency has direct authority to regulate these companies." Report at page 13. This assumes, without explanation, both that such regulation is desirable or needed, and that it should be accomplished at the federal level. Notably, registered public utility systems are the only entities over which the Commission has such authority; the Commission has no such comprehensive authority over other types of utility or non-utility holding company systems or over the approximately ninety holding company systems exempted from the 1935 Act pursuant to Section 3(a) thereunder. The development of the securities registration and corporate disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, the evolution of the federal securities laws relating to fraud, and the increased sophistication of the accounting profession have significantly increased the level of investor protection beyond that existing in 1935. Accordingly, the Commission believes that the Act does little to safeguard investors and the public interest from the risks of improper sales practices and abusive corporate

management and control in utility holding companies. Moreover, in the event the 1935 Act is repealed, securities issuances, utility acquisitions, and affiliate transactions by companies engaged in wholesale sales of electric energy in interstate commerce would be subject to regulatory scrutiny by the Federal Energy Regulatory Commission under 16 U.S.C. §§ 824b, 824c and 824g, or by state utility commissions.

Second, Chapter 3 of the draft report lists several potential problems which may result from the "regulatory gaps" caused by repeal of the 1935 Act. Among these is the possibility that non-utility acquisitions, i.e. diversification, "could adversely affect the rates consumers pay for their electricity" if such non-utility businesses turned out to be unprofitable or if the company invested so heavily in such businesses as to be unable to provide needed financing for the utility subsidiary. Report at page 16. These fears of harmful diversification, however, apparently rest on a mistrust of holding company management's incentives and ability to make sound resource allocation decisions, and on a misunderstanding of today's business environment. The Commission's statement indicated that public utilities no longer enjoy the distinct investment advantages which they had in 1935 or even 10 years ago; thus the argument that any move by a utility into another business necessarily increases the risk of the total enterprise no longer has the same validity. SEC Statement at 62. Moreover, the financial reporting and disclosure requirements of the Securities Acts provide strong safeguards against irresponsible investments by holding company management.

Other regulatory gaps cited in the report include concerns that (1) service company affiliates might overcharge a utility subsidiary for their services, Report at page 18; and (2) interstate holding companies could keep books and records outside the state, id. at 19. Our review indicates that state commissions generally have the power to identify the costs which may be considered in establishing utility rate bases; certainly there is no constitutional impediment to enactment of such authority in any state where it does not already exist. Thus, undocumented or unjustified charges against capital or operating revenues may be disallowed by the relevant state authority. Indeed, the Supreme Court long ago established that states may require utilities to prove the reasonableness of contractual

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and other operating and service costs and to provide access to the books and records of affiliates. See SEC Statement at 46, citing Western Distributing Co. v. Public Service Commission, 285 U.S. 119 (1932), and Natural Gas Pipeline Co. v. Slattery, 302 U.S. 300 (1937).

Third, the report indicates that the costs associated with the administration of the 1935 Act are "relatively small." Report at page 14. This conclusion seems to reflect consideration of only the costs incurred by the Commission. In order to assess realistically the costs of the 1935 Act, however, it is also necessary to consider the costs incurred by industry in complying with its requirements, and whether those costs produce a commensurate public benefit. The Commission's staff has estimated compliance costs to be approximately $3 million annually for the twelve registered systems, exclusive of costs attributable to delays caused by regulatory review. A separate and more difficult cost factor to estimate relates to inhibition of opportunities, including financings, resulting from the 1935 Act. This affects not only registered holding companies but also exempt companies which may forego certain business activities for fear of becoming subject to the Act's restrictions.

Aside from these specific points, we note more generally that GAO's draft report seems implicitly to reflect a novel theory of the proper relationship between Congress and an independent regulatory agency. In essence, GAO appears to take the position that, until the Commission has conducted its own quasi-legislative hearing process and received and weighed the views of all affected special interest groups, it should refrain from presenting recommendations to the Congress. In my view, this notion reverses the legislative and administrative functions. The Commission, based on its experience in administering the 1935 Act and its familiarity with the level of investor protection afforded by other provisions of the federal securities laws, has concluded that the 1935 Act has served its primary purpose and may be repealed without jeopardizing the interests of investors. Congress, not the Commission, is the proper forum in which to probe the reactions of state regulators, industry representatives, competitors, consumers, and other interested persons to this recommendation.

For these reasons, I strongly disagree with GAO's conclusion that the Commission should undertake further study of the current usefulness of the 1935 Act and the

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potential impact of legislative and administrative changes on consumers and states. The Commission's June, 1982, statement adequately explains and supports its position; any contrary views of other interested persons are best presented directly to Congress.

In light of the considerations set forth in this letter, I urge the GAO to reconsider its findings and refrain from issuing the draft report. In the event that you choose to proceed notwithstanding the Commission's comments, I request that a copy of this letter be appended to your report.

Sincerely,

Daniel L. Goelzer

Daniel L. Goelzer
General Counsel

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