

THE ELECTRIC SUPPLY AND TRANSMISSION ACT OF 2001

HEARINGS

BEFORE THE
SUBCOMMITTEE ON ENERGY AND AIR QUALITY
OF THE

COMMITTEE ON ENERGY AND
COMMERCE

HOUSE OF REPRESENTATIVES

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THE ELECTRIC SUPPLY AND TRANSMISSION ACT OF 2001

THURSDAY, DECEMBER 13, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON ENERGY AND AIR QUALITY,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2123, Rayburn House Office Building, Hon. Joe Barton (chairman) presiding.

Members present: Representatives Barton, Largent, Whitfield, Ganske, Norwood, Shimkus, Fossella, Bryant, Walden, Tauzin (ex officio), Boucher, Sawyer, Wynn, John, Waxman, Markey, Gordon, McCarthy, and Dingell (ex officio).

Staff present: Jason Bentley, majority counsel; Sean Cunningham, majority counsel; Andy Black, policy coordinator; Sue Sheridan, minority counsel; and Eric Kessler, minority professional staff.

Mr. BARTON. The subcommittee will come to order. Today is a continuation of 2 days of hearings on the Electric Supply and Transmission Act of 2001. These are legislative hearings on a pending bill, H.R. 3406, preparing to go to markup next week.

Today we have two panels. Our first panel is our executive branch witnesses. We have the Honorable Isaac Hunt, who is the Commissioner of the Securities and Exchange Commission; and we have the Honorable Sandra Hochstetter, who is Chairman of the Arkansas Public Service Commission. She is appearing on behalf of the National Association of Regulatory Utility Commissioners, better known as NARUC.

Lady and gentleman, welcome. Your statement is in the record in its entirety. We are going to recognize you, Commissioner Hunt, to elaborate on your statement for 6 minutes; and then we will recognize the Chairwoman Hochstetter to elaborate on her statement. Welcome to the subcommittee.

STATEMENTS OF HON. ISAAC C. HUNT, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION; AND HON. SANDRA L. HOCHSTETTER, CHAIRMAN, ARKANSAS PUBLIC SERVICE COMMISSION, ON BEHALF OF NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. HUNT. Thank you, Mr. Chairman, Ranking Member Boucher, and members of the subcommittee. I am Commissioner Isaac C. Hunt, Jr., of the U.S. Securities and Exchange Commission. I am pleased to have this opportunity to testify before you on behalf of

the Commission about H.R. 3406 and the SEC's continuing support for repeal of the Public Utility Holding Company Act of 1935.

The SEC continues to support efforts to appeal the 1935 Act and replace it with legislation that preserves certain important consumer protections. In considering repeal, it is useful to review both the history that led Congress to enact the Act in 1935 and the changes that have occurred in the electric industry since then.

During the first quarter of the last century misuse of the holding company structure led to serious problems in the electric and gas industry. Abuses arose, including inadequate disclosure of the financial position, and earning power of holding companies, unsound accounting practices, excessive debt issuances, and abusive affiliate transactions.

The 1935 Act was enacted to address these problems. In the years following the passage of the Act the SEC worked to reorganize and simplify existing public utility companies in order to eliminate the problems that Congress identified.

By the early 1980's the SEC concluded that the 1935 Act had accomplished its basic purpose and that many aspects of it had become redundant with other Federal and State regulation.

In addition, changes in the accounting profession and in the investment banking industry had provided investors and consumers with a range of protections unforeseen in 1935. Because of these changes the SEC unanimously recommended that Congress repeal the 1935 Act based on its conclusion that it was no longer necessary to prevent the recurrence of the abuses that led to the Act's enactment.

For a number of reasons, including the potential for abuse through the use of a multi-State holding company structure, related concerns about consumer protection, and the lack of a consensus for change, repeal legislation was not enacted during the early 1980's.

Because of continuing changes in the industry, however, the SEC continued to look at ways to administer the statute more flexibly. In response to continuing changes in the utility industry during the early 1990's, then Chairman Arthur Levitt directed the SEC staff in 1994 to undertake a study of the 1935 Act that culminated in a June 1995 report.

That report again recommended repeal of the 1935 Act, or amendment of the Act to give the SEC broad exemptive authority to administer the Act.

The June 1995 report also outlined and recommended that the Commission adopt a number of administrative initiatives to streamline regulation under the Act. The SEC has implemented many of these initiatives.

The utility industry has continued to undergo rapid change since publication of the report. Congress facilitated some of these changes. Specifically the Energy Policy Act of 1992 added statutory exemptions to the 1935 Act, which allow holding companies to own exempt wholesale generators and foreign utility companies and allow registered holding companies to engage in a wide range of telecommunication activities.

Based on the findings in 1995, as well as the continuing pace of change in the industry, the SEC continues to recommend that Congress repeal the 1935 Act, subject to appropriate safeguards.

Repeal of the Act is not, however, a magical solution to the current energy problems in the United States. While it can be viewed as a part of a needed response, repeal will not directly affect the supply of electricity due to the fact that the Energy Policy Act, as I just mentioned, removed restrictions under the Act for investment and generation facilities.

Repeal of the Act would, however, remove provisions that prohibit utility companies from owning utilities in different parts of the country, and generally prevent non-utility businesses from acquiring utilities in more than one State.

If the 1935 Act were repealed, the greatest impacts would probably be the continuing consolidation of the utility industry, as well as the entry of new companies into the utility business.

Repeal of the Act would also eliminate any impediments that exist to other regulators' attempts to modernize regulation of the utility industry. For example, the FERC recently implemented new regulations designed to create independent regionally operated transmission grids.

As a result of FERC's new regulations, many utilities will cede operating control, and in some cases actual ownership, of their transmission facilities, to newly created entities.

The status of both the new entities that will control these systems, and the status of the utility companies that will own stakes in the new entities, raise a number of issues under the 1935 Act.

Most notably, it has been asserted that the limits the Act places on the other business activities of a utility holding company will create obstacles for non-utility companies to invest in or operate these new transmission entities.

The SEC believes that it has the necessary authority under the Act to deal with the issues created by FERC's restructuring without impeding that restructuring. Nevertheless, repeal of the Act would effectively resolve these issues.

In conclusion, let me emphasize that the SEC takes seriously its duties to administer faithfully the letter and spirit of the 1935 Act and is committed to promoting the fairness, liquidity, and efficiency of the United States securities markets.

By supporting conditional repeal of the 1935 Act, the SEC hopes to reduce unnecessary regulatory burdens on America's energy industry while providing adequate protections for energy consumers. Mr. Chairman and Members, I would be pleased to answer your questions.

[The prepared statement of Hon. Isaac C. Hunt, Jr. follows:]

PREPARED STATEMENT OF HON. ISAAC C. HUNT, JR., COMMISSIONER, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman Barton, Ranking Member Boucher, and Members of the Subcommittee: I am pleased to have this opportunity to testify before you on behalf of the Securities and Exchange Commission ("SEC") regarding H.R. 3406 and the SEC's continuing support for repeal of the Public Utility Holding Company Act of 1935 ("PUHCA" or "1935 Act"). In particular, because much of the regulation required by PUHCA is either duplicative of that done by other regulators or unnecessary in the current environment, the SEC continues to support repeal of PUHCA. H.R. 3406 would accomplish the goal of eliminating duplicative and unnecessary regulation. As

the SEC has testified in the past, however, we continue to believe that repeal should be accomplished in a manner that also preserves important protections for consumers of utility companies in multistate holding company systems.

I. INTRODUCTION

To understand the SEC's position on repeal of PUHCA, it is useful to review both the history that led Congress to enact PUHCA in 1935 and the changes that have occurred in the electric industry since then. During the first quarter of the last century, misuse of the holding company structure led to serious problems in the electric and gas industry. These abuses included inadequate disclosure of the financial position and earning power of holding companies, unsound accounting practices, excessive debt issuances and abusive affiliate transactions. The 1935 Act was enacted to address these problems.¹ The Act also placed restrictions on the geographic scope of holding company systems and limited holding companies to activities related to their gas or electric businesses. Because of its role in addressing issues involving securities and financings, the SEC was charged with administering the Act. In the years following the passage of the 1935 Act, the SEC worked to reorganize and simplify existing public utility holding companies in order to eliminate abuses.

By the early 1980s, however, many aspects of the 1935 Act regulation had become redundant: state regulation had expanded and strengthened since 1935, and the SEC had enhanced its regulation of all issuers of securities, including public utility holding companies. Changes in the accounting profession and the investment banking industry also had provided investors and consumers with a range of protections unforeseen in 1935. The SEC therefore concluded that the 1935 Act had accomplished its basic purpose and that many of its remaining provisions were either duplicative or were no longer necessary to prevent the recurrence of the abuses that had led to the Act's enactment. The SEC thus unanimously recommended that Congress repeal the Act.²

For a number of reasons—including the potential for abuse through the use of a multistate holding company structure, related concerns about consumer protection, and the lack of a consensus for change—repeal legislation was not enacted during the early 1980s. Because of continuing change in the industry, however, the SEC continued to look at ways to administer the statute more flexibly.

In response to continuing changes in the utility industry during the early 1990s, and the accelerated pace of those changes, in 1994, then-Chairman Arthur Levitt directed the SEC's Division of Investment Management to undertake a study, under the guidance of then-Commissioner Richard Y. Roberts, to examine the continued vitality of the 1935 Act. The study was undertaken as a result of the developments noted above and the SEC's continuing need to respond flexibly in the administration of the 1935 Act. The purpose of the study was to identify unnecessary and duplicative regulation, and at the same time to identify those features of the statute that remain appropriate in the regulation of the contemporary electric and gas industries.³

The SEC staff worked with representatives of the utility industry, consumer groups, trade associations, investment banks, rating agencies, economists, state, local and federal regulators, and other interested parties during the course of the study. In June 1995, a report of the findings made during the study ("Report") was issued. The staff's Report outlined the history of the 1935 Act, described the then-current state of the utility industry as well as the changes that were taking place in the industry, and again recommended repeal of the 1935 Act. The Report also

¹ See 1935 Act section 1(b), 15 U.S.C. § 79a(b).

² See *Public Utility Holding Company Act Amendments: Hearings on S. 1869, S. 1870 and S. 1871 Before the Subcomm. On Securities of the Senate Comm. On Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 359-421 (statement of SEC).

³ The study focused primarily on registered holding company systems. There were, at the time of the study, 19 such systems. The 1935 Act was enacted to address problems arising from multistate operations, and reflects a general presumption that intrastate holding companies and certain other types of holding companies, which the 1935 Act exempts and which now number 119, are adequately regulated by local authorities. Despite their small number, registered holding companies account for a significant portion of the energy utility resources in this country. As of September 30, 2001, the 27 registered holding systems (which included 35 registered holding companies) owned 133 electric and gas utility subsidiaries, with operations in 44 states, and in excess of 2500 nonutility subsidiaries. In financial terms, as of September 31, 2001, the 27 registered holding company systems owned more than \$417 billion of investor-owned electric and gas utility assets and received in excess of \$173 billion in operating revenues. The 27 registered systems represent over 40% of the assets and revenues of the U.S. investor-owned electric utility industry and almost 50% of all electric utility customers in the United States.

outlined and recommended that the Commission adopt a number of administrative initiatives to streamline regulation under the Act.

Since the report was published, the utility industry in the United States has continued to undergo rapid change. Some of these changes have been facilitated by Congress. Specifically, as a result of recently-created statutory exemptions, anyone, including registered and exempt holding companies, is now free to own exempt wholesale generators and foreign utilities and to engage in a wide range of telecommunication activities.⁴ In addition, the SEC has implemented many of the administrative initiatives that were recommended in the Report.⁵

III. REPEAL OF PUHCA

Based on the findings in the Report as well as the continuing pace of change in the utility industry, the SEC continues to recommend that Congress repeal the 1935 Act subject to appropriate safeguards.⁶ As the Report stated, regulation under the 1935 Act that affects the ability of holding company systems to issue securities, acquire other utilities, and acquire nonutility businesses is largely redundant in view of other existing regulation and controls imposed by the market.⁷ Repealing the Act is not, however, a magic solution to the current problems facing the U.S. utility industry. PUHCA repeal can be viewed as part of the needed response to the current energy problems facing the country—notably, the Administration's recent report on energy policy includes a recommendation that PUHCA be repealed.⁸ But repeal of the Act will not, for example, have any direct effect on the supply of electricity in

⁴Sections 32 and 33 of the Act, which were added to it by the Energy Policy Act of 1992, permit, subject to certain conditions, the ownership of exempt wholesale generators and foreign utility companies. The impact of section 32 on the electricity industry is discussed in more detail below. Section 34, which was added by the Telecommunications Act of 1996, permits holding companies to acquire and retain interests in companies engaged in a broad range of telecommunication activities.

⁵The Report recommended rule amendments to broaden exemptions for routine financings by subsidiaries of registered holding companies (*see* Holding Co. Act Release No. 26312 (June 20, 1995), 60 FR 33640 (June 28, 1995)) and to provide a new exemption for the acquisition of interests in companies that engage in energy-related and gas-related activities (*see* Holding Co. Act Release No. 26667 (Feb. 14, 1997), 62 FR 7900 (Feb. 20, 1997) (adopting Rule 58)). In addition, the Report recommended and the SEC has implemented changes in the administration of the Act that would permit a "shelf" approach for approval of financing transactions. For example, during calendar year 2000, all eleven of the new registered holding companies received multi-year financing authorizations that included a wide range of debt and equity securities. The Report further recommended a more liberal interpretation of the Act's integration requirements which has been carried out in our merger orders. The Report also recommended an increased focus upon auditing regulated companies and assisting state and local regulators in obtaining access to books, records and accounts. Six state public utility commissions participated in the last three audits of the books and records of registered holding companies.

⁶We do, however, have a concern about coupling PUHCA repeal with provisions that would provide unique regulatory benefits to small groups of companies under other statutes that the Commission administers. Section 125 of H.R. 3406 raises this concern. Section 125 appears to address a unique set of circumstances that give rise to questions about the status of an issuer as an "investment company" under the Investment Company Act of 1940. The Investment Company Act already provides the Commission with significant flexibility to deal with status issues. We therefore see no reason for legislation to deal with such issues. More broadly, we are prepared to work with any utility holding companies currently relying on the exemption from the definition of "investment company" provided by section 3(c)(8) of the Investment Company Act if repeal of PUHCA leads to questions about their status under the Investment Company Act.

⁷As we have testified previously, however, there is a continuing need to protect consumers. Although deregulation is changing the way utilities operate in some states, electric and gas utilities have historically functioned as monopolies whose rates are regulated by state authorities. Some regulators subject these rates to greater scrutiny than others. There is a continuing risk that a monopoly, if left unguarded, could charge higher rates and use the additional funds to subsidize affiliated businesses in order to boost its competitive position in other markets. Thus, so long as electric and gas utilities continue to function as monopolies, the need to protect against this type of cross-subsidization will remain. In view of the sophistication of contemporary securities regulation, and analysis by the public and private sectors, the best means of guarding against cross-subsidization is likely to be audits of books and records and federal oversight of affiliate transactions. The SEC therefore continues to recommend the enactment of legislation to provide necessary authority to the FERC and the state public utility commissions relating to affiliate transactions, audits and access to books and records, for the continued protection of utility consumers. More broadly, repeal of the 1935 Act may be accomplished either separately or as part of a more comprehensive package of energy reform legislation. The SEC does not have a preference as to whether the Act is repealed on a stand-alone basis or as part of broader, energy-related legislation.

⁸*See* National Energy Policy: Report of the National Energy Policy Development Group at 5-12 (May 2001) (recommending the reform of "outdated federal electricity laws, such as the Public Utility Holding Company Act").

the United States. The Act does not, for example, currently place significant restrictions on the construction of new generation facilities. As part of the Energy Policy Act, Congress amended the Act in 1992 to remove most restrictions on the ability of registered and exempt holding companies (as well as nonutility companies) to build, acquire and own generating facilities anywhere in the United States. These types of facilities—exempt wholesale generators or “EWGs”—are not considered to be electric utility companies under PUHCA, and, in fact, are exempt from all provisions of PUHCA. The only limitation that remains under PUHCA is one imposed by Congress on registered holding companies—namely, that a registered company may not finance its EWG investments in a way that may “have a substantial adverse impact on the financial integrity of the registered holding company system.”⁹ In short, the Energy Policy Act removed restrictions on the ability of registered and exempt holding companies to build, acquire and own generating facilities anywhere in the United States. As a result, a number of registered holding companies now have large subsidiaries that own generating facilities nationwide. Numerous other companies not subject to the Act have also entered the generation business.¹⁰

Instead, repeal of the Act would eliminate regulatory restrictions that prohibit utility holding companies from owning utilities in different parts of the country and that prevent nonutility businesses from acquiring regulated utilities. In particular, repeal of the restrictions on geographic scope and other businesses would remove the impediments created by the Act to capital flowing into the industry from sources outside the existing utility industry. Repeal would thus likely have the greatest impact on both the continuing consolidation of the utility business as well as the entry of new companies into the utility business.

Repeal of the Act would also eliminate any impediments that exist to other regulators’ attempts to modernize regulation of the utility industry. For example, during the past year, questions have arisen about how the Act will impact the ability of the Federal Energy Regulatory Commission (“FERC”) to implement its plans to restructure the control of transmission facilities in the United States.¹¹ Specifically, in order to “ensure that electricity consumers pay the lowest price possible for reliable service,” the FERC recently implemented new regulations designed to create “independent regionally operated transmission grids” that are meant to “enhance the benefits of competitive electricity markets.”¹² As a result of FERC’s new regulations, many utilities will cede operating control—and in some cases, actual ownership—of their transmission facilities to newly-created entities. The status of these entities, as well as the status of utility systems or other companies that invest in them, raise a number of issues under the Act. Most prominently, it has been asserted that the limits the Act places on the other businesses in which a utility holding company can engage will create obstacles for nonutility companies that may wish to invest in or operate these new transmission entities.

The SEC believes it has the necessary authority under the Act to deal with the issues created by the FERC’s restructuring without impeding that restructuring. Nonetheless, repeal of the Act would effectively resolve these issues.

The SEC takes seriously its duties to administer faithfully the letter and spirit of the 1935 Act and is committed to promoting the fairness, liquidity, and efficiency of the United States securities markets. By supporting conditional repeal of the 1935 Act, the SEC hopes to reduce unnecessary regulatory burdens on America’s energy industry while providing adequate protections for energy consumers.

Mr. BARTON. Thank you, Commissioner.

⁹While no Commission approval is required for the acquisition of an EWG as a result of the Energy Policy Act, Commission approval is required, for example, before a registered holding company can issue securities to finance the acquisition of, or guarantee securities issued by, an EWG. Under the Energy Policy Act, Congress directed the SEC to adopt rules with respect to registered holding companies’ EWG investments. Pursuant to these requirements, in 1993 the SEC adopted rules 53 and 54 to protect consumers and investors from any substantial adverse effect associated with investments in EWGs. Rule 53 created a partial safe harbor for EWG financings. Rule 53 describes circumstances in which the issue or sale of a security for purposes of financing the acquisition of an EWG, or the guarantee of a security of an EWG, will be deemed not to have a substantial adverse impact on the financial integrity of the system. For transactions outside the Rule 53 safe harbor, a registered holding company must obtain SEC approval of the amount it wishes to invest in EWGs. The standards that the SEC uses in assessing applications of this type are laid out in Rule 53(c).

¹⁰See, e.g., National Energy Policy: Report of the National Energy Policy Development Group at 5-11 (May 2001) (noting that “[m]ost new electricity generation is being built not by regulated utilities, but by independent power producers”).

¹¹See FERC Order 2000, “Regional Transmission Organizations,” 65 FR 810 (Jan. 6, 2000) (codified at 18 C.F.R. § 35.34).

¹²Order 2000, 65 FR at 811.