

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The top bulb has a dark blue cap, and the bottom bulb has a light blue cap.

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*ELECTRICITY RESTRUCTURING BACKGROUND:
PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
(PUHCA)*

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Abstract. This report provides background on PUHCA, including its history and impact. It also discusses how PUHCA reform fits into the current electric utility industry restructuring debate.

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Electricity Restructuring Background: Public Utility Holding Company Act of 1935 (PUHCA)

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Summary

In 1935, the Public Utilities Holding Company Act (PUHCA) was enacted to eliminate unfair practices and other abuses by electricity and natural gas holding companies by requiring federal control and regulation of interstate public utility holding companies. These abuses arose from the inability of individual states to effectively regulate the financial transactions of multistate and multi-layered utility companies that evolved in the 1910s and 1920s.

PUHCA remained virtually unchanged for 50 years until the enactment of the Public Utility Regulatory Policies Act (PURPA). Enactment of PURPA and the Energy Policy Act of 1992 (EPACT) increased competition in the electric generating sector by creating new entities that generate and sell electricity at wholesale without being regulated as utilities under PUHCA. Success of these regulatory entities was made possible by new technologies, such as gas combined-cycle turbines. As a result of increasing competition in the industry, some groups are calling for additional PUHCA reform or repeal. Comprehensive legislation to restructure the electric utility industry, including PUHCA reform, was introduced in the 105th Congress, and the issue is expected to continue to be active in the 106th Congress.

This report provides background information on PUHCA, including its history and impact. It also discusses how PUHCA reform fits into the current electric utility industry restructuring debate. For related information on electricity restructuring, see CRS Report RL32728, *Electric Utility Regulatory Reform: Issues for the 109th Congress*.

Creation of the Public Utility Holding Company Act of 1935

From the very beginning of the U.S. electric power industry in the late 1800s, technology, economics, and regulations have defined the structure of the industry. At the end of the 1800s, transmission was by direct current (DC), involving large copper conductors. DC power could be transmitted economically only over short distances, requiring generation to be built close to its load. Introduction of a reliable alternating

current transmission system in 1903, which provided for long distance transmission at less cost than DC, and the introduction of steam turbine generation technology that was more efficient than reciprocating engines, produced a change of corporate structure. At the same time that economies of scale encouraged utility consolidation, utilities were acquiring increasing numbers of subsidiary companies, some with little or no relation to the utilities' primary business.

From 1900 through 1920 the number of private electric systems grew from approximately 2,800 to 6,500.¹ Starting in 1920, the number of private electric systems declined dramatically primarily because of consolidation and pyramiding of utilities through holding companies. Not only did many operating utilities, in diverse parts of the country, come under the control of a small number of holding companies, but those holding companies themselves were owned by other holding companies. As many as ten layers separated the top and bottom of some pyramids. By 1932, three groups controlled 45% of the electricity generated in the United States.

Although more than two-thirds of the states had public utility commissions of varying powers by 1920, none of these entities had the economic regulatory power of a modern public utility commission. The state public utility commissions were unable to control the multistate nature of holding companies. Prior to enactment of the Public Utilities Holding Company Act of 1935 (PUHCA), electric and gas holding companies were characterized as having excessive consumer rates, high debt-to-equity ratios, self-dealing, and increasingly unreliable service. A holding company parent was able to charge its associated utilities exorbitant amounts for services, such as construction of facilities, fuel supply, or billing. Excessive fees charged to operating companies were passed through to consumers as higher rates. Holding companies incurred increasing amounts of debt to finance their interests in a growing number of subsidiaries. The economics of generating and transmitting electricity had changed dramatically since 1900. Economies of scale were not been taken advantage of and the marginal costs (the cost of each additional unit of generation) were less than average cost. The classic monopoly situation existed.

Most highly leveraged holding companies that managed to stay solvent during the prosperous 1920s collapsed after the stock market crash because they could not service their debt. Lower demand for electricity resulted in inadequate revenue to meet fixed obligations. As more and more companies went bankrupt, service deteriorated. While there were advantages to the holding company structure, holding company abuses became apparent after the stock market crash in 1929 when investors lost millions of dollars. During the seven-year period between 1929 and 1936, 53 holding companies with combined securities of \$1.7 billion went into bankruptcy or receivership. Twenty-three others were forced to default on interest payments or to offer extension plans.²

¹ Messing, Marc. *Centralized Power: The Politics of Scale in Electricity Generation*. Oelgeschlager, Gunn and Hain. Cambridge, Massachusetts. 1979. p. 45.

² Philips, Charles F. *The Regulation of Public Utilities, Theory and Practice*. Public Utilities Reports, Inc. Arlington, VA. 1993. p. 239.

In 1928, the Federal Trade Commission issued a report that listed the abusive practices of holding companies.³ It concluded that the holding company structure was unsound and “frequently a menace to the investor or the consumer or both.” As noted earlier, holding companies operated with no federal and little state regulation. The state utility commissions lacked sufficient authority and resources to control holding companies because companies operated generally in many states and had extremely complex structures. The federal government decided regulatory action was required. The Federal Power Act, which established a federal utility regulatory system, was enacted at the same time as the Public Utility Act of 1935⁴; these two Acts were intended to work in tandem. Title I of the Public Utility Act of 1935 is known as the Public Utilities Holding Company Act of 1935 (PUHCA).

PUHCA was enacted to eliminate unfair practices and other abuses by electricity and gas holding companies by requiring federal control and regulation of interstate public utility holding companies. A regulatory bargain was created between utilities and the government. In exchange for an exclusive service territory, utilities are required to provide reliable electric service to all customers at a regulated rate. A holding company under PUHCA is an enterprise that directly or indirectly owns 10% or more of stock in a public utility company. To eliminate the complex and confusing structure of holding companies that had made them almost impossible to regulate, Section 11b of Title I (the “Death Sentence Clause”) of PUHCA abolishes all holding companies that were more than twice removed from their operating subsidiaries. All electric and natural gas holding companies are required to register with the Securities and Exchange Commission (SEC). Under PUHCA, the SEC regulates mergers and diversification proposals of holding companies whose subsidiaries engage in retail electricity or natural gas distribution. In addition, PUHCA requires that before purchasing securities or property from another company, a holding company must file for approval with the SEC.

Other major sections of PUHCA provide that:

- registered holding companies and their subsidiaries must have SEC approval prior to issuing securities;
- operating utilities are forbidden from making loans to their parent holding company; all loans and intercompany financial transactions are regulated by the SEC;
- the operations of non-exempt holding companies are limited to single and integrated public utility systems and to such businesses that are reasonably incidental or economically necessary or appropriate to the operations of such integrated systems; and,
- non-exempt holding companies that are subject to SEC regulation must maintain certain accounts and records, which are subject to SEC review.

The SEC does allow companies to operate in several areas if this preserves the economy of operation, or if the areas are located in a single state, adjoining states, or contiguous foreign country, and providing that the creation of such a holding company does not inhibit efficient operation or effective regulation.

³ FTC, Utility Corporation, Senate Document No. 92, 70th Congress, 1st session. (1928).

⁴ 49 Stat. 803 (1935), 15 U.S. Code §§79 *et seq.*

Effectiveness of PUHCA

After enactment of PUHCA, the SEC simplified and reorganized the complex financial and corporate structures of holding company systems, primarily by splitting electricity and gas operations. Between 1938 and 1962, 2,419 electric and gas distribution utilities came under the jurisdiction of the Securities and Exchange Commission, either as registered holding companies or as subsidiaries. Of these companies, 928 were subject to divestiture.⁵

Currently, most holding companies are exempt from PUHCA because they operate intrastate. Under section 3(a)(1), a holding company may be exempt from PUHCA if its business operations and those of its subsidiaries occur within one state. Exemption under section 3(a)(2) can be granted when the holding company is a public utility that operates within the state in which it is organized or within contiguous states. Holding companies can gain exemption from PUHCA under Section 3(a)(1) or 3(a)(2) unless the SEC determines that such an exemption would be “detrimental to the public interest or the interest of investors or consumers.” An exemption can also be revoked by the SEC for the same reason. Companies that are considered exempt from PUHCA are still subject to state regulation. Holding companies that are registered under PUHCA engage in interstate activity and/or they are diversified into industries other than electricity and gas.

As of November 1, 1997, 151 holding companies, with total assets of \$444 billion, are exempt by rule or order from PUHCA. As of September 30, 1996, 12 non-exempt electric holding companies had combined consolidated assets of \$125 billion (18% of entire electric systems assets). As the electric utility industry has become more concentrated through merger and acquisition activity, the number of non-exempt (registered) holding companies has increased. By December 31, 1997, 19 electric and gas holding companies with combined assets of \$180 billion were registered under PUHCA, 26% of the electric industry assets and 24% of the gas industry assets.⁶

PUHCA and Restructuring

Enactment of the Public Utility Regulatory Policies Act of 1978 (PURPA) and the Energy Policy Act of 1992 (EPACT) increased competition in the electric generating sector by creating new entities that generate and sell electricity at wholesale without being regulated as utilities under PUHCA.⁷ Success of these regulatory entities was made

⁵ Phillips, p. 634.

⁶ According to the SEC, the 19 registered electric(E) and gas (G) holding companies are: Allegheny Energy (E), Ameren (E & G), American Electric Power Company (E), Central and Southwest Corporation (E), Cinergy Corporation (E & G), Columbia Energy Group (G), Conectiv (E & G), Consolidated Natural Gas Company (G), Eastern Utilities Associates (E), Entergy Corporation (E), GPU Corporation (E), Interstate Energy Corporation (E & G), National Fuel Gas Company (G), New Century Energies (E & G), New England Electric System (E), Northeast Utilities (E), PECO Energy Power Company (E), Southern Company (E), Unital Company (E & G).

⁷ For a discussion on EPACT and PURPA, see Abel, Amy. Electricity Restructuring Background: the Public Utility Regulatory Policies Act 1978 and the Energy Policy Act of 1992. (continued...)

possible by new technologies, such as gas combined-cycle turbines. These generators are smaller than typical baseload facilities, allowing them to compete economically in the power market. Once again, marginal costs were below average costs. However, the economies of scale argument, which was once used as a rationale for a monopoly situation, no longer exists.

Comprehensive legislation to restructure the electric utility industry was introduced in the 105th Congress and is expected to continue to be an active issue in the 106th Congress. Proposals to increase competition in the electric utility industry involve segmenting the industry into three functions-- generation, transmission and distribution. Generation would be subject to competition, while transmission and distribution would be subject to federal and state regulation, respectively. This type of restructuring would permit retail consumers to choose their electricity generators. In addition, most comprehensive electric utility restructuring legislation addresses PURPA's mandatory purchase requirements, and retail competition, as well as PUHCA reform (see CRS Issue Brief IB10006, *Electricity: The Road Toward Restructuring*).

As the restructuring debate has evolved, utilities and the SEC have called for reform or repeal of PUHCA, asserting that PUHCA has achieved what it was designed to do and, it is argued, PUHCA discourages competition. Calls for PUHCA reform are not new. In the 1980s, utilities sought to diversify in order to exploit the benefits of independent power producers under PURPA. In 1982, the SEC recommended to Congress that PUHCA be repealed. Repeal legislation was not passed in the 1980s in part due to concerns about consumer protection. In 1995, the SEC concluded a study of the regulation of public utility holding companies. The SEC called for a conditional repeal of the Public Utility Holding Company Act, with a transition period. The SEC:

...believes that the Act [PUHCA] continues to play a role in protecting energy consumers. Most importantly, the SEC can obtain, audit and oversee a multistate holding company system's books and records, particularly in regard to affiliate transactions.... Past efforts to repeal the Act were unsuccessful largely because they failed to account for the continuing importance of this aspect of the regulatory scheme.

In following the [repeal] option preferred by the Division [SEC], Congress would repeal the Holding Company Act, including its limits on financing and geographic and business diversification. At the same time, Congress would enact new provisions to ensure access to books and records required for the effective discharge of a state's regulatory responsibilities and to establish federal audit authority and oversight of intrasystem transactions. The task of carrying out these provisions logically should be given to the federal agency that most directly protects energy consumers, the Federal Energy Regulatory Commission.⁸

⁷ (...continued)

98-419 ENR. May 4, 1998.

⁸ The Regulation of Public-Utility Holding Companies. Division of Investment Management, Securities and Exchange Commission. Washington, D.C. June 1995. p 7. (continued...)

The main argument for PUHCA reform has been that its provisions are antiquated and PUHCA has already achieved its goal by making holding companies manageable. Moreover, it is argued that various other regulations since PUHCA's enactment have been instituted to prevent holding company abuse. An additional argument for PUHCA reform has been made by electric utilities that want to further diversify their assets. Electric utilities contend that reform would allow utilities to improve their risk profiles through diversification in much the same way as in other businesses: the risk of any one investment is diluted by the risk associated with all investments. Utility holding companies that have been exempt from SEC regulation argue that PUHCA discourages diversification because the SEC could repeal exempt status if the exemption would be "detrimental to the public interest." Also, it is argued that PUHCA places consumers at a disadvantage by inhibiting competition in the electric utility industry.⁹

Opponents of PUHCA repeal, including some consumer groups, state regulators, the American Public Power Association¹⁰, and small business groups, argue that until the industry completes its transition to a competitive market, PUHCA's regulations are needed to protect consumers.¹¹ Arguments against stand-alone PUHCA repeal include:

- concerns over market power (large utilities with numerous market advantages could inhibit competition);
- PUHCA guards against monopolies and anti-competitive behavior;
- possible increased risk of cross-subsidization between a regulated portion of utility holding company business and their unregulated business activities; and,
- concern that states will lack authority or resources to monitor interstate holding company activities.

In addition to being proposed in stand-alone legislation, PUHCA reform has been included in comprehensive electric restructuring legislation. Some argue that if comprehensive legislation adequately deals with possible market power abuses that could arise under a new system, as well as transitional issues that may be created in moving from a regulated generating sector to a competitive deregulated generation sector, PUHCA could be eliminated for electric utilities. However, if Congress chooses a less comprehensive approach, decisions will have to be made as to how much of the current PUHCA might be needed to protect consumers in a more competitive environment, and whether a conditional repeal is appropriate.

⁸ (...continued)

[<http://www.sec.gov/news/studies/puhc.txt>]

⁹ For the views of Edison Electric Institute, an Association representing investor-owned utilities, see [<http://www.eei.org/Industry/structure/9puhca.htm>].

¹⁰ [<http://www.appanet.org/ppeui/3-6statement.html#Intro>]

¹¹ For a set of views against PUHCA repeal, see [<http://www.citizen.org/cmep/restructuring/puhca/otherssay.htm>].