REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

The Securities And Exchange Commission's Regulation Of Public Utility Holding Companies: An Evaluation Of Commission Comments On A Critical Report

In an earlier report, GAO raised questions regarding the Securities and Exchange Commission's administration of the Public Utility Holding Company Act. GAO recommended that the Commission study the applicability of the act in relation to the Nation's present needs.

That report was issued without the Commission's comments. In its subsequent comments, the Commission rejected all of GAO's recommendations. GAO found nothing in the Commission's comments that would cause it to change its position.

This report summarizes the findings of GAO's earlier report and its evaluation of the Commission's comments.

FGMSD-78-7

JANUARY 4, 1978

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

B-124898

To the President of the Senate and the
Speaker of the House of Representatives

On June 20, 1977, we issued a report entitled, "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). The report raised questions concerning the narrowness of the Commission's administration of a statute which the Congress had intended to be wide ranging and pervasive.

Our report was issued without Commission comments because the Commission was unable to prepare a response within the 30 days we allowed. On June 30, 1977, the Commission issued comments--comments which rejected all of our report's recommendations. Although lengthy, the comments were not, in our opinion, persuasive and do not justify changes in our recommendations.

Our June report recognized that the Commission accomplished much in the early years of regulation in reducing the size and complexity of utility holding companies. The Commission's administration of the act, however, changed over the years. Currently, the Commission's administration of the act is too narrow and applies to too small a segment of the utility industry to fulfill all the act's objectives.

In our report we estimated that about 100 utility companies are classified as public utility holding companies as defined by the act. At the time of our examination all but 14 had been granted exemptions from regulation. As noted in our report, the Commission has little or no contact with the exempt companies and does not keep current records on the activities of these companies.

In the report we questioned whether the Commission's surveillance of the 14 regulated companies was adequate. The Commission was not conducting field investigations to assure that the companies were complying with the act's constraints on controlling influences, political payments, and intercompany transactions which could lead to holding company abuse. In its response, the Commission stated

that it had carefully and vigorously supervised the activities of regulated holding companies.

We reported that in granting regulatory exemptions, the Commission had relied too much on the geographic location of companies' retail utility services and had not considered the possible detriment to the public interest. Many exempt companies (1) were comparable in size and function to the companies which the Commission continues to regulate, (2) conducted both gas and electric utility operations, and (3) engaged in nonutility businesses of the type the act sought to prevent, such as farming, travel agencies, and real estate. Consequently, the public, investors, and consumers are not provided the protection from holding company abuses intended by the act. The Commission commented that it saw no need for changing its interpretation of the act's exemption provisions.

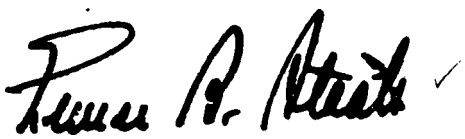
We reported that both regulated and exempt companies had made costly high-risk investments in fuel and fuel-related businesses which were outside their primary area of utility expertise. The report noted that the Commission relied almost entirely on company-submitted data, which in our opinion were inadequate for approving the financing of such businesses. We also reported that the Commission had little information on how the operation of such businesses by utility companies affected the interests of the public, investors, and consumers. The Commission stated in its comments that the companies' proposals for financing had received special review attention and that it had required full explanations regarding the companies' expected use of fuel and the reasons why other fuel sources were unavailable.

The Commission held that its reduced level of regulation represented an accommodation to the substantial achievement of the act's objectives. It stated that Commission policy in administering the act has consistently given full attention to the congressional interest of preventing utility holding company abuses. We still believe, as we recommended in our previous report, that a study of developments in the gas and electric utility industry is needed to assess the continued usefulness of the act. We therefore recommend that the Congress direct the Commission to (1) make the study of developments in the gas and electric

utility industry as required by section 30 of the act and recommended in our June report and (2) report back on the results.

Our evaluation of Commission comments is presented in appendix I; the Commission's comments are in appendix II.

We are sending copies of this report to the Director, Office of Management and Budget, and the Chairman, Securities and Exchange Commission.



Comptroller General
of the United States

EVALUATION OF SECURITIES AND EXCHANGE COMMISSION

COMMENTS ON GAO'S JUNE 20, 1977, REPORT

The purpose of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79 et seq.) administered by the Securities and Exchange Commission is to protect the public, investors, and consumers from abuses associated with the control of gas and electric utility companies by use of the holding company device. (A holding company generally is a corporation which owns and uses the voting stock of other corporations to influence their decisionmaking with the objective of controlling their policies and management.) The act was a direct response by the Congress to prevasive holding company control over the utility industry and to abuses resulting from that control.

During the years immediately following passage of the act, the Commission succeeded in reorganizing or breaking up the large holding companies. In recent years, however, it has operated on the premise that its major responsibilities under the act have been carried out and that a less active regulatory effort is required.

OVERSIGHT OF THE REGULATED COMPANIES

In our report we questioned whether the Commission's surveillance of the 14 regulated companies was adequate. We noted that the Commission was not conducting the type of field investigations generally considered necessary to assure that the companies were complying with constraints imposed by the act on controlling influences, political payments, and intercompany transactions (such as loans, contracts, dividend payments, and sales of assets) which could lead to holding company abuse. We also pointed out that, by and large, the States did not have the authority to carry out these and other functions mandated in the act.

In responding to our report, the Commission stated that it had carefully and vigorously supervised the activities of registered holding companies. It nonetheless acknowledged that most of its efforts had been devoted to financial matters, and it questioned the need for field investigations. Field investigations, according to the Commission, would be of limited benefit because:

--The Commission receives from various reports information needed for surveillance of intercompany loans and dividend policies.

--Intercompany transactions require Commission approval; attempts to conceal them appear minimal.

--Field inspections would be of doubtful effectiveness in uncovering irregular payments.

--Commission rules effectively exclude interlocking relationships with financial institutions.

The Commission may be correct in believing that the information reported to it is complete and reliable and that intercompany transactions conform to regulatory restrictions. Without indepth field investigations, however, we do not know whether this is so. In our view, the fact that some irregular transactions are not easily detectable, does not justify freeing them from the scrutiny of field investigations. Further, simply issuing rules, such as those restricting interlocking relations, does not mean that they will be followed. If this were true, much of the work of law enforcement groups would be unnecessary.

In summary, we do not believe it is possible to be reasonably certain that regulated holding companies are in fact complying with the act's restrictions on business practices and controlling influences without the information that would be provided by the independent first-hand assessments of field investigations.

Our report also questioned whether reorganization of utility holding companies had been completed. As succinctly stated by the Commission in its comments, the Congress did not intend gas and electric utility holding companies to become permanent Federal wards. Nonetheless, we noted that the Commission had no plans to reorganize the remaining regulated companies, even though it appeared from our analysis that a case could be made for further reorganization if the act's size standards were applied. We recognized, however, that these standards might not be current and complete and recommended that they be reevaluated, as contemplated in the act.

The Commission commented that, in the act's early years, it studied the size of companies as it reorganized them, and that after 1935--the period when most of the growth in the gas and electric utility industry occurred--size studies appeared to be superfluous. The Commission stated that the standards governing the size of regulated companies were fundamentally sound but it did not address the issue of whether utility reorganizations in accordance with these standards had been completed.

COMMISSION POLICIES IN GRANTING EXEMPTIONS

Our report questioned the Commission's policy of exempting companies from the full force of the act. Some companies no doubt should be exempt, but we questioned whether those not in compliance with the act's standards should be.

The act provides for exempting holding companies that conduct their utility operations predominantly within one State, with the qualification that such exemptions should not be granted if they are detrimental to the interests of the public, investors, or consumers. As to detriment, the act and its legislative history make it clear that the Congress considered it harmful for holding companies to provide both gas and electric utility service, to engage in nonutility businesses, and to control subsidiary utility companies which, on their own, are able to provide efficient and satisfactory customer service. Holding companies might otherwise restrict competition and become too large to be managed efficiently or regulated effectively.

The Commission has relied primarily on the act's geographic qualifications in exempting companies as being intrastate in character. It has not required companies to comply with the act's other standards as a condition of qualifying for or retaining exempt status. We reported that, as a result, many exempt companies were

--comparable in size and function to regulated companies;

--conducting both gas and electric utility operations; and

--engaging in nonutility businesses, such as farming, travel agencies, real estate, and data processing.

We do not know how many exempt companies have these characteristics. The Commission does not accumulate such data, and we did not make a detailed analysis. But our analysis of the 35 largest utility holding companies showed that 24 were unregulated. Of these, 8 provided both gas and electric services, 12 were engaged in businesses unrelated to utilities, and 18 had invested in fuel and fuel-related ventures.

In granting exemptions the Commission holds that the act's limitations on size and diversification into other businesses apply only to regulated companies and not to companies meeting the intrastate geographic qualifications

for exemption. Additionally, the Commission holds that operations of intrastate holding companies can be successfully controlled by the States. In our report, we questioned the Commission's positions for a number of reasons.

1. It largely ignores the act's requirement that no exemptions be granted if they are detrimental to the interest of the public, investors, or consumers.

2. Its separate standards for regulated and exempt companies produce inconsistent results.

3. It ignores the fact that companies that are geographically intrastate engage in transactions affecting interstate commerce.

4. It assumes that the States have authority as comprehensive as the Commission's and that they use it effectively (the Commission, however, has taken the position that its authority does not duplicate that of the States).

Putting all this aside, the fundamental question is whether the act's constraints--which are intended to protect the interests of the public, investors, and consumers--are still relevant after 42 years. We reported that the sparse data collected by the Commission did not enable us to reach an objective conclusion. Accordingly, we recommended that the Commission review the act's standards for granting exemptions and determine whether continuation of its present exemption policies is in the public interest.

The Commission stated in its comments that our report seemed to assume that geographic location of utility companies was an inappropriate criterion for exemption. It responded that, to the contrary, section 3 of the act makes geographic location a primary standard for exemptions, whether or not the company meets all of the requirements enumerated in section 11. Section 11, frequently termed "the heart of the act," contains important restrictions on utility companies' size, corporate structure, and operating modes. According to its comments, the Commission has held from the earliest days of the act's administration that a utility holding company does not have to meet all section 11 standards to obtain a section 3 exemption. The Commission explained at some length how the exempt companies identified in our report meet the Commission's exemption criteria. In conclusion, the Commission stated that it saw no need for changing its interpretation of the act's exemption provisions or for seeking amendatory exemption legislation.

We agree that intrastate geographic location can be a basis for considering exemptions. We found that companies which have been exempted conduct utility operations predominantly in one State. While geographic location is a basis for exemption, the Commission can refuse to grant an exemption if it finds that the exemption will be detrimental to the public interest or the interest of investors or consumers. The Commission does not take into account the requirements of section 11 in determining whether an exemption would be detrimental. We believe this interpretation of the exemption provision does not produce the results intended by the act, although we recognize that the act places the responsibility for determining detriment to the public interest or the interest of investors or consumers in the Commission.

INVESTMENT IN FUEL-RELATED VENTURES

We reported that both regulated and exempt companies had made costly, high-risk investments in fuel and fuel-related businesses which were outside their primary area of utility expertise and which ran in scope from research, exploration, and extraction to transportation and storage, and spanned the conventional fuel sources of coal, gas, and oil. We reported that in approving investment requests for regulated companies, the Commission had relied almost entirely on company-submitted data which, in our opinion, were inadequate. We also reported that the Commission did not have information on how the public, investors, and consumers were affected by permitting the companies to invest in fuel businesses. The potential for harm, therefore, had not been determined. Accordingly, we recommended that the Commission conduct a study to determine if such investments were necessary and in the best interests of the public, investors, and consumers.

The Commission stated in its comments that the companies' individual proposals for financing had received special review attention with a strong emphasis on the proposals' technical and economic features. Full explanations, it said, were required regarding companies' expected use of fuel and the reasons why other fuel sources had become unavailable. The Commission noted that developing alternatives to utilities' going into fuel and fuel-related businesses would require studies of much broader fields than the utility industry.

Our report recognized that the fuel crisis could either (1) represent a sound reason for utility companies to engage

in fuel businesses in the manner and to the extent that they had or (2) merely be the plausible event which had been used to justify diversification beyond the conventional boundaries of utility service. Because the Commission lacks information needed to show that its approval of companies' fuel ventures meets the public need for continuing utility service, we recommended further consideration of these diversification activities.

CONCLUSIONS

In its comments the Commission acknowledged that its level of regulation had declined but held that this represented an accommodation to substantial achievement of the act's objectives. The Commission stated that,

> "* * * contrary to the conclusion of the Comptroller General, the general policy of the Commission in administering this legislation has consistently been to give full effect to the Congressional intent of preventing the repetition of those abuses which led to passage of the act in 1935."

Overall, the Commission's comments on our report suggest a more vigorous and meaningful exercise of regulatory oversight over utility holding companies than the Commission actually provides. We still believe, as recommended in our report, that a study of developments in the gas and electric utility industry is needed to assess the continued usefulness of the act.

RECOMMENDATION TO THE CONGRESS

We therefore recommend that the Congress direct the Commission to (1) make the study of developments in the gas and electric utility industry as required by section 30 of the act and recommended by our June report and (2) report back on the results.

APPENDIX II

COMMENTS OF THE SECURITIES AND EXCHANGE COMMISSION
ON THE COMPTROLLER GENERAL'S REPORT OF JUNE 20, 1977,
TO THE CONGRESS ON THE ADMINISTRATION OF THE PUBLIC
UTILITY HOLDING COMPANY ACT OF 1935

APPENDIX II

TABLE OF CONTENTS

APPENDIX II

I. SUMMARY AND INTRODUCTION

The Securities and Exchange Commission submits these comments to express its views on the Comptroller General's Report to the Congress on the Commission's administration of the Public Utility Holding Company Act of 1935. Although these comments are directed principally to material contained in the Comptroller General's Report, we set forth first certain background information regarding the events and circumstances which led to the passage of the Act, the evils in the holding company structures which the Congress sought to eliminate, and the extent of federal regulation of public utility holding companies contemplated when the Act was adopted. This information, which is not set forth in the Comptroller General's Report, is essential both to an understanding of the complexities and structure of the Act and also to a meaningful analysis of the Commission's current efforts in the administration of the Act.

A. The Comptroller General's Report Reflects a Misunderstanding of the Statute and Its Administration by the Commission.

Under the Public Utility Holding Company Act of 1935, the Commission regulates interstate public utility holding company systems engaged in the electric utility business or the retail distribution of gas. The Act was adopted in response to the control exercised by a relatively few large financial corporations of a major part of the utility industry in this country. This situation was aggravated by the unsoundness of financial structures created to effect that control, and the lack of meaningful economic or operational relationships among the constituent parts of the resultant holding company systems. The Congress was particularly concerned that effective state regulation of utility service was seriously impaired by such use of the holding company device.

Under the Act, the Commission's jurisdiction extends to all companies in a registered holding company system, including companies that are not classified as utility companies under the Act. But, as we note below, in many circumstances holding company systems were exempted from regulation. The Commission was directed to regulate the physical integration of public utility companies and functionally related properties of registered holding company systems, and to effect the simplification of intercorporate relationships and financial structures of such systems. The Act also directed the Commission to pass upon the financing operations of holding companies and their subsidiary companies, the acquisition and disposition of securities and properties, certain accounting practices, servicing arrangements, and intercompany transactions. Most of these powers relate only to companies in registered holding company systems, however, not to utility companies or holding companies not required to register under the Act.

The dominant themes throughout the Comptroller General's Report relate to the issues of the size of utility systems and the Commission's application of the exemptive provisions of the Act. As to size, the Report generally notes that the Commission has not developed criteria relating to how large a holding company or utility company should be in order to operate efficiently. With regard to the Act's exemptive provisions, the Report is critical of the fact that the Commission has granted exemptions to a large portion of the utilities industry. The Report also questions the adequacy of the efforts and resources devoted to administration of the Act in recent years by the Commission. The concerns expressed in the Comptroller General's Report reflect, in large measure, a misunderstanding of the purpose of the Act. Accordingly, our substantive comments are directed to the major issues which are focused upon in the Comptroller General's Report.

With respect to the issue of size, the Act expressly recognizes that the size of utility systems depends on technological requirements and the character of the region served. In contrast, the Comptroller General's discussion focuses on size measured in absolute terms of dollar values in assets and revenues—standards which the Congress did not include in the Act. Since the Act was adopted, there has been a tenfold nationwide increase in capital invested and in generating capacity for electric service which reflects a corresponding increase in the physical size of efficient generating units and in demand for energy. Such growth is not related to holding company status because the size of individual utility companies has grown accordingly. Virtually all of this growth has been internal.

The Commission's administration of the Act has effectively limited mergers and consolidations to those which can be affirmatively justified by the goals set forth in the Act. The Commission substantially completed the reorganization phase of its mandate about 20 years ago. The utility industry today consists mostly of the strong, independent local systems which the Act sought to achieve. The reduction in the coverage of the Act reflects attainment rather than abandonment of its purpose. The Commission has also carefully and vigorously supervised the activities of companies in registered holding company systems, relating to financing, the acquisition of securities and properties, accounting practices, servicing arrangements, and intercompany transactions.

In this connection, the Comptroller General's Report considerably understates the information resources applied to administration of the Act. It overlooks the use of evidentiary hearings in administration of the Act, the field inspection program undertaken by the staff with respect to new problems arising in the fuel area, and the very extensive information available about the industry, whether or not subject to the Act, from filings under the securities laws and

from other regulatory sources. More fundamentally, it fails to recognize the specialized knowledge and experience of those assigned to administer the Act. No inference can fairly be drawn that data submitted by those regulated is accepted without meaningful review. And the areas in which the Report suggests that further audit and verification are needed are, for the most part, matters in which available data is ample.

The utility industry became substantially involved in the financing and ownership of fuel sources and related facilities in response to the energy crisis. This reaction was industrywide and was not a phenomenon related to holding company status. The Commission has directed particular attention to the economic and technical justifications for this development in passing on the applications of the companies subject to the Act.

The Comptroller General's Report appears to be critical in that the Commission has not exercised power over exempt holding companies. But the Congress determined that those holding companies which were entitled to a Section 3 exemption would be virtually free of substantive regulation under the Act and would not be required to conform to the Act's provisions and standards applicable to registered holding company systems, and the Commission has no jurisdiction over independent operating companies that, pursuant to its administration of the Act, have been spun-off from registered holding company systems.

The Comptroller General has recommended that the Commission conduct an extensive study of the developments in the gas and utility industry and has suggested four specific subject areas which should be examined in the recommended study. Our views with respect to each of these specific areas are set forth infra at Point VI.

B. The Commission Has Substantially Effectuated the Statutory Aims and Continues To Do So.

1. Historical Perspective

During the 1920's the utility industry was marked by the two-fold experience of the increased growth of utility companies and the expansion of holding company empires through the acquisition of utility companies. 1/ In addition to controlling the nation's supply of electric and gas energy, these holding companies had expanded into such diverse fields as coal mining, foundries, textiles, agriculture, transportation, ice and cold storage, real estate, finance and credit, theaters, and amusement parks. 2/

As a result of the growth of holding company systems, finance rose to a position of prominence in this vital field of electrical and gas energy. Concentration of control was accompanied by the creation of unsound and top-heavy financial structures; holding companies were pyramided on top of each other, and within each company there were often multi-levels of securities. These mountains of paper rested on the common stock of the operating companies. Because holding companies tended to borrow as heavily as possible, their securities were highly speculative and they were marked by excessive leverage. 3/ As a result of leverage, small changes in the earnings of the underlying companies had dramatically explosive effects on the earnings applicable to holding company securities. During the boom years up to 1929, book profits of holding companies appeared huge.

1/ Securities and Exchange Commission, Report for the SEC Subcommittee of the House Committee on Interstate and Foreign Commerce on the Public Utility Holding Company Act of 1935, 1-20 (Oct. 15, 1951).

2/ Id. at 15.

3/ Id. at 9.

But, when the boom collapsed, leverage worked in reverse, and many holding companies and their subsidiaries were forced to default on their obligations and had to cease dividend payments to stockholders. The complex capital structures of these entities also afforded many opportunities for the manipulation of accounts and finances and for diverting profits or losses through intercompany channels to the detriment of public investors. Equally important was the way in which the corporate pyramids defeated or obstructed local regulation of the underlying operating companies.

2. Enactment of the Public Utility Holding Company Act of 1935.

The Public Utility Holding Company Act of 1935 was enacted "to subject to effective public control public-utility holding companies which transcend State lines in their interests and activities."4/ The Act followed an exhaustive investigation by the Federal Trade Commission, and extensive hearings and debates by the Congress. These inquiries disclosed in public utility holding company finance and operations a variety of abuses which the Act was designed to correct. The more significant of these are enumerated in Section 1(b) of the Act:

(1) Inadequate disclosure to investors of the information necessary to appraise the financial position and earning power of the companies whose securities they purchase;

(2) the issuance of securities against fictitious and unsound values;

(3) overloading operating companies with debt and fixed charges, thus tending to prevent voluntary rate reductions;

(4) the imposition of excessive charges upon operating companies for various services such as management, supervision of construction and the purchase of supplies and equipment;

(5) the control by holding companies of the accounting practices and rate, dividend and other policies of their operating subsidiaries so as to complicate or obstruct state regulation;

4/ H.R. Rep. No. 1318, 74th Cong., 1st Sess. 3 (1935)

(6) the control of subsidiary holding companies and operating companies through disproportionately small investment;

(7) the extension of holding company systems without relation to economy of operations or to the integration and coordination of related properties.

In passing the Act, Congress sought to deal with these problems by:

a. Requiring each holding company registered under the Act to confine itself to a single intergrated public utility system, with provisions for the retention of additional utility systems and related incidental businesses under certain designated circumstances;

b. Providing for the simplification of registered holding company structures including the elimination of unnecessary holding companies and the reorganization of those that were unduly complicated and over-capitalized, and the redistribution of voting power among securities holders of holding and operating companies in order to assure the investing public a voice—or at least a potential voice—in these enterprises, commensurate with its capital contributions;

c. Requiring the securities issued by registered holding company systems to meet specified statutory standards to assure the soundness of the capital structure of the system;

d. Halting the loading of excessive charges by affiliated service companies in registered holding companies on the operating utility subsidiaries, by requiring that all services performed by affiliates for any company in its system be rendered at cost fairly allocated; and

e. Regulating companies in registered holding company systems to eliminate fictitious or deceptive accounts and unsound business practices.

The Act was particularly designed to eliminate those holding companies serving no useful purpose, and thus to afford to the operating companies the

advantages of localized management and to strengthen local regulation. 5/ This objective finds its most direct expression in Section 11 of the Act. 6/

Section 11(b)(1) requires the operations of holding company systems to be limited to one or more integrated systems and to such additional businesses as are reasonably incidental or economically necessary or appropriate to the operation of the integrated systems. Section 11(b)(2) requires the elimination of undue complexities in the corporate structures of holding company systems, and the redistribution of voting power among their securities holders on a fair and equitable basis.

The Act provides for the registration of holding companies (Sec. 5) and substantive provisions such as those in Section 11 are generally limited to companies in registered holding company systems; these substantive provisions include the regulation of securities transactions of holding companies and their subsidiaries (Secs. 6 and 7); the regulation of the acquisition of securities and utility assets by holding companies and their subsidiaries (Secs. 9 and 10); the regulation of sales of public utility securities or assets, payment of dividends, solicitation of proxies, intercompany loans and other intrasystem transactions (Sec. 12); the control of

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5/ American Power & Light v. Securities and Exchange Commission, 329 U.S. 90, 113 (1946); North American Company v. Securities and Exchange Commission, 327 U.S. 686, 704-706 (1946).

6/ Section 11 has been characterized as the "heart of the Act". See S. Rep. No. 621, 74th Congress, 1st Sess. 11 (1935). See also, Securities and Exchange Commission v. New England Electric System, 384 U.S. 176, 180 (1966); North American Company v. Securities and Exchange Commission, supra, 327 U.S. at 704 n. 14.

services, sales, and construction contracts (Sec. 13); and the control of accounting practices (Sec. 15).

Certain types of holding company systems were not intended to be so regulated. Section 3 of the Act specifies five categories of holding companies that are entitled to an exemption from substantially all of the Act's other provisions. 7/ The Act's broad exemptive provisions

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7/ Section 3(a) of the Act provides that holding companies shall be exempted from the Act when:

"(1) Such holding company and every subsidiary company thereof which is a public utility company, are predominantly intrastate in character and carry on their business substantially in a single State in which such holding company and every subsidiary company thereof are organized;

"(2) Such holding company is predominantly a public-utility company operating as such in one or more contiguous States, in one of which it is organized;

"(3) Such holding company only incidentally is a holding company, being primarily engaged or interested in one or more other businesses other than the business of a public-utility company and (A) not deriving, directly or indirectly, any material part of its income from any one or more subsidiary companies, the principal business of which is that of a public utility company, or (B) deriving a material part of its income from any one or more such subsidiary companies, if substantially all the outstanding securities of such companies are owned, directly or indirectly by such holding company;

"(4) Such holding company is temporarily a holding company solely by reason of the acquisition of securities for purposes of liquidation or distribution in connection with a bona fide debt previously contracted or in connection with a bona fide arrangement for the underwriting or distribution of securities; or

"(5) Such holding company is not and no subsidiary company thereof is a public-utility company operating within the United States."

S. Rep. No. 621, supra at 6.

reflect one of the delicate compromises reached in Congress between those who believed that holding companies should be completely abolished in view of the numerous abuses that had been perpetrated upon investors and consumers through the holding company structure, and those members of Congress who vigorously resisted the creation of federal regulatory authority in this area. As a result, Congress concluded that not all public utility holding companies would be subjected to pervasive federal control and, indeed, structured the Act in a fashion so as to permit numerous holding companies to avoid regulation under the newly-created legislative scheme particularly where the characteristics of the system were such that the component companies could be subjected to regulation by the states.

3. Regulatory Direction of the Commission's Administration of the Public Utility Holding Company Act.

The title of the Comptroller General's Report 8/ and Chapter 2 thereof 9/ state that the Commission's regulatory approach has changed over the years since passage of the Act. That conclusion apparently is based, without more, upon an observation of the level of the Commission's efforts in administering the Act over the years, rather than upon a reasoned and thorough examination of the purposes for federal regulation of public utility holding companies. In fact, contrary to the conclusion of the Comptroller General,

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8/ The Report is entitled "The Force of the Public Utility Holding Company Act Has Been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies."

9/ Chapter 2 of the Report is entitled "The Commission's Regulatory Approach Has Changed Over the Years."

the general policy of the Commission in administering this legislation has consistently been to give full effect to the Congressional intent of preventing the repetition of those abuses which led to the passage of the Act in 1935, and to make the administration of the law as workable as possible without imposing unnecessary restrictions of a kind which bear no relationship to the Congressional aims.

In the first twenty years of its administration of the Act (1935 through 1955), the Commission's major task was the administration and enforcement of Section 11(b), involving the break-up and reorganization of registered holding companies. In 1938, when Section 11(b) became operative, there were 214 registered holding companies, which controlled 922 electric or gas utility companies and 1,054 nonutility companies. Today, there are only 14 registered systems, which control 68 utility subsidiaries and 79 nonutility companies.

Section 11(b) of the Act, the heart of the statute, contemplated an effective system of orderly deregulation. Congress did not intend that utilities would remain permanent federal wards under the Act. As has been noted, the Act introduced federal authority into a field traditionally subjected to state or local jurisdiction, because, as Congress found, the holding company device had been abused and was a means to evade state and local regulation.

Vigorous enforcement of Section 11(b) by the Commission over the years eliminated most of the multistate holding companies and reversed the tidal wave of consolidations that had been occurring in the years prior to 1935.

When the Act was passed, about 80 percent or more of the utilities were controlled by holding companies that were registered under the Act. One of the salutary effects of Section 11(b) has been the emergence of many utilities as independent operating companies.

During the past fifteen years, the Commission's major task has involved it in the financing of registered holding company systems, the standards for which are prescribed in Sections 6 and 7. The purpose of these sections is to assure that registered systems subject to the Act are prudently capitalized at economically acceptable costs, because a utility so capitalized serves the interests of both investors and consumers. In fiscal year 1976, total financings authorized under the Act amounted to $4.9 billion. The other provisions of the Act dealing with mergers and acquisitions, new questions under Section 11, and service company regulations also continue to require substantial attention.

To the extent that the Comptroller General's conclusion—that the Commission's regulatory approach under the Act has changed—can be read to imply that the Commission has failed to fulfill its responsibilities, we disagree. As we have noted, such a conclusion appears to have been distilled from a comparison of the level of the Commission's efforts in the early administration of the Act with the current regulatory efforts under conditions and circumstances where the evils and abuses which gave rise to the passage of the Act have been virtually eradicated.

II. ISSUE OF SIZE

The dominant theme of the Comptroller General's Report, found throughout the chapters on the Commission's regulatory approach as well as in the chapter discussing exemptions, relates to the issue of size. The Report concludes (p. 13) that the Commission has not developed criteria for size or standards relating to how large a holding company or a utility company should be in order to operate efficiently. Further, the Report asserts (pp. 12-13, 32) that, without explicit guidelines as to size. there was no effective means of ascertaining which of the registered systems may be too large to retain the utility companies which they now control and which of the exempted systems may be too large to warrant a continuation of their exemptions.

Significantly, the Report fails to relate the factor of size to the relevant provisions of the Act, 10/ but instead focuses upon criteria such as assets and revenues. 11/ But, in passing the Public Utility Holding Company Act, the Congress nowhere indicated a concern over the issue of size viewed in light of such narrow criteria.

With respect to the size of registered holding companies, Section 11(b)(1) generally limits a registered holding company to a single, integrated, public utility system, as the Commission, by order in each case, shall prescribe. Section 2(a)(29)(A) of the Act defines integrated electric systems as a group of electric facilities physically interconnected, or capable of interconnection, which may operate as an economical and coordinated system, and is confined to a single area or region in one or more states. That section further states

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10/ See Section 3(a) and Section 11(b)(1).

11/ The table at page 23 of the Report sets forth the size of the registered systems, most of them with over $1 billion in assets, and the size of a select group of exempt holding companies with over $1 billion in assets.

that the integrated system shall be

> "not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation * * *" 12/

The ultimate relevance of size as thus considered is addressed to its effects upon localized management, efficient operation and effectiveness of regulation. A definition of size measured by dollar values of assets or of revenues —criteria which are highlighted in the Comptroller General's Report—would be far less meaningful than the Act's definitional provisions.

It is evident that Congress, in adopting Section 11(b)(1), was not concerned with the issue of size in terms of dollars; it addressed itself instead to that issue in terms of meaningful and flexible standards articulated in Sections 2(a)(29)(A) and (B) and 11(b)(1), in order to permit the Commission, in its administration of the Act, to effectuate holding company reorganizations in a fashion beneficial to investors and consumers alike. Thus, Section 11(b)(1) directed the Commission to make its decisions as to size in light of the state of the art and the characteristics of the region. These are fundamental and well-chosen standards which were promulgated in recognition of the fact that size is a function of technology and the geographic region in which the service area is located. The first standard—technology—changes with time, and the second—geographic region—may differ for each utility company. The latter may also change in time, depending upon industrial and demographic developments upon which growing consumer demand depends. A case-by-case approach, as has been adopted by the Commission, which gives content and substance to the standards of the statute, is a rational method for dealing

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12/ Section 2(a)(29)(B) defines a gas integrated system in like terms.

with the issue of the size of utility holding companies. 13/ In contrast, a handbook setting forth inflexible guidelines as to size, as the Comptroller General apparently recommends, would only produce the illusion of simplicity; and, in the context of any particular case, will not be illuminating.

Although the absolute size of utility companies has increased ten-fold since the passage of the Act, 14/ primarily as a result of technological advances and demographic changes during that period, such growth, in large measure, has been internal (i.e., growth within a service area or extension into adjoining areas). And, registered holding company systems have followed substantially the same pattern of internal growth. Also, the major utility companies that are not in registered holding company systems continue to serve approximately the same territories they did when they were spun off from such systems. 15/ Overall, there has been no significant

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13/ These standards, as applied to the facts of a particular case, are discussed in detail in the numerous Commission opinions which were issued during the active phase of the Section 11(b)(1) program in the earlier years of the Commission's administration of the Act.

14/ At the time the Act was adopted the largest steam-electric unit was about 200mw, which cost $32 million to build. Federal Power Commission 1964 National Power Survey, Part I, p. 14. The average size of all units was 20mw. Ibid. The largest unit today is 1,300mw, which costs over $500 million to build. Steam-Electric Plant Construction Cost and Annual Production Expenses, 26th Annual Supplement, p. IX (1973). The average unit under construction is 500mw. Ibid. Total assets of privately owned Class A and B electric utilities in the United States were $15.7 billion in 1941, of which $12.6 billion represented utility plants. 1941 Federal Power Commission Annual Report of Statistics of Privately Owned Electric Utilities in the United States. They generated 144.3 billion kwh. In 1975, total assets were $157 billion; net utility plant was $137.4 billion; and total generation amounted to 1,493.1 billion kwh. 1976 Federal Power Commission Annual Report of Statistics of Privated Owned Electric Utilities in the United States.

15/ We should note here that integration and simplification under Section 11(b) led to the consolidation of redundant subsidiaries and a significant number of exchanges of outlying properties owned by one system to round out the service area of another.

departure from the goal of utility systems dedicated to the service of a single geographic region, as defined in the Act.

In contrast, extrinsic holding company growth through acquisitions by both registered and exempt holding companies is governed by the requirements of section 10 of the Act, which, in significant respects, are stricter than the standards of Section 11(b)(1). Section 10(c)(2) requires that, in order to approve an acquisition, the Commission must find affirmatively that the acquisition "will serve the public interest by tending towards the economical development of an integrated public utility system." As a consequence, since the passage of the Act, utility holding companies have not experienced any significant degree of external growth. 16/

Absolute size, in this industry, is not dependent on holding company status. If a size limitation on individual utility systems were desired, the holding company relationship would not be an appropriate jurisdictional basis for implementing such a policy. In terms of size, in the restricted sense of the Comptroller General's Report, the operating utilities listed

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16/ In 1946, the Commission denied an application by American Electric Power Company to acquire Columbus and Southern Ohio Electric Company, 22 S.E.C. 808. A later proposal for the same acquisition (File No. 70-4596) led to extensive hearings, and the case is pending for decision. In addition, in one instance the Commission denied authorization for a major consolidation in Massachusetts, New England Electric System, Holding Company Act Rel. No. 18635, 5 SEC Docket 372 (Oct. 30, 1974). At another time, it authorized a combination of two large utility companies in Illinois, Illinois Power Company, 44 S.E.C. 140 (1970), but on conditions which the applicants found unacceptable. Similarly, Northeast Utilities was authorized by the Commission to acquire two major Connecticut utilities and two smaller adjoining utilities in Western Massachusetts (Northeast Utilities, 42 S.E.C. 963 (1966); 43 S.E.C. 462 (1967)). And, there is now pending a proceeding regarding the status under Section 11(b)(1) of a major registered system. Central and South West Corporation, Holding Company Act Rel. No. 19361, 8 SEC Docket 1202 (Jan. 30, 1976).

below, which are not a part of any holding company system, are of approximately the same order of magnitude as the registered systems (as of December 31, 1975). See page 22, infra.

	(000's omitted) Assets	Operating Revenues	Involvement in Activities of Fuel Procurement
Consolidated Edison of N.Y., Inc.	$6,315,409	$2,667,938	
Pacific Gas & Electric	5,905,981	2,233,371	x
Southern California Edison	4,650,307	1,668,015	x
Public Service Electric & Gas	4,473,473	1,630,525	x
Detroit Edison Co.	3,934,752	1,070,780	x
Virginia Electric & Power	3,871,808	1,033,336	x
Duke Power	3,740,799	954,414	x
Florida Power & Light	3,416,938	1,182,644	x
Consumers Power	3,361,133	1,341,100	x
Niagara Mohawk Power	2,652,625	972,706	x
Carolina Power & Light	2,402,022	606,329	x
Baltimore Gas & Electric	2,187,138	680,042	
Houston Lighting & Power Co.	1,990,608	634,153	x
Long Island Lighting Co.	1,902,621	358,122	
Pacific Power & Light	1,834,737	301,495	x
Potomac Electric Power	1,778,871	492,510	
Duquesne Lighting Co.	1,593,285	405,124	x
Florida Power	1,524,597	504,496	
Cleveland Electric Illum.	1,513,247	523,165	x

* Source: Moody's Public Utility Manual (1976).

In its discussion of the issue of size, the Comptroller General's Report notes (p. 15) that Section 30 of the Act authorized and directed the Commission to make general studies of utility companies to consider "the sizes, types and location of public utilities" for the purpose of developing recommendations for "integrated public utility systems," and that the Commission has not conducted any studies under Section 30. Studies under Section 30, however, were

never intended as part of the regulatory structure of the Act. Indeed, the immediate, major task facing the Commission after passage of the Act was the reorganization of registered systems under Section 11(b). Studies to that end were expressly provided for in Section 11(a), which instructed the Commission to examine each registered holding company system in order, among other things, to simplify its corporate structure, to eliminate complexities, and to confine it to properties and businesses of an integrated public utility system. The Commission reviewed most of the electric industry and the larger part of the gas industry in the course of reorganizing companies or systems in conformance with the statutory standards of Section 11(b).

Additional or supplementary studies under Section 30 were not undertaken. When the Commission's Section 11(b) program had been largely completed in 1955, such studies appeared somewhat distant and superfluous after the passage of almost a quarter of a century. At this time, in view of the vast technological changes in the utility industry, studies contemplated by Section 30 appeared to call for legislative reassessment, both in terms of need and of purpose. If such types of studies are found still to be germane, and depending upon the breadth of the studies contemplated, it may be more appropriate that the responsibility to conduct such studies should be lodged with the federal agency charged with developing a national energy policy. We would, of course, be willing to assist in any such studies if they are authorized by Congress and if the necessary funds should be appropriated.

III. EXEMPT HOLDING COMPANIES

Chapter 3 of the Report, dealing with the granting of exemptions, largely ignores the language and structure of the Act, and, consequently, confuses the standards specified in Section 3 of the Act for the granting of exemptions with the entirely different standards, contained primarily in Section 11 of the Act, for companies which do not qualify for an exemption. There seems to be an assumption, based upon the Report's conceptual pre-occupation with size, that the Commission has complete discretion to grant or withhold exemptions and should exercise that discretion with primary reference to the issue of size and the other standards specified in Section 11 for nonexempt companies and that geographical location is an inappropriate criteria for exemption. On the contrary, geographic location is the primary standard for exemption. Section 3(a)(1) provides that the Commission shall exempt holding companies if they are predominantly intrastate and located within a single state. Section 3(a)(2) provides for exemption if the company is predominantly an operating utility operating in contiguous states.

Size is not among the criteria mentioned in Section 3. If a company qualifies under Section 3, it is entitled to an exemption whether or not it meets all the requirements enumerated in Section 11 for a nonexempt holding company including, particularly, the requirement of Section 11(b)(1) that the operations of the system be limited to a "single integrated public utility system." 17/ The Commission, accordingly, has repeatedly held, from

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17/ All the exemptions under Section 3(a), including those in subsections (a)(1) and (a)(2), are subject to the qualification that the exemption (continued)

the earliest days of its administration of the Act, that a company does not have to meet all the standards of Section 11 in order to obtain an exemption under Section 3 and the Commission's interpretation has been judicially affirmed. 18/ The Report does not expressly take issue with this conclusion; it simply ignores it and assumes, in the discussion on pages 22 through 28, that the standards for exemption and the standards for companies which do not qualify for exemption should be identical, and that the Commission has mistakenly failed to adopt this approach.

As we have noted, Section 3 of the Act provides, in mandatory terms, for carefully defined exemptions of wide scope. A major purpose of the Act was to make possible, rather than to displace, state regulation, by eliminating evasion of state jurisdiction through the holding company device. The relevant exemptive provisions of Section 3 identify those types of holding company systems which are essentially equivalent to local operating

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17/ (continued)
shall be granted "unless and except to the extent" that the Commission finds that the exemption would be detrimental to the public interest or the interest of investors or consumers. But, as to the meaning of "public interest," see North American Company v. Securities and Exchange Commission, supra, 327 U.S. at 698-699; Municipal Electric Association of Massachusetts v. Securities and Exchange Commission, 413 F.2d 1052, 1056 (C.A.D.C., 1969); Alabama Electric Cooperative, Inc. v. Securities and Exchange Commission, 353 F.2d 906, 907 (C.A.D.C., 1965).

18/ City of Cape Girardeau v. Securities and Exchange Commission, C.A.D.C., No. 74-15901, (Sept. 22, 1975), affirming per curiam Union Electric Company, Holding Company Act Rel. 18368, 4 SEC Docket 89 (Apr. 10, 1974); see also Public Service Corporation of New Jersey, 27 S.E.C. 682 (1948); Northern States Power Co., 36 S.E.C. 1 (1954); National Utilities and Industries Corp., Holding Company Act Rel. 17857 (Jan. 11, 1973); Pacific Lighting Corporation, Holding Company Act Rel. 17855 (Jan. 11, 1973); Union Electric Company, 40 S.E.C. 1072 (1962); Delmarva Power & Light Co., Holding Company Act Rel. 19717, 10 SEC Docket 735 (Oct. 19, 1976).

companies and, as such, are subject to state and local jurisdiction. 19/

An example of a large system that is exempt under the intrastate standards of Section 3(a)(1) is Texas Utilities and its subsidiaries. Texas Utilities, the parent company, and all its operating utility subsidiaries, are Texas corporations, and the subsidiary operations are confined within the State of Texas. The exemptions for the three gas holding companies referred to in the Report (page 23) were granted on the basis of the same controlling facts.

For an exemption under Section 3(a)(2) (applying to a company that is predominantly an operating utility operating in contiguous states), the critical issue turns on the word "predominantly." The Commission has considered this issue in many decisions and has determined that the proper statutory criterion is the relative magnitude of the utility operations of the subsidiaries to the utility operations of the parent company. The case of Commonwealth Edison Co. is an excellent illustration of how essential it is that all operative facts must be considered to give content and meaning to the statutory standards of Section 3(a)(2).

Commonwealth Edison is a substantial electric utility which operates in the State of Illinois and is subject to the jurisdiction of the Illinois Commerce Commission. It is a holding company because it has an Indiana

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19/ Appendix A, attached hereto, is a revised presentation of the exempt electric holding companies listed in the Comptroller General's Report. Two of the companies contained in the Comptroller General's table on p. 23, Detroit Edison Company and Pacific Gas & Electric Company, are operating utilities which are not part of any holding company system. Of the other nine, eight are exempt under the standards of Section 3(a)(2). Focusing on mere size as such, the Report (page 23) incorrectly characterizes these exemptions as having been granted on "de facto" standards, but, as we have noted, exemptions from the Act are based on the explicit standards of Section 3.

subsidiary which generates energy for Commonwealth. In terms of operating and economic realities, Commonwealth Edison is an operating utility company and the subsidiary facility in Indiana, about 1 percent of the entire system, is a corporate extension of Commonwealth's generating capacity within the State of Illinois. The fact that Commonwealth itself is one of the largest utility companies in the country is irrelevant to the issue of whether it is entitled to an exemption from regulation under the Act.

Thus, the Table at page 22 of the Report notes that there were 20 exempt utility systems and 11 registered utility systems having more than $1 billion in assets in 1975. Two of the 20 were, in fact, not holding companies at all and the Table ignores the other large utility systems listed at page 17, supra, which are also not holding companies. 20/ The following tabulation gives a more balanced view of the very large electric systems in the industry:

Consolidated Assets 1975	Registered Systems	Exempt Systems	Operating Companies Not in Holding Company System
Above $5 billion	2	1	2
$3 billion -$5 billion	3	2	7
$1.5 billion - $3 billion	5	6	10
Over $1.5 billion	11	9	19

The Report repeatedly questions the propriety of exempting gas utility systems which also have production and pipeline companies (pages 14, 23, 28-30). But, the Report ignores special provisions of the Act which deal with the subject. Section 2(a)(4) of the Act defines a gas utility company as a company engaged in the distribution of gas "at retail" (emphasis supplied). Companies engaged

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20/ Section 2(a)(7)(A) of the Act defines a "holding company" as a company which has one or more public utility subsidiaries. Section 2(a)(5) defines a public utility company as an electric or gas utility company.

in pipeline transmission for sale at wholesale. accordingly, are not utility companies for purposes of the Act. 21/ Thus, the three registered holding company systems (identified at page 23 of the Report) 22/ have production and pipeline subsidiaries which, though nonutilities under the Act, are retainable in the holding company system under Section 11(b)(1) because of their functional relationship to their retail gas subsidiaries. 23/

The three exempt gas holding company systems (identified at page 23 of the Report), which also have functionally related production and pipeline subsidiaries, were granted exemptions under Section 3(a)(1) because their utility operations, the distribution of gas at retail, were intrastate. It would have been absurd to deny them the exemption under Section 3(a)(1), for which they were clearly qualified, merely because they have pipeline subsidiaries, which even registered systems may retain under the standards of Section 11(b)(1).

21/ Legislation with respect to pipeline companies was deferred until 1938. In that year Congress adopted the Natural Gas Act, which gives the Federal Power Commission jurisdiction over such companies with respect to rates and other matters.

22/ They are Columbia Gas System, Inc., Consolidated Natural Gas Co., and National Fuel Gas Co.

23/ Panhandle Eastern Pipeline Co. v. Securities and Exchange Commission, 170 F.2d 453 (C.A. 8, 1948).

IV. CURRENT ADMINISTRATION OF THE PUBLIC UTILITY HOLDING COMPANY ACT

Chapter 2 of the Comptroller General's Report broadly discusses numerous facets of the Commission's current administration of the Act. This chapter presents a cursory examination of the present level of the Commission's regulatory efforts under the Act and suggests, in essence, that the Commission is failing to fulfill its Congressional mandate by not enforcing certain of the Act's provisions. But examination and criticism of the Commission's regulatory efforts does not warrant the conclusion that the Commission has been derelict in fulfilling its responsibilities under the Act.

Chapter 2 of the Report contains, among other things, a subsection entitled, "Other Regulators Cannot Fulfill Commission Rsponsibilities," which briefly discusses the regulatory power of state and federal authorities (other than the Commission) over utility companies. The discussion in this subsection appears generally to challenge the Congressional policy that any regulation of companies which meet the exemptive tests of the Act should be carried out by the states and other federal authorities. 24/

The quotation on page 7 of the Report from an opinion of the Commission granting an exemption under Section 3(a)(1) of the Act merely recognizes the premise of Section 3(a)(1) that the operations of an intra-state holding company system can be effectively controlled by the state. The Report goes on to suggest, by describing the variations in state regulatory legislation, that such an exemption could be conditioned on a Commission finding as to

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24/ There is no serious question that the Commission's authority over registered holding company systems subject to the Act is, to a large degree, nonduplicative of the authority of state or other federal regulatory bodies.

the adequacy of state regulation. Presumably, a revocation of an exemption would be suggested if the state's regulatory policy should change. This interpretation would be tantamount to imposing uniform federal standards drawn from the Act on all state utility regulation, a proposition that would, if implemented, contravene the Congressional intent.

Chapter 2 of the Report also examines the process by which the Commission's staff reviews utility company financing proposals. In this regard, the Report questions the adequacy and breadth of the staff's review of such proposals. It should be noted, however, that the description at page 9 of the Report substantially understates the scope of staff reviews. Consideration of a financing proposal necessarily begins with the kind of ratio analysis described at page 9 and continues from there. 25/ In the early 1970's, after a long period when the regular financings of public utility systems had become almost routine, the staff found it necessary to seek budget forecasts in order to fit together escalating capital needs arising principally from construction requirements, bank borrowing limits, and permanent or long term financing programs.

Staff analysis does not have to start anew with each application because financing applications of companies subject to regulation under the Act involve, in effect, a continuing process of review, and are dealt with in the perspective of a regulatory updated future program. The information supplied by the applicant company is examined by experienced personnel

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25/ Contrary to the statement on page 9 of the Report—that the staff does not consider the need for additional facilities—that is one of the statutory issues under Section 7(d)(3) which is considered by the staff in its review of such proposals. See, e.g., Georgia Power Company, Holding Company Act Rel. 18517 at n. 5. 4 SEC Docket 665, 666 n. 5 (Jul. 31, 1974); Ohio Power Company, Holding Company Act Rel. 19502, 9 SEC Docket 515 (Apr. 27, 1976).

familiar with current developments and with the approaches to similar problems of other utilities. As a result of staff review of an initial application and of inquiries made to the applicant company, it is not uncommon for companies to amend their applications to include additional information requested by the staff and to make significant changes in the proposed transactions.

It is true that the staff does not purport to make an engineering or technical study of a registered system's planning. Each of the systems is a large enterprise, with a long history of serving its territory. Each maintains a large expert staff to do its planning. This type of planning depends in the final analysis on complex assumptions as to future market requirements and future costs. Long range forecasting of the need and cost of generating capacity to meet future load requirements, both industrial and residential, is not an exact science. Forecasts are necessarily modified or changed in light of developments, and, in fact, construction programs have been deferred, reduced or accelerated in light of more current data. We do not believe that field inspections and audits by our staff would produce in advance the significant modifications that utility planning committees gain in hindsight and as a result of actual experience.

Moreover, with respect to financing proposals, the Report overlooks the use of the evidentiary hearing as an additional and important fact-finding technique. In recent years, six major proceedings have been conducted of large holding company systems, which involved detailed examinations of the systems' operations and planning. The Commission's staff actively participates in these proceedings, directing particular attention to technological and economic factors. In fact, in two of these proceedings, the Commission

authorized the employment of independent expert witnesses to testify about the issues of size and economies of scale. 26/

Following the discussion of the staff's review of financing proposals, Chapter 2 concludes with a number of subsections discussing certain provisions of the Act relating to business practices, controlling influences, and size, 27/ and concludes that none of these issues is sufficiently being investigated by the Commission (pages 10-17). That contention appears to be premised upon the ground that the Commission has not implemented a program of continued surveillence through field investigations and inspections of companies' books and records to determine if holding companies are violating these provisions.

We question the extent to which a need exists for the implementation of a program of continued surveillence of the type suggested by the Report. Adoption by the Commission of the suggestion on page 11 of the Report that regular field audits are required to police compliance with Section 12 of the Act regarding business practices by registered systems would appear to be of limited benefit. Matters within the scope of that section, such as intercompany loans 28/ and dividend policy, are fully covered by the annual reports under the Act required to be filed with the Commission by registered companies, which are audited by independent accountants, and in the budget information regarding the registered systems and component

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26/ See American Electric Power Company, Administrative Proceeding No. 3-1476; Delmarva Power & Light Co., Holding Company Act Rel. 19717, 10 SEC Docket 735 (Oct. 19, 1976).

27/ With respect to the discussion of size in the Report, we have previously stated our views, supra, pages 13-18.

28/ Under Section 12(b) of the Act intercompany loans may be, and are, authorized.

companies that is also provided to the Commission. Moreover, intercompany transactions require prior approval of the Commission. 29/ The possibility of attempts to conceal such transactions appears minimal and would not appear to warrant the institution of a program of periodic audits by the staff in an effort to discover such activity. With respect to the possibility of political or other irregular payments by companies subject to the Act, there can be no serious question that the Commission would be concerned about such payments made by those companies, just as it is concerned about similar payments made by the other public companies which offer and sell securities to the investing public. 30/ But, it is doubtful that a program of the type of field inspections suggested by the Report could effectively uncover such payments.

29/ See Section 13(b) of the Act.

30/ It should be noted that, in the administration of the Act, the Commission has available to it those enforcement tools which it has used sucessfully in the administration of the other federal securities laws. Section 18(a) of the Act, which authorizes the Commission, in its discretion, to investigate any facts, conditions, or practices to determine whether any person has violated or is about to violate the Act or the rules and regulations promulgated thereunder, is substantially similar to provisions included in the various other federal securities laws administered by the Commission, see Section 20 of the Securities Act of 1933, 15 U.S.C. 77t; Section 21 of the Securities Exchange Act of 1934, 15 U.S.C. 78u; Section 321 of the Trust Indenture Act of 1939, 15 U.S.C. 77sss; Section 42 of the Investment Company Act of 1940, 15 U.S.C. 80a-41; Section 209 of the Investment Advisers Act of 1940. 15 U.S.C. 806-9. In addition, the staff has contact with other federal and state agencies and cooperates with such authorities through the exchange of information in order to facilitate administration of their respective mandates. Further, information regarding registered systems and their component companies is provided to the Commission by parties interested in and affected by the activities of such companies. The Report makes no mention of the fact that a major registered system—the American Electric Power Company—has publicly announced that it is the subject of a formal investigation under the Act by the Commission. See Form S-7 filed by Indiana & Michigan Electric Co., September 10, 1975, File No. 2-5-4433.

The Report also suggests a need to investigate "controlling influences."31/ The Act permits the Commission to find a company or an individual to be a holding company which exercises a controlling influence over a public utility company, even if that influence arises otherwise than through the statutorily defined stock interest. With respect to both registered systems and the major utility companies which are not part of registered systems, such investigations would appear unnecessary. These companies are large public companies and given their frequent public financings, the reports required to be filed with the Commission, and the other applicable requirements of the federal securities laws, the staff is provided with information sufficient to determine the existence of any "controlling influence" over these companies.

The information available to the Commission for small utility companies, which are principally retail gas companies, is not sufficient to determine the existence of "controlling influences." But this does not mean that the Report's suggestion for investigations of "controlling influences" is warranted as to these small companies. They are not only small, but they also are numerous and widely scattered; merely to identify them would involve

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31/ It should be noted that the case on page 12 of the Report (North Penn Gas Company, et al., Holding Company Act Rel. No. 19254, 8 SEC Docket 482 (Nov. 20, 1975) was not a "controlling influence" case. An individual who owned most of the stock of an exempt Pennsylvania gas holding company had been duly authorized under Sections 9(a)(2) and 10 to purchase a majority of the stock of a neighboring Pennsylvania gas company from its controlling stockholders. (John H. Ware, Holding Company Act Rel. No. 16319 (Mar. 20, 1969)). He undertook, at the time of the authorization, to consolidate this new company with the other companies and to provide for the minority shareholders. The proceeding referred to was directed to the form and terms of the consolidation and the price to be paid the minority shareholders.

collecting and examining the reports filed with about 50 state commissions. Extensive follow-up field investigations throughout the country might then be necessary to determine the existence of any controlling influence. As far as the Act is concerned, it appears that such a project might not be a provident use of public funds. In view of the lack of reliable national statistics on the retail gas business, this is an area in which Congress may desire such a study on broader grounds.

As a final matter, it should be noted that Section 17(c) of the Act explicitly regulates one important influence, whether or not controlling, on registered utility systems, by barring investment bankers or commercial bankers, with such exceptions as the Commission may authorize, 32/ from serving as directors or officers of registered systems. The rules adopted under Section 17(c) (17 CFR 250.70) effectively exclude all interlocking relationships with investment bankers, including securities dealers, and with the large commercial banks in major financial centers. 33/

32/ In general, the exceptions permit, within broad limits, officers and directors of registered systems to be directors of small banks or of banks within the system's service territory.

33/ In 1941, the Commission adopted Holding Company Act Rule 50, 17 CFR 250.50, which requires competitive bidding for securities issues of the registered holding companies and subsidiaries. Although the Rule had other objectives, one of its effects was to supplement the ban on overt affiliation of investment bankers as directors or officers by excluding other forms of influence by control of financing.

V. SERVICE AND FUEL COMPANIES

Section 13 of the Act, and rules thereunder, are directed to companies in a holding company system which sell goods or render services to the other system companies. Under Section 13(b), charges of service companies are limited to "cost."

Misuse of service companies was one of the major abuses to which the Act was directed and this subject received much attention during the reorganization phase of the Commission's administration of the Act. As a result, service companies were reduced in scope and required to operate in a well defined manner under comprehensive rules. For a long period of time, service company charges became a minor portion of the cost of utility service and the enforcement of Section 13 of the Act did not present a problem.

In recent years, because of the energy crisis, circumstances have changed. As a consequence, the Commission's staff has undertaken the necessary review, including five field inspections of service companies in registered systems, in order to assess the new issues and developments. While the involvement of electric utility companies in fuel supply antedated the Act and had been found to be functionally related to the operations of an integrated system, such involvement was generally insignificant during most of the history of the Act. Because both fuel and transportation were freely available on the open market, the electric utilities, as major and reliable consumers, were in a favored position, and had no need to acquire additional resources in these areas. This policy changed radically with the advent of the energy crisis, which has to be dealt with effectively and expeditiously, because utility companies must operate without interruption and cannot generate

electricity without a supply of fuel for the boilers. 34/

The Commission intentionally adopted no predetermined standards for fuel-related activities at the beginning of the program. The energy crisis was and still is rapidly developing, and virtually every registered system has its own views as to what should be done. Experiment and innovation were considered desirable. The Commission is moving toward a comprehensive approach on the basis of experience rather than on the basis of theory. 35/

Contrary to the statement on page 34 of the Report, specific applications have received very special attention, with a strong emphasis on technical and economic features. Other agencies were consulted, particularly with respect to representations as to transportation difficulties, a subject with which the staff had little experience. Full explanations were required as to the expected use of the fuel and as to reasons other sources had become unavailable. And, in the meantime, as has been noted, the staff is engaged in inspections of service companies, including fuel affiliates, in order to develop rules and a system of accounts and thus adapt Section 13 to current needs.

34/ The Report notes (pages 33-34) that 11 of the 14 registered systems and 18 of the 24 utility companies not subject to the Act made extensive investments in fuel and fuel-related projects. A closer analysis would show that the response of the large electric utility companies was virtually unanimous, as shown in the table on page 17, supra.

35/ State commissions are also confronted with the same problem in terms of ratemaking.

VI. RECOMMENDATION OF THE COMPTROLLER GENERAL THAT THE COMMISSION CONDUCT A STUDY OF THE DEVELOPMENTS IN THE GAS AND ELECTRIC UTILITY INDUSTRY.

As a final matter, it should be noted that the Comptroller General's Report recommends that the Commission conduct a thoroughgoing study of developments in the gas and electric industry in order to determine the continued usefulness of the Act and to evaluate the standards under the Act. In that connection the Comptroller General has specified four subject matter areas which should be examined in the recommended study. Based on the foregoing discussion, our specific responses are as follows:

1. Whether "the business practices of holding companies and the exercise of improper controlling influences upon them are or might be adequately monitored by State and Federal authorities under statutes not specifically addressed to utility holding companies."

A system controlling significant interrelated properties in more than one state cannot be fully regulated by a state, unless the transactions of the regulated company in that state with its associates can be reduced to a very narrow and simple compass. The exemptions provided in Section 3(a)(1) and Section 3(a)(2) correspond rather precisely to the inherent jurisdictional limitations on effective state regulation of a utility system. Nor would a Federal agency be able effectively to regulate a holding company system unless its statutory authority were to include the principal subjects dealt with by the Act. See pages 27-29, supra.

2. Whether "the act's standards governing the size and structure of gas and electric companies are currently appropriate."

The standards affecting the size and structure of electric or gas utility companies, such as the definitions of an integrated system in Section 2(a)(29), are couched in qualitative economic terms and expressly refer to relevant current conditions. Accordingly, such standards are not subject

to obsolescence. See pages 13-18, supra.

3. Whether "continuation of exemptions is detrimental to the public interest and whether the standards for granting exemptions need changing."

The exemptive provisions of Section 3(a) were designed to define the appropriate scope of federal regulation under the Act and have not been an obstacle to the Commission's efforts to eliminate the abuses which gave rise to this Act. Only if Congress should determine that broader federal regulation is required would it be appropriate to narrow the exemption provisions. Or perhaps such regulation should be predicated on some more comprehensive and relevant jurisdictional basis than holding company status. Our experience does not indicate a need for amending Section 3(a) or for changing the Commission's interpretations under that Section. See pages 19-23, supra.

4. Whether "it is in the public interest to permit public utility companies to engage in exploration, research, production, and long-distance transportation of fuel."

Both reliable fuel supplies and research and development are unquestionably essential to the continued operation of utility companies. The recent entry of utility companies into these fields was largely a response to the lack of reliable sources of fuel and transportation to serve new generating capacity. Alternative solutions would have to be based on studies over much broader fields than the utility industry such as the fuel and the railroad industry. See pages 31-32, supra.

APPENDIX II

APPENDIX A

RELEVANT STATISTICS OF LARGE EXEMPT COMPANIES
as of December 31, 1975

Company	Net Total Utility Plant (000s omitted) Amount	Percent	Operating Revenues (000s omitted) Amount	Percent	Status Exemption
Commonwealth Edison	$5,213,237	98.6	$1,710,537	99.3	3(a)(2)
subsidiaries	72,999	1.4	11,794	0.7	
	$5,286,236	100.0	$1,722,331	100.0	
Detroit Edison)	$3,934,752	100.0	$1,070,780	100.0	*
subsidiaries)					
Texas Utilities					3(a)(1)
Dallas Power & Light	$ 653,297	23.0	$ 225,701	25.4	
Texas Electric Service	879,323	31.0	259,620	29.2	
Texas Power & Light	1,308,474	46.0	398,136	44.8	
subsidiaries	-	-	5,279	0.6	
	$2,841,094	100.0	$ 888,736	100.0	
Pennsylvania Power & Light	$2,031,227	99.6	$ 538,699	99.0	3(a)(2)
subsidiaries	7,789	0.4	5,501	1.0	
	$2,039,016	100.0	$ 544,200	100.0	
Pacific Gas & Electric	$5,905,981	99.	$2,233,371	100.0	*
subsidiaries	12,191	0.2			
	$5,918,172	100.0			
Philadelphia Electric	$3,591,152	99.1	$1,128,526	99.4	3(a)(2)
subsidiaries	31,099	0.9	6,284	0.6	
	$3,622,251	100.0	$1,134,810	100.0	
Northern States Power	$1,847,434	91.0	$ 626,066	92.7	3(a)(2)
subsidiaries	182,055	9.0	49,290	7.3	
	$2,029,489	100.0	$ 675,356	100.0	
Union Electric	$1,789,655	90.4	$ 518,634	88.9	3(a)(2)
subsidiaries	188,989	9.6	64,821	11.1	
	$1,978,644	100.0	$ 583,455	100.0	
Public Service of Colorado	$1,125,182	97.3	$ 436,407	94.1	3(a)(2)
subsidiaries	30,935	2.7	27,221	5.9	
	$1,156,117	100.0	$ 463,628	100.0	
Cincinnati Gas & Electric	$1,081,075	92.9	$ 441,402	92.0	3(a)(2)
subsidiaries	82,218	7.1	38,466	8.0	
	$1,163,293	100.0	$ 479,868	100.0	
Wisconsin Electric Power	$ 790,338	73.2	$ 352,840	69.7	3(a)(2)
subsidiaries	289,699	26.8	153,728	30.3	
	$1,060,037	100.0	$ 506,568	100.0	

* Not a holding company.

SOURCE: Moody's Public Utility Manual (1976), Form 10-K of the respective companies, registration statements, and the Federal Power Commission's Statistics of Privately Owned Electric Utilities in the United States (1975).

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