

# ENERGY LAW JOURNAL

Volume 27, No. 1

2006

## PUHCA'S GONE: WHAT IS NEXT FOR HOLDING COMPANIES?

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On February 8, 2006, the repeal of the Public Utility Holding Company Act of 1935 (PUHCA) became effective.<sup>1</sup> PUHCA repeal comes seventy years after the statute was enacted and over a quarter century after the Securities and Exchange Commission (SEC), the agency charged with administering PUHCA, concluded that PUHCA had outlived its purpose and first recommended that it be repealed. The story of PUHCA is a reflection of the U.S. industrial revolution in the twentieth century, the growth of financial markets and the increased sophistication of regulatory agencies and institutions necessary to keep abreast of an increasingly complex industry. PUHCA's repeal is an acknowledgement that the modern electric and gas industry requires a newer, less heavy-handed regulatory approach. It also marks the beginning of a new era of holding company regulation. The Federal Energy Regulatory Commission (FERC), has been granted limited new authority over holding companies in the Public Utility Holding Company Act of 2005 and in amendments to section 203 of the Federal Power Act as part of the Energy Policy Act of 2005 (EPAAct 2005). State regulators also generally have had jurisdiction over many kinds of transactions involving utilities and holding companies for some time but will no longer have the backstop of SEC regulation to lean on. It remains to be seen whether PUHCA's demise will usher in a new era of consolidation for electric and gas utilities.

PUHCA was widely believed to have discouraged investment in electric and gas utility infrastructure by companies that could not restructure to satisfy PUHCA's prohibition on the ownership of diversified businesses. PUHCA also prohibited combinations of electric and gas utility companies that were not located in the same region, coordinated, and additionally for electric utilities, interconnected.<sup>2</sup> These PUHCA restrictions, in combination with the FERC's competition policy that discourages electric utility combinations in the same market, have made it difficult to complete utility acquisitions. Principally

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1. Section 1263 of the Energy Policy Act of 2005 (EPAAct 2005), repealed PUHCA, with an effective date of six months after the enactment of EPAAct 2005. Energy Policy Act of 2005, Pub. L. No. 109-58, §§ 1264, 1274(a), 119 Stat. 594.

2. Public Utility Holding Company Act of 1935 §§ 2(a)(29), 11, 15 U.S.C. §§ 79(b), (k) (repealed 2005). See also *Nat'l Rural Elec. Coop. Ass'n v. Sec. & Exch. Comm'n*, 276 F.3d 609 (D.C. Cir. 2002) (remanding merger of American Electric Power Co. and Central and South West Corp. to the SEC for further explanation of how the combination satisfied the PUHCA interconnection and single area or region requirements).

because of PUHCA, the U.S. electric and gas utility industry has remained relatively fragmented for many decades.

PUHCA repeal means that electric and gas utility acquisitions face one fewer regulatory hurdle. Many more investors, including those that traditionally did not invest in the energy industry, can participate in utility ownership. This is a positive change that should lead to a more vibrant and resilient industry and better service at a lower cost. PUHCA repeal, however, also means that the FERC, state utility commissions, credit rating agencies and others must adjust to a new regulatory environment. The SEC will no longer be regulating holding company systems and attempting to protect public utility company subsidiaries from the dangers of unsound capital structures, affiliate transactions abuses and misadventures in diversification.

Over the coming months utility regulators will evaluate whether the repeal of PUHCA has caused a regulatory gap and, if so, how to best address the gap. Should the FERC re-create PUHCA through rules based largely on its Federal Power Act and Natural Gas Act authority to protect the ratepayers of public utilities and natural gas companies? Should the FERC try “cooperative federalism” and work more closely with state public utility commissions through audits and policy development?<sup>3</sup> Will the FERC’s primary jurisdiction over public utilities and natural gas companies cause it to focus on building appropriate structural and financial protections around utility subsidiaries (i.e., ring-fencing), while leaving holding companies relatively unregulated? Finally, if the FERC’s response is not seen to be effective, will state commissions move to adopt regulatory policies and promote the adoption of new laws to address perceived gaps created by PUHCA repeal?

The regulatory balance has shifted. Utility holding companies and investors are unencumbered and have new investment options. The FERC and state utility regulators, who for the most part lack jurisdiction over holding companies, should be reviewing their existing rules and policies to ensure that electric and gas utilities subject to their jurisdiction are adequately insulated from potential holding company risks.<sup>4</sup> Holding company management should be engaged in the same exercise to determine how it can insulate utility operations from other

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3. Section 209 of the Federal Power Act (FPA), and section 17 of the Natural Gas Act (NGA), provide a mechanism for the FERC and state commissions to work cooperatively on matters arising under the acts through a board composed of persons nominated by the various state commissions and appointed by the FERC. Federal Power Act § 209, 16 U.S.C. § 824(h) (2000); Natural Gas Act § 17, 15 U.S.C. § 717(p) (2000). *See also* Comments of the National Association of Regulatory Utility Commissioners, FERC Docket No. RM05-32-000, at 3 (2005) (“In addition, NARUC recommends that the Commission institute procedures for periodic audits to eliminate the negative impacts of any inappropriate transactions and allocations of costs. Conducting these audits in concert with State commissions is consistent with *cooperative federalism*, as per Section 209 of the FPA and Section 17 of the NGA, as well as for the sake of efficiency and economy.” (emphasis in original)).

4. EPAAct 2005 grants the FERC and state utility commissions access to holding company books and records as relevant and necessary for the exercise of their respective ratemaking jurisdictions. *See* Energy Policy Act of 2005, Pub. L. No. 109-58, §§ 1264, 1265, 119 Stat. at 974–75. The FERC also was granted authority to determine cost allocations between service companies and public utilities in certain cases. *Id.* § 1275. Although many states have enacted certain utility ring fencing provisions by statute, regulation or order, very few states have statutes that directly regulate utility holding companies other than in the context of a merger or change of control. Wisconsin is one of the few states with a statutory regime expressly targeted at public utility holding companies. *See* WIS. STAT. § 196.795 (2005). The New Jersey Board of Public Utilities recently issued proposed rules that would limit diversification by utility holding companies. *See* NEW JERSEY BD. OF PUB. UTILITIES, PROPOSED NEW RULES: N.J.A.C. 14:4-4 (Dec. 19, 2005).

holding company business risks. The examples of holding company abuses that led to PUHCA's enactment teach us that if holding company management uses the holding company structure imprudently and to the public detriment, the advantages of the holding company in enabling the consolidation of the utility industry will be lost once again.

This article reviews the conditions in the utility industry that gave rise to PUHCA and tracks the changes that eventually led to its repeal. With that as context, it is easier to evaluate and understand present day strategies that the FERC, state utility commissions and holding company managements may use to obtain the benefits of holding companies while avoiding consumer harm. Ring-fencing of the public utility subsidiaries of holding companies emerges as the most-promising means of achieving this balance.

#### HOLDING COMPANY ABUSES AND THE PUHCA SOLUTION

Thomas Edison opened the first commercial power plant on New York's Pearl Street in 1882, serving just one square mile of lower Manhattan with direct current (DC) technology. By 1896, a little more than a decade later, power from two hydroelectric generators built at Niagara Falls by Westinghouse Electric Corporation, using competing alternating current (AC) technology, was first transmitted to Buffalo, New York.<sup>5</sup> In the years that followed, other electric generating plants and distribution systems were built to serve major cities, but because it was more cost effective and profitable to serve densely populated areas, the countryside in between was largely unserved. "[In] 1935, over 90% of farms . . . lacked central station electric service."<sup>6</sup>

During the early years of the utility industry, industrialists cobbled together vast systems of utility companies. During 1929–1932, for example, sixteen major holding company systems produced 76.4% of the electric energy generated by privately owned utility plants, and three systems produced 44.5% of the electric output.<sup>7</sup> Four holding company systems controlled more than half

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5. The battle of competing technological platforms during the early years of the electric utility industry was hard fought. The Pearl Street Station and other electrical systems constructed by Thomas Edison used DC technology, while a competing method, backed by George Westinghouse, used AC technology, which had several advantages. High loads of direct current often melted copper wires and DC power could not be transmitted for distances of greater than a mile without excessive voltage drops. DC power systems also could not readily provide different voltage levels for use by various machines. Edison's imperfect solution was distributed generation and separate power grids carrying different voltages. AC power technology, developed by Nikolai Tesla and licensed to Westinghouse, was a far better solution. AC power could be transmitted long distances at high voltages over wires that would melt if used to transmit the same power in the low voltage, high current DC form. In addition, voltages in an AC system could be readily manipulated with transformers to suit the motors and other technologies being developed at the time. AC power was more dangerous than DC and Edison is reputed to have tried to popularize being electrocuted as being "Westinghoused". Wikipedia, *War of Currents*, available at [http://en.wikipedia.org/wiki/War\\_of\\_Currents](http://en.wikipedia.org/wiki/War_of_Currents) (last visited Feb. 19, 2006).

6. DIV. OF INV. MGMT., SEC. EXCH. COMM'N, *THE REGULATION OF PUBLIC UTILITY HOLDING COMPANIES* at 1, n. 1 (1995) [hereinafter 1995 REPORT]. The history of the growth of gas distribution utilities shares many similarities with the electric utility industry. The gas utility industry developed from small local gas works and later central plants that manufactured gas from coal and other organic materials. Manufactured gas was distributed locally through wooden pipes. A principal early use of manufactured gas was for street and commercial lighting. Pipeline technology for the long-distance transmission of natural gas at high pressures did not come into common use until after World War II. *Id.*

7. FED. TRADE COMM'N, *FINAL REPORT ON ECONOMIC, CORPORATE, OPERATING, AND FINANCIAL PHASES OF THE NATURAL-GAS-PRODUCING, PIPELINE, AND UTILITY INDUSTRIES, WITH CONCLUSIONS AND RECOMMENDATIONS* 37, pt. 72-A (1935) [hereinafter FTC REPORT].

of the total natural gas pipeline mileage.<sup>8</sup> Most holding companies used a pyramid structure where one company controlled many others through ownership of voting common stock, which represented only a fraction of the total capital invested in the utility businesses. The top holding company raised additional capital mainly through the issuance of non-voting preferred stock and bonds. Additional levels of sub-holding companies, controlled through voting common stock interests held by upper-level holding companies, also raised capital through the issuance of non-voting securities. The sub-holding companies acquired control over operating utility companies by holding their voting securities. By 1931, five public-utility holding company systems were controlled by the holders of common stock worth less than one percent of the entire system's assets.<sup>9</sup>

The financial leverage created by the pyramidal holding companies came crashing down during the Great Depression. From 1929–1935, fifty-three holding companies went bankrupt. Thirty-six utilities with publicly held securities also went bankrupt, when due to financial structures heavy with debt securities they were unable to continue to pay fixed interest charges.<sup>10</sup>

The collapse of the utility holding companies during the Depression led to Congressional investigations and prosecutions. After the collapse of the Insull Group, the third largest holding company group at the time, its chairman Samuel Insull was accused of fraud and fled (allegedly disguised as a woman) to Greece. Ironically, he returned in 1935 to stand trial and was acquitted.<sup>11</sup>

The collapse of so many utilities and holding companies coincided with an extensive, 101-volume study of the industry conducted by the Federal Trade Commission (FTC) from 1928–1935.<sup>12</sup> The study formed much of the basis of the Congressional findings leading to the enactment of PUHCA. The FTC study found many systemic abuses including: the issuance of securities to the public based on unsound asset values or on paper profits from intercompany transactions; the extension of holding company ownership to disparate, nonintegrated operating utilities throughout the country without regard to economic efficiency or coordination of management; the mismanagement and

8. *Id.* at 46.

9. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 128 (Houghton Mifflin Co. 1982); FTC REPORT, *supra* note 7, pt. 72-A at 154–66.

10. *Study of Operations Pursuant to the Public Utility Holding Company Act of 1935: Hearings Before the Securities Subcomm. of the H. Comm. on Interstate and Foreign Commerce*, 79th Cong. pt. 3 at 851 (1946).

11. DOUGLAS W. HAWES, *UTILITY HOLDING COMPANIES* 2–7 (1987).

12. The FTC study was initiated by Senate Resolution 83 in the 70th Congress. The Senate directed the FTC to report on (1) utility asset and liability growth, (2) details regarding securities issuance practices, (3) the relationships between holding companies and financial, engineering, construction and other service providers, (4) service transactions and related fees, commissions and expenses, and (5) the value or detriment to the public of holding companies and what legislation, if any, should be enacted by Congress to correct any abuses. Notably, the Senate also empowered the FTC to

inquire and report whether, and to what extent, such corporations or any of the officers thereof or any one in their behalf or in behalf of any organization of which any such corporation may be a member, through the expenditure of money or through the control of the avenues of publicity, have made any and what effort to influence or control public opinion on account of municipal or public ownership of the means by which power is developed and electrical energy is generated and distributed, or since 1923 to influence or control elections . . . .

S. Res. 83, 70th Cong. (1928).

exploitation of operating subsidiaries through excessive service charges, excessive common stock dividends, upstream loans and an excessive proportion of senior securities; and the use of the holding company to evade state regulation.<sup>13</sup> Accounting manipulations were typical holding company abuses. Utility assets were often written up through the sale of properties to controlled subsidiaries at amounts higher than market values, and depreciation charges were often inadequate. These and other abuses inflated earnings and justified increased dividends, while weakening the capital structure of utilities and their ability to provide service.<sup>14</sup>

James Bonbright and Gardiner Means, in their seminal book, *The Holding Company*, argue that “the holding company has become the greatest of the modern devices by which business enterprises may escape the various forms of social control that have been developed, wisely or unwisely, as a means of limiting the vast power of the great captains of industry.”<sup>15</sup> A concern for the concentrated power of business trusts and their dangerous influence on national politics and economics was a theme underlying the enactment of PUHCA. As President Franklin Roosevelt expressed it, PUHCA was as much about a desire to control the corrosive effects of powerful business interests (particularly the influence of Wall Street) on the democratic process, as it was about promoting economical and efficient utility service throughout the nation:

But where the utility holding company does not perform a demonstrably useful and necessary function in the operating industry and is used simply as a means of financial control, it is idle to talk of the continuation of holding companies on the assumption that regulation can protect the public against them. Regulation has small chance of ultimate success against the kind of concentrated wealth and economic power which holding companies have shown the ability to acquire in the utility field. No Government effort can be expected to carry out effective, continuous, and intricate regulation of the kind of private empires within the Nation which the holding-company device has proved capable of creating.

Except where it is absolutely necessary to the continued functioning of a geographically integrated operating utility system, the utility holding company with its present powers must go. If we could remake our financial history in the light of experience, certainly we would have none of this holding-company business. . . . It is a corporate invention which can give a few corporate insiders unwarranted and intolerable powers over other people's money. In its destruction of local control and its substitution of absentee management, it has built up in the public-utility field what has justly been called a system of private socialism which is inimical to the welfare of a free people.

Most of us agree that we should take the control and the benefits of the essentially local operating utility industry out of a few financial centers and give back that control and those benefits to the localities which produce the business and create the wealth. We can properly favor economically independent business, which stands on its own feet and diffuses power and responsibility among the many, and frowns upon those holding companies which, through interlocking directorates and other devices, have given tyrannical power and exclusive opportunity to a favored few. It is time to make an effort to reverse that process of the concentration of power which has made most American citizens, once traditionally independent owners of their

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13. FTC REPORT, *supra* note 7, pt. 73-A at 62.

14. *See generally* JAMES C. BONBRIGHT & GARDINER C. MEANS, *THE HOLDING COMPANY: ITS PUBLIC SIGNIFICANCE AND ITS REGULATION* 149–87 (McGraw-Hill Book Company, Inc. 1969) (regarding the abuses necessitating the regulation of public utility holding companies).

15. *Id.* at 7.

own businesses, helplessly dependent for their daily bread upon the favor of a very few, who, by devices such as holding companies, have taken for themselves unwarranted economic power. I am against private socialism of concentrated private power as thoroughly as I am against governmental socialism. The one is equally as dangerous as the other; and destruction of private socialism is utterly essential to avoid governmental socialism.<sup>16</sup>

On August 26, 1935, President Roosevelt signed PUHCA into law. PUHCA joined the arsenal of federal legislation designed to control holding companies in other contexts, such as the Interstate Commerce Act and the Banking Act of 1933, which addressed the abuses of the railroad holding companies and bank holding companies, respectively.<sup>17</sup>

Because many of the abuses chronicled by the FTC involved corporate and financial structure, rather than utility operations and ratemaking, the administration of PUHCA was given to the recently-formed Securities and Exchange Commission. PUHCA differed from the Securities Act of 1933 and the Securities Exchange Act of 1934, which were designed to provide investors with clear and timely information upon which to base investment decisions. Under the Securities Act, if a registration statement appropriately disclosed the risks of investing in an over-leveraged start up company with untested management and a questionable product, the SEC had no power to prevent the issuer from selling securities. By contrast, PUHCA required the SEC to evaluate the appropriateness of securities issued by registered holding companies and their subsidiaries to assure that the holding company system would remain financially sound in the interest of investors, consumers and the public.<sup>18</sup>

It is hardly an exaggeration to say that these restrictions effectively made the SEC another board of directors over the investor-owned electric and gas registered holding companies. These companies represented a large portion of the investor-owned electric and gas utility industry. As of December 31, 2004, the thirty-two registered holding companies under SEC jurisdiction held total consolidated assets of approximately \$684 billion, and served approximately

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16. President Franklin D. Roosevelt, Message from the President of the United States Transmitting a Report of the National Power Policy Committee with Respect to the Treatment of Holding Companies, H.R. Doc. No. 74-137 (1935).

17. The railroad industry became the first industry subject to federal regulation in 1887 with the enactment of the Interstate Commerce Act. The railroad monopolists were widely accused of corrupting politics, manipulating railroad securities and practicing rate discrimination. The industry was largely deregulated under the Staggers Rail Act of 1980. The Banking Act of 1933 is most notable for controlling abuses associated with bank holding companies by separating commercial banks and securities firms, and for establishing the Federal Deposit Insurance Corporation. The Financial Services Modernization Act of 1999 (also known as the Gramm-Leach-Bliley Act) eliminated the separation of commercial and investment banking and permitted the creation of financial holding companies with banks, securities firms and insurance companies as subsidiaries. See Bonbright & Means, *supra* note 14 (providing a full discussion on the similarities between utility, railroad and bank holding companies).

18. GOV'T ACCOUNTABILITY OFFICE, PUBLIC UTILITY HOLDING COMPANY ACT; OPPORTUNITIES EXIST TO STRENGTHEN SEC'S ADMINISTRATION OF THE ACT (July 2005) [hereinafter GAO REPORT].

In its review of financing applications, one of SEC's objectives is to protect the financial integrity of registered holding companies by, for example, requiring holding companies and their utility subsidiaries seeking financing authority to have an equity-capitalization ratio of at least 30 percent. This aspect of SEC's administration of PUHCA—that is, a review of the financial condition of a registrant—differs from its administration of other securities statutes, in which SEC reviews security issuances primarily by promoting full and fair disclosure and preventing and suppressing fraud.

*Id.*

seventy-five million customers.<sup>19</sup>

#### A CLOSER LOOK AT PUHCA'S PROTECTIVE PROVISIONS

PUHCA's most controversial provision was section 11, known as the holding company "death sentence."<sup>20</sup> Section 11 required the Commission to

examine the corporate structure of every registered holding company and subsidiary company thereof, the relationships among the companies in the holding-company system of every such company and the character of the interests thereof and the properties owned or controlled thereby to determine the extent to which the corporate structure of such holding-company system and the companies therein may be simplified, unnecessary complexities therein eliminated, voting power fairly and equitably distributed among the holders of securities thereof, and the properties and business thereof confined to those necessary or appropriate to the operations of an integrated public-utility system.<sup>21</sup>

Congress had found that the growth and extension of holding companies often did not bear a relationship to the economical and efficient operation of public utility systems. The scattered utility service territories prevented the efficient development of regional utility systems that could share generating and transmission resources and provide electricity to farms and rural residents. The integration requirement of section 11 had the effect of encouraging universal service through the build-out of a system's service territory and the spread of electrification to contiguous unelectrified areas, thereby complementing the work of the public power agencies established contemporaneously with PUHCA; the Tennessee Valley Authority, the Rural Electrification Administration, and the Bonneville Power Authority.<sup>22</sup>

Section 11 required the SEC, with only narrow exceptions, to limit each registered holding company to a single integrated electric or gas utility system possessing a relatively simple corporate and capital structure free of multi-tiered holding companies, non-functionally related businesses and inequitable distributions of voting power.<sup>23</sup> As a result, the first order of business for the Commission was to dismantle the utility trusts.

Holding companies that went through the section 11 simplification process were said to have been "put through the wringer."<sup>24</sup> In a twenty-year period from 1935 to 1955, the SEC reduced 214 registered holding companies, which controlled 922 utility companies and 1,054 nonutility companies, to twenty-five registered holding companies with 171 electric and gas subsidiaries and 137 nonutility subsidiaries.<sup>25</sup> The simplification process reduced holding companies generally to an electric or gas utility system confined to a single area or region, with interconnected utility assets capable of coordinated and efficient operation. The holding company system could not be so large that it could not be effectively managed or regulated.

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19. DIV. OF INV. MGMT., SEC. & EXCH. COMM'N, FINANCIAL AND CORPORATE REPORT, REGISTERED HOLDING COMPANIES UNDER THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935 27-28 (2005).

20. *N. Am. Co. v. SEC*, 327 U.S. 686 (1946).

21. Public Utility Holding Company Act of 1935 § 11, 15 U.S.C. § 79(k) (repealed 2005).

22. 1995 REPORT, *supra* note 6, at 14 n.70.

23. Public Utility Holding Company Act of 1935 § 11, 15 U.S.C. § 79(k) (repealed 2005).

24. 1 Louis Loss & Joel Seligman, Securities Regulation 137 (1998).

25. HAWES, *supra* note 11, at 2-18.

Because unsound diversification had contributed to holding company system collapses, Congress directed the SEC in section 11(b)(1) of PUHCA to take action to limit each holding company system to a single integrated public utility system “and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public utility system . . . .”<sup>26</sup> To that end the SEC required registered holding companies to divest non-utility businesses that did not have a functional relationship to the operation of the utility system. “[T]he Commission’s geographic integration and corporate simplification of the utility industry remains the most comprehensive structural relief ever achieved by an agency of the federal government.”<sup>27</sup> “Vigorous enforcement of section 11(b) by the Commission over the years eliminated most of the multi-state holding companies and reversed the tidal wave of consolidations that had been occurring in the years prior to 1935.”<sup>28</sup>

Once the major simplification cases ended, the SEC’s administration of PUHCA focused on the ongoing regulation of registered holding companies under PUHCA’s other provisions. Under sections 6 and 7, for example, the SEC regulated the issuance of securities by registered holding companies and their subsidiaries. PUHCA was intended to supplement, not supplant, effective state regulation of utilities. Under section 6, a utility subsidiary could issue securities without SEC authorization provided that the state commission authorized the transaction. For those transactions that did require SEC authorization, the standards under section 7 of PUHCA required an issuer to demonstrate that the proposed securities issuance was reasonable in light of the issuer’s overall capital structure and was supportable by the issuer’s earning capacity.

Under section 12 of PUHCA, the SEC monitored and restricted potentially abusive financial transactions among companies in a registered holding company system. A registered holding company, for example, was prohibited from borrowing or obtaining credit or indemnification from its public utility subsidiaries. Loans among associated companies were restricted to terms that would not adversely affect the interest of investors or consumers, and dividends were generally limited to amounts paid from current or retained earnings. All these restrictions served to protect the capital and credit of the operating utility companies and of the non-utility subsidiaries that provided support to utilities in various functional areas.

Above-market contracts for equipment, services and construction that were forced on utility subsidiaries by holding companies were another abuse of the pre-1935 era. SEC control over goods and service transactions among associated companies was effected through section 13 of PUHCA. Registered holding companies were prohibited from providing goods and services to their utility subsidiaries, except under special and unusual circumstances. However, subsidiary and “mutual” service companies owned by utilities could be organized to provide services economically and efficiently at a fairly and equitably allocated cost. SEC rules, accounting systems and reporting

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26. Public Utility Holding Company Act of 1935 § 11(b)(1), 15 U.S.C. § 79(k) (repealed 2005).

27. SELIGMAN, *supra* note 9, at 263.

28. SEC. & EXCH. COMM’N, COMMENTS OF THE SEC ON THE COMPTROLLER GENERAL’S REPORT OF JUNE 20, 1977 TO THE CONGRESS ON THE ADMINISTRATION OF THE OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935 11 (1977) (on file with the author).



requirements were designed to assure that service companies operated efficiently and avoided cross-subsidization through fair cost allocations. The SEC monitored compliance with these provisions through regular inspections of holding company systems, and of service companies in particular. The inspection program is credited with remedying various deficiencies that resulted in consumer savings of approximately \$458 million between 1999 and 2004.<sup>29</sup>

Other provisions of PUHCA addressed the substantial political influence holding companies had exerted over government at all levels. Contributions to political parties and to candidates for federal, state or local office were prohibited by section 12(h), and lobbying of Congress, the SEC or the FERC was subject to disclosure under section 12(i).<sup>30</sup> The influence of "Wall Street" on holding companies and their subsidiaries was addressed by restricting, under section 17(c), officers and directors of banks, including investment banks, from also serving as officers and directors of companies in registered holding company systems.

#### PARTIAL PUHCA REPEAL

PUHCA was amended by the Energy Policy Act of 1992 (EPAct 1992).<sup>31</sup> EPAct 1992 introduced major exemptions for wholesale generators (EWGs) and foreign utility companies (FUCOs). The passage of the Telecommunications Act of 1996 also added an exemption for certain telecommunication companies (ETCs).<sup>32</sup> The EWG exemption permitted a person to acquire electric generating facilities used exclusively for the production and sale of power at wholesale without becoming a holding company subject to PUHCA.<sup>33</sup> An EWG was expressly excluded from the definition of electric utility company under PUHCA. This exemption contributed greatly to the creation of a competitive power market through the expansion of non-utility generators (i.e., generating companies not subject to PUHCA or state rate regulation that sold their power at wholesale, and typically at market rates, to distribution utilities).<sup>34</sup>

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29. GAO REPORT, *supra* note 18. SEC examination teams reviewing 20 registered holding company systems made recommendations to reallocate costs and tax benefits within holding company systems and identified ways to improve service company operations. One misallocation of tax benefits accounted for 72% or \$330 million of the identified savings. The GAO found that these savings may overstate the true benefit to consumers in holding company systems because the SEC recommendations are not effectively communicated to state utility commissions that could take the information into account in rate setting. *Id.*

30. Lobbying against PUHCA was vigorous.

The utilities lobbied furiously against the bill in general, but [against section 11] in particular, and flooded the congressional offices with almost a million pieces of mail. After several weeks of hearings before the Interstate Commerce Committee, which Rayburn chaired, the bill was reported out, but with substantially less drastic provisions in Section 11 than originally proposed. . . . Meanwhile, Senator (later Justice) Hugo Black's parallel hearings in the Senate were uncovering the fact that the lobbyists had spent \$1.5 million to generate a flood of mail (they had taken many names from telephone directories).

HAWES, *supra* note 11, at 2-15 to -16.

31. Energy Policy Act of 1992, Pub. L. No. 102-486, § 711, 106 Stat. 2776.

32. Public Utility Holding Company Act of 1935 §§ 32-34, 15 U.S.C. §§ 79 (z)(5)(a)-(c) (repealed 2005).

33. An EWG located outside the U.S. also was permitted to sell power at retail.

34. Non-utility generators, or independent power producers (IPPs), were encouraged first by the Public Utility Regulatory Policies Act of 1978 (PURPA) which established a category of "qualifying facilities" (QFs) that could sell power at wholesale to utilities at the latter's incremental avoided cost. QFs, however, had

The FUCO exemption permitted the acquisition of electric and gas utility companies located and doing business outside of the U.S. Because FUCOs also were not considered public utility companies under PUHCA, FUCOs did not need to be part of the same integrated utility system as a registered holding company's U.S. public utility operations. In the 1990s, FUCOs became a popular way for holding companies to seek higher growth rates and returns through diversification. U.S. holding companies flocked to Argentina, Australia and the U.K. to bid on government utility privatizations. Generally, these investments were not particularly successful.<sup>35</sup> The FUCO exemption also was used creatively by foreign-based utility holding companies (e.g., National Grid plc, E.ON AG) to shield their non-U.S. utility operations from regulation under PUHCA while acquiring, owning and operating U.S. public utility companies.<sup>36</sup>

ETCs provided another avenue for diversification. A company engaged exclusively in telecommunications, information services and related or incidental services could qualify as an ETC. A registered holding company could acquire an ETC without obtaining SEC authorization. Before the ETC exemption was made available, it had been difficult for registered holding companies to demonstrate, as required by section 11 of PUHCA, that telecommunications companies were "functionally related" to the electric or gas utility business and thus permissible diversification.

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certain technology and ownership restrictions. EPAAct 1992 expanded the role of IPPs with the fairly broad EWG exemption and the FERC supported the development of a competitive wholesale power market by adopting Order No. 888. Order No. 888, *Promoting Wholesale Competition Through Open Access Nondiscriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 31,036 (1996), 61 Fed. Reg. 21,540 (1996) (to be codified at 18 C.F.R. pts. 35, 385) [hereinafter Order No. 888], *order on reh'g*, Order No. 888-A, F.E.R.C. STATS. & REGS. ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B, 81 F.E.R.C. ¶ 61,248, 62 Fed. Reg. 64,688 (1997), *order on reh'g*, Order No. 888-C, 82 F.E.R.C. ¶ 61,046 (1998), *aff'd in relevant part sub nom.*, Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom.*, New York v. FERC, 535 U.S. 1 (2002). Order 888 promoted wholesale electricity competition by providing open access for all electricity suppliers to the electricity transmission grid owned by the traditional vertically integrated utilities.

35. See e.g., Leonard S. Hyman, *Investing in the "Plain Vanilla" Utility*, 24 ENERGY L.J. 1, 10 (2003).

In the past, utility managers failed their investors when they bet the company on a technology they did not understand (nuclear power), when they entered businesses far afield from their experience (diversification), and when they plunged into seemingly related businesses without adjusting their finances to the new risk levels (merchant generation, power marketing, and foreign investment).

*Id.* See also Stan Choe, *Charlotte, N.C.-Based Duke Energy Awaits Payoff from Latin America Gamble*, THE CHARLOTTE OBSERVER, May 17, 2004 (noting poor performance of Latin American investments made by Dominion Resources Inc. and Southern Co., and marginal performance of Duke Energy Corp.'s investments in the region).

36. National Grid, a U.K.-based electric transmission owner and operator acquired New England Electric System in 2000 and became one of the first foreign registered holding companies. The National Grid Group plc Acquisition of New England Electric System, Holding Company Act Release No. 27,154 (Mar. 15, 2000). E.ON AG, a German electric and gas utility holding company acquired Powergen plc, the U.K.-based owner of LG&E Energy Corp., a Kentucky utility holding company. E.ON AG, Holding Company Act Release No. 27,539 (June 14, 2002). Both National Grid and E.ON organized their non-U.S. utility companies as FUCOs (thus by definition not "utilities" under PUHCA) to protect them from regulation under PUHCA. FUCO status also permitted the acquisition of the U.S. utility targets without triggering the PUHCA requirement under section 11 that all utilities must be part of a single integrated public utility system. It was impossible to integrate utilities across the Atlantic.

## THE EVOLUTION OF THE UTILITY INDUSTRY AND FINANCIAL MARKETS

Electric and gas utility technologies developed rapidly in the years preceding the adoption of PUHCA, and the device of the holding company permitted substantial consolidation of small utilities through mergers and acquisition. Mergers in the electric utility industry from 1917 through 1930 averaged in excess of 200 per year, peaking at over 300 per year in the mid-1920s.<sup>37</sup> PUHCA reversed that trend. Between 1935 and 1950, more than 750 utilities were spun off from holding companies in connection with rationalization of utility systems under section 11 of PUHCA.<sup>38</sup> From 1936 through 1975 there were 517 mergers, occurring at an annual rate of less than fifteen a year. From 1976 through 1998, seventy-six mergers took place, about three per year on average.<sup>39</sup>

Although fewer mergers have occurred in recent years, they have been in many cases "mega-mergers" as large companies acquire or merge with other large companies.<sup>40</sup> Nevertheless, the U.S. utility industry remains highly fragmented with approximately 3,169 separate electric utilities.<sup>41</sup> In 1998, investor owned utilities represented 239 of all utilities, held 66% of U.S. electric generating capacity, and represented 75% of sales to ultimate consumers.<sup>42</sup> Notably, even after a period of consolidation over the past fifteen years, the industry seems to be less concentrated than it was when PUHCA was enacted. Changes in technology and the regulatory structure of the utility industry during the seventy-year administration of PUHCA suggest that there are significant opportunities for further restructuring and consolidation within the utility industry.

Utility infrastructure in the United States has been extended by investor-owned, cooperative and publicly-owned utilities to the point that only the most remote settlements lack access to utility service. Regional transmission organizations and independent system operators have formed to manage the operation of the transmission grid over broad regions for reliability and efficiency. In some cases, the transmission organizations also coordinate the market in wholesale power to assure the efficient dispatch of generating resources.<sup>43</sup> These organizations and markets continue to develop under the guidance of the FERC and its authority over interstate commerce in electricity under the Federal Power Act.<sup>44</sup>

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37. ENERGY INFO. ADMIN., U.S. DEP'T OF ENERGY, THE CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY 1999: MERGERS AND OTHER CORPORATE COMBINATIONS 11 (1999) [hereinafter EIA REPORT].

38. *Id.*

39. EIA REPORT, *supra* note 37.

40. The Energy Information Administration estimates that the 20 largest investor-owned utilities (IOUs) held 56% of IOU-held generating capacity in 1992. Through mergers the 20 largest IOUs increased their portion of IOU-held generating capacity to 73% by 2000. *Id.* at ix.

41. ENERGY INFO. ADMIN., U.S. DEP'T OF ENERGY, THE CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY 2000: AN UPDATE 18, tbl. 3 (2000).

42. *Id.* at 23-28.

43. See FED. ENERGY REGULATORY COMM'N., RTO-ISO HANDBOOK (2005), available at <http://www.ferc.gov/industries/electric/indus-act/rto/handbook.asp>.

44. Under sections 205 and 206 of the FPA the FERC must ensure that, with respect to any transmission in interstate commerce or any sale of electric energy for resale in interstate commerce by a public utility, no person is subject to any undue prejudice or disadvantage. To that end, in 1996 the FERC adopted Order Nos.

In the early 1900s, the utility industry had been viewed as a natural monopoly, consisting of vertically integrated generating, transmission and distribution facilities. The monopoly utilities required substantial regulation to assure that the efficiencies of a well developed network could be enjoyed by the nation without the abuses associated with monopoly control.<sup>45</sup> Today, much of the industry is characterized by unbundled generation, transmission and distribution. In the many markets in which generation has been wholly unbundled from retail utility service, competition has taken hold—if not always smoothly, as California’s experience with a competitive energy market has shown.<sup>46</sup> In competitive markets, the FERC is charged with assuring that no participant over which it has jurisdiction has the ability to manipulate the prices in the market. In addition, the FERC seeks to lessen market entry barriers so that power suppliers can enter and exit the market and react to changes in demand.

Transmission facilities also have been unbundled, particularly in the eastern United States. The management of these facilities by organizations independent of the generating companies and subject to the oversight of the FERC and market participants (i.e., the generators, utilities and industrial consumers) is intended to provide non-discriminatory access to the high voltage transmission network and efficient and coordinated operation. In addition, the FERC sought to provide an incentive to construct additional facilities to relieve transmission constraints. Transmission continues to be regulated by the FERC on a cost of service tariff basis.<sup>47</sup>

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888 and 889 to remedy undue discrimination or preference in access to the monopoly owned transmission wires that control whether and to whom electricity can be transported in interstate commerce, and to provide all suppliers of electricity equal access to information about the availability of transmission service. Order No. 888, *supra* note 34. Order No. 889, *Open Access Same-Time Information System (Formerly Real-Time Information Networks) and Standards of Conduct*, F.E.R.C. STATS. & REGS. ¶ 31,035, at p. 31,583, 61 Fed. Reg. 21,737 (1996), *order on reh’g*, Order No. 889-A, *Open Access Same-Time Information System and Standards of Conduct*, [Regs. Preambles] F.E.R.C. STATS. & REGS. ¶ 31,049 (1997), 62 Fed. Reg. 12,484 (1997), *order denying reh’g*, Order No. 889-B, 81 F.E.R.C. ¶ 61,253 (1997). In 2000, the FERC found that “opportunities for undue discrimination continue to exist that may not be remedied adequately by [the] functional unbundling [remedy of Order No. 888] . . . .” Order No. 2000, *Regional Transmission Organizations*, [Regs. Preambles 1996–2000] F.E.R.C. STATS. & REGS. ¶ 31,089, at p. 31,015 (1999), 65 Fed. Reg. 809 (1999) [hereinafter Order No. 2000], *order on reh’g*, Order No. 2000-A, F.E.R.C. STATS. & REGS. ¶ 31,092 (2000) 65 Fed. Regs. 12,088 (2000), *aff’d sub nom.*, Pub. Util. Dist. No. 1 v. FERC, 272 F.3d 607 (D.C. Cir. 2001). The FERC issued another order to encourage the formation of regional transmission organizations, independent of the inherent conflict of interest that generation-owning transmission providers have to give their supply resources transmission preference. *Id.*

45. See Roger Ridelhoover, *The Role of Entry in Deregulating Gas and Electricity*, 19 ENERGY L.J. 2, 308 (1998).

46. Seventeen states have retail competition for some or all customers. In six states retail competition and restructuring has been repealed, delayed or suspended. The remainder of states have not been restructured to provide retail competition. Paul L. Joskow, *Markets for Power in the United States: An Interim Assessment*, 27 ENERGY JOURNAL 1, fig. 3 (2005).

State restructuring legislation has either required or encouraged the divestiture of generation assets: (1) to encourage competition among generating companies, (2) to prevent a few companies from dominating the marketplace, and (3) as a condition for the recovery of costs incurred by utilities for power plants and contracts under a regulated environment that may not be recoverable in a competitive market for generation.

ENERGY INFO. ADMIN., U.S. DEP’T OF ENERGY, ELECTRIC POWER INDUSTRY RESTRUCTURING FACT SHEET (2004), available at [http://www.eia.doe.gov/cneaf/electricity/page/fact\\_sheets/facts.html](http://www.eia.doe.gov/cneaf/electricity/page/fact_sheets/facts.html).

47. See generally Order No. 2000, *supra* note 44. The FERC asserted a number of “significant benefits related to establishing RTOs: (1) RTOs would improve efficiencies in the management of the transmission grid;

Local distribution networks (gas and electric), like transmission, remain a natural monopoly, but they are monopolies subject to state regulation. Although statutory authority, regulatory expertise and resources vary by state, as a general matter the state regulatory environment is much improved from 1935. Most states exercise jurisdiction over utility financing transactions (often with the exception of short-term debt issuances), and guard against the use of utility credit to support nonutility businesses.<sup>48</sup> Many states also control affiliate transactions involving utilities subject to their jurisdiction to prevent cross-subsidization from driving up the rates paid by consumers.<sup>49</sup> Competitive power markets also have lessened the opportunities for power suppliers to pass excessive costs on to affiliated utilities because the principal cost of service—energy and capacity—is now more responsive to competitive pressure.<sup>50</sup> Lastly, organizations such as the National Association of Regulatory Utility Commissioners (NARUC) have helped to educate state commissions and to promote a high standard of regulatory practice across the states.<sup>51</sup>

When PUHCA was enacted, the Securities Act of 1933 and the Securities Exchange Act of 1934 were in their infancy. Advances in the full disclosure system under these laws has produced better and more timely information for investors.<sup>52</sup> In addition, despite spectacular financial meltdowns such as Enron

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(2) RTOs would improve grid reliability; (3) RTOs would remove opportunities for discriminatory transmission practices; (4) RTOs would result in improved market performance; and (5) RTOs would facilitate lighter-handed governmental regulation.” *Id.* at p. 31,017. In Order 2000 the FERC attempted to develop ratemaking practices that would more effectively manage congestion by, among other things, providing incentives for transmission owning utilities to efficiently operate and invest in their systems. Order No. 2000, *supra* note 44, at pp. 31,170–96.

48. The extent of state jurisdiction over public utility financings, asset sales, mergers, accounting and access to books and records is fairly uniform. There is less uniformity among the states with respect to affiliate transactions regulation. *See* 1995 REPORT, *supra* note 6, at app. A (Summary of Responses to State Survey of Regulation of Public-Utility Holding Companies).

49. *See* REGULATORY RESEARCH ASSOCS., INC., SPECIAL REPORT: RING FENCING, A STATE-BY-STATE SUMMARY (Oct. 15, 2003) (providing examples of the regulation of affiliate transactions by legislation or state commission order in the following states: Arizona, Arkansas, Colorado, Connecticut, Illinois, Kansas, Maine, Maryland, Montana, New Jersey, New Mexico, New York, Oregon, Pennsylvania, Texas, Virginia, Wisconsin and Wyoming). *See also*, EDISON ELEC. INST., COST ALLOCATION AND AFFILIATE TRANSACTIONS: A SURVEY AND ANALYSIS OF STATE COST ALLOCATION ISSUES AND TRANSFER PRICING POLICIES (June 1999) (indicating that the following states did not have rules or regulations regarding affiliate transactions: Alabama, Florida, Louisiana, Mississippi, North Carolina, North Dakota, Rhode Island, South Carolina, Vermont and West Virginia).

50. *See* Joskow, *supra* note 46, at 1 (stating “[e]mpirical evidence suggests that well-designed competitive market reforms have led to performance improvements in a number of dimensions and have benefited customers through lower retail prices.” (emphasis omitted)).

51. In 1976, NARUC established the National Regulatory Research Institute (NRRI). NRRI, which is based at Ohio State University, provides the regulatory community with research, analysis, expert testimony and training. NRRI prepares short research pieces (primers and briefing papers) and surveys on topics of immediate interest to NARUC member states. NRRI participates in NARUC committees, subcommittees, task forces and working groups. NRRI staff serve as faculty for NARUC-sponsored programs at the Institute of Public Utilities at Michigan State University, the Center for Public Utilities at New Mexico State University and NARUC’s Water Rate School. NRRI reports on the regulation of the nation’s electric, gas, telecommunications, and water utilities. Since its founding, the NRRI has published nearly 500 reports and has conducted numerous conferences and workshops for public utility commissioners and others. *See* NAT’L REGULATORY RESEARCH INST., ABOUT THE NRRI, <http://www.nrri.ohio-state.edu/About> (last visited Mar. 6, 2006).

52. For example, the annual reporting requirements [under] the Exchange Act applied only to companies with

and WorldCom, accounting practices have become more uniform and the quality of public company financial information has dramatically improved. The adoption of the Sarbanes-Oxley Act of 2002 increased the emphasis on the reliability of financial statements and internal controls. Utility accounting, in particular, has improved as the FERC adopted a uniform system of accounts and state commissions adopted accounting systems generally based on the FERC system. In 1975, the SEC recognized these developments and rescinded the accounting system it had developed for registered holding companies.<sup>53</sup>

Institutions also have evolved to play an important role in reviewing the data disseminated to the public and in improving the quality of information that filters into the marketplace. Notably, holding company and utility reports, such as the annual report on Form 10-K filed under the Securities Exchange Act of 1934 and the public utility annual report on FERC Form 1, have surpassed the reports required under PUHCA in their usefulness to investors and regulators.<sup>54</sup> Underwriters conduct due diligence when they underwrite an offering, and analysts track large issuers—including utilities and holding companies—for the investor community. Rating agencies (e.g., Standard & Poor's, Moody's, and Fitch) review financial statements, meet with management and measure utility performance and risk against industry metrics using sophisticated analytical models.<sup>55</sup> Given the large capital needs of the utility sector and the higher interest rates paid by issuers with "speculative" ratings, holding company and utility managements are keenly focused on maintaining an investment grade rating for their securities.

In 1982, the SEC recommended that Congress repeal PUHCA in its entirety stating that "investors in registered public utility holding companies would

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securities listed on exchanges, and [this] applied to few public utility holding companies. In 1964, Congress amended the Exchange Act so that its annual reporting and other requirements would apply to all companies with over \$1 million in assets and more than 500 shareholders.

1995 REPORT, *supra* note 6, at 128.

53. See Adoption of Revised Rule 26 Under the Public Utility Holding Company Act of 1935 and Rescission of the Uniform System of Accounts for Holding Companies, Holding Company Act Release No. 18,963, 6 SEC Docket 801-1 (May 1, 1975).

54. In 2003, the SEC Inspector General reported that many of the PUHCA forms are outdated, ineffective, or contain requirements that do not currently serve a useful regulatory purpose. GAO REPORT, *supra* note 18, at 19.

55. Letter from Raymond W. McDaniel, President, Moody's Investment Service, to Jonathan G. Katz, Secretary, U.S. Sec. and Exch. Comm'n (July 28, 2003) (letter regarding Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, File No. S7-12-03), available at <http://www.sec.gov/rules/concept/s71203/moodys072803.htm>.

Ratings condense a great deal of research into easy-to-use symbols that are relatively stable and accessible to all. In effect, they can be likened to other tools used by securities laws to promote transparency and stability in the capital market. As a result, regulatory authorities have increasingly utilized ratings as mechanisms to address dual policy goals of promoting transparency and limiting unnecessary volatility in the financial market. Over time, the regulatory use of ratings has proliferated. Securities regulators, banking regulators, insurance regulators, and legislators who oversee the activities of regulated entities use ratings.

*Id.* Ratings agencies were roundly criticized for missing the declining financial strength of Enron and WorldCom, among other dramatic financial implosions. One writer opines that "most investment-grade defaults result from factors that rating agencies typically cannot forecast until too late, like strategic goofs, fraud, legal and regulatory adversities and just plain bad luck." Richard Lehmann, *The Rating Game*, FORBES.COM, Aug. 15, 2005, [http://www.forbes.com/forbes/2005/0815/106\\_print.html](http://www.forbes.com/forbes/2005/0815/106_print.html).

remain adequately protected” if PUHCA were repealed.<sup>56</sup> The agency repeated that recommendation over the next twenty-plus years.<sup>57</sup>

In the early 1980s . . . the SEC concluded that many aspects of 1935 Act regulation had become redundant. Specifically, 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. 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 Commission thus unanimously recommended that Congress repeal the Act.<sup>58</sup>

#### THE REGULATION OF UTILITY HOLDING COMPANIES AFTER PUHCA REPEAL

PUHCA repeal alone will not cause a rush of utility consolidation. Merger activity is principally influenced by management’s ability to find merger partners that are attractive based on fundamental business reasons. Transactions are based on efficiency savings, strategic advantage and whether each partner to the merger can agree on valuation, control over the merged entity and other issues. Mergers in the electric utility industry will continue to be subject to FERC and state commission authorization and there is no indication that the standards that these regulators apply to proposed transactions will be relaxed.

On the contrary, given PUHCA repeal, we can expect that the FERC and state commissions will increase their vigilance over cross-subsidization between utility and nonutility businesses in a holding company group, the use of utility balance sheets to finance nonutility businesses, and the financial soundness of the proposed holding company owners. In turn, potential utility acquirers should think of ways to use corporate structure and management and operating practices to insulate utility subsidiaries from a holding company and its nonutility operations.

The trend in regulation can go at least two ways after PUHCA’s repeal. Regulators can attempt to re-create the PUHCA regulatory model which subjects entire holding company systems to regulation. Alternatively, regulators can focus more narrowly on the companies within a holding company system that serve captive customers. The latter approach of constructing a ring fence to protect only certain companies from the unregulated activities of the broader group is most sensible because it provides consumer protection without imposing barriers to investment or unnecessary regulation.

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56. *Public Utility Holding Company Act Amendments: Hearing on S. 1869, S. 1870, S. 1871 and S. 1977 Before the Securities Subcomm. of the S. Comm. on Banking, Housing, and Urban Affairs, 97th Cong. 397 (1982)* (statement of John S.R. Shad, Chairman, Securities and Exchange Commission).

57. See, e.g., 1995 REPORT, *supra* note 6, at 137.

58. *The Effect of the Bankruptcy of Enron on the Functioning of Energy Markets: Hearing Before the Subcomm. on Energy and Air Quality of the H. Comm. on Energy and Commerce, 107th Cong. 50 (2002)* (statement of Isaac C. Hunt, Jr., Comm’r, Securities and Exchange Commission). Pending repeal, the SEC worked within the bounds of the Act to minimize the constraints it imposed on a changing industry. See GAO REPORT, *supra* note 18.

We therefore believe that we have an obligation to administer the Act in a way that reflects how changing technology, changing regulation and changes in the capital markets impact utilities and holding company systems. Indeed, we believe that if we did not respond to these changes, we might not only damage our nation’s utility system, but we could also harm the very interests that the Act directs us to protect.

*Id.* at 42.

In its 1995 study of utility holding company regulation, the SEC's Division of Investment Management recommended that if Congress repealed PUHCA, it should ensure state access to books and records, and provide for federal audit authority and oversight of affiliate transactions.<sup>59</sup> That is largely what happened under EAct 2005.

EAct 2005 grants state utility commissions and the FERC access to the books and records of any company in a holding company system to the extent "relevant to the costs" of an associated public utility and "necessary or appropriate for the protection of utility customers with respect to jurisdictional rates."<sup>60</sup> EAct 2005 also extends the FERC's powers under sections 306 to 317 of the Federal Power Act to holding company systems, not just public utilities. These provisions give the FERC authority to conduct investigations and hearings, compel the production of witnesses and documents, enjoin and restrain violations, and impose penalties.<sup>61</sup>

When a holding company and a state commission disagree on the appropriate allocation of costs between a service company and a utility subsidiary, EAct 2005 provides that the FERC may resolve the dispute. At the election of either party, the FERC is charged with determining the cost allocation in such transactions, without prejudice to the ability of the state commission or the FERC to disallow allocated costs in a ratemaking proceeding.<sup>62</sup>

The standards that the FERC will apply to cost allocation determinations were described in a recent FERC order adopting final rules under the subtitle of EAct 2005 known as the Public Utility Holding Company Act of 2005 (PUHCA 2005).<sup>63</sup> Traditional centralized service companies that are currently selling goods and services to associated companies "at cost" are not required to switch to the market pricing standard that has typically been used by the FERC.<sup>64</sup> Traditional centralized service companies typically provide corporate administration and support services such as corporate governance, treasury, accounting, legal and risk management that are not readily compared to market alternatives. A specialized service company, such as one that is engaged in providing fuel supply services or construction, in contrast, will remain subject to the FERC's market pricing standard. The FERC will monitor traditional centralized service companies with a new annual report that such companies are required to file on FERC Form 60.

The PUHCA 2005 regulations also impose certain books and records maintenance requirements on holding companies and require traditional centralized service companies to follow the FERC Uniform System of Accounts, after a one-year phase in period.<sup>65</sup> The rules require holding companies to file a

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59. 1995 REPORT, *supra* note 6, at 133-37.

60. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1264, 119 Stat. at 974. (regarding federal access to books and records). Section 1265 of the EAct 2005 on state access to books and records, varies in minor respects but effects the result. *Id.* § 1265.

61. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1270, 119 Stat. at 976.

62. *Id.* § 1275.

63. Order No. 667, *Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005*, F.E.R.C. STATS. & REGS. ¶ 31,197 (2005), 70 Fed. Reg. 75,592 (2005).

64. Service companies that were regulated under PUHCA have long been subject to a cost-based pricing standard that requires a service company to allocate its costs fully to the companies served.

65. *See generally* 18 C.F.R. pt. 366 (2005).



notification of holding company status on Form FERC-65. In addition, holding companies claiming an exemption from the whole of the regulation, or waiver from certain accounting and reporting requirements, would assert that status on Form FERC-65A (exemption) or FERC 65-B (waiver).

Companies qualifying for exemption will not need to make their books and records available to the FERC under PUHCA 2005, although the FERC may still seek to obtain access to them under the Federal Power Act or the Natural Gas Act. In addition, exempt companies do not need to keep and preserve books and records in accordance with the FERC's rules, and their associated service companies will not need to follow the Uniform System of Accounts or file the FERC Form 60. Companies that qualify for a waiver are treated just like exempt companies except that the FERC retains the ability to access their books and records.

Exemptions from PUHCA 2005 are available to:

- Holding companies that are such solely as a result of ownership of qualifying facilities under the Public Utility Regulatory Policies Act of 1978, EWGs and/or FUCOs;
- Passive investors, so long as the ownership remains passive, including
  - Mutual funds,
  - Collective investment vehicles whose assets are managed by certain institutions, and
  - Persons that buy and sell public utility securities in the ordinary course of business and do not exercise operational control over the utility.
- FERC jurisdictional utilities that have no captive customers and that are not affiliated with any jurisdictional utility that has captive customers, and holding companies that own or control only such utilities,
- Transactions where the holding company affirmatively certifies on behalf of itself and its subsidiaries, as applicable, that it will not charge, bill or allocate to the public utility or natural gas company in its holding company system any costs or expenses in connection with goods and services transactions, and will not engage in financing transactions with any such public utility or natural gas company, except as authorized by a state commission or the FERC.
- Transactions between or among affiliates that are independent of and do not include a public utility or natural gas company,
- Electric power cooperatives, and
- Local distribution companies that are not regulated as "natural gas companies" pursuant to sections 1(b) or 1(c) of the Natural Gas Act.<sup>66</sup>

Waivers from PUHCA 2005 are available to:

- Single state holding company systems;
- Holding companies owning generating facilities that total 100 MW or less in size and which are used fundamentally for their own load or for sales to affiliated end-users; and

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66. *Id.* § 366.3.

- Investors in independent transmission-only companies.<sup>67</sup>

The PUHCA 2005 regulations are notable for two things. First, the FERC focused its exemptions and waivers on non-traditional holding companies and single-state holding companies. The FERC's interest in holding company books and records is to monitor the costs incurred by traditional utilities with captive customers so that it can assure that jurisdictional rates are appropriate. It used the exemptions and waivers to cull companies that would be unlikely to have an impact on jurisdictional rates. The FERC should be commended on its focused approach to ring fencing. Second, the FERC resisted the suggestions from some commenters to regulate holding company diversification. To do so would have imposed arbitrary restrictions on the investment activities of public utility companies and would have constituted substituting the judgment of the regulator for that of investors.

EPAct 2005 also expands the FERC's authority under section 203 of the Federal Power Act. Under that section, the FERC's authority to review and authorize the disposition of public utility facilities now covers holding company acquisitions of securities valued in excess of \$10 million, of a "transmitting utility, an electric utility company, or a holding company in a holding company system that includes a transmitting utility, or an electric utility company" or any merger or consolidation with such company.<sup>68</sup> The statute directs the FERC to approve an acquisition if

the proposed transaction will be consistent with the public interest, and will not result in cross-subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company, unless the Commission determines that the cross-subsidization, pledge, or encumbrance will be consistent with the public interest.<sup>69</sup>

Amended section 203 strengthens the current "public interest" review standard to make up for the absence of SEC review of holding company acquisitions of public utilities under PUHCA. With PUHCA's repeal, an acquirer will no longer be required to demonstrate that its post-acquisition public utility system will constitute either a single electric system or a single gas utility system consistent with PUHCA's "integrated system" requirement.<sup>70</sup> The acquirer also will not be required to show that the transaction would not (i) tend toward interlocking relations or the concentration of control of public utility companies, (ii) unduly complicate the capital structure of the holding company system, or (iii) be detrimental to the public interest, the interest of investors or consumers, or the proper functioning of the holding company system.<sup>71</sup> In addition, there will be no need to demonstrate that the consideration paid in connection with the acquisition is reasonable and fair.<sup>72</sup>

In a recent rulemaking proposal related to the implementation of the FERC's new section 203 authority, the FERC has asked whether it should adopt new rules and policies to protect consumers against cross-subsidization and

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67. 18 C.F.R. § 366.3.

68. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1289(a)(2), 119 Stat. at 982 (amending section 203(a) of the FPA).

69. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1289(a)(4), 119 Stat. at 982.

70. Public Utility Holding Company Act of 1935 § 10(c)(2), 15 U.S.C. § 79j (repealed 2005).

71. *Id.* § 10(b).

72. Public Utility Holding Company Act of 1935 § 10(b), 15 U.S.C. § 79j (repealed 2005).

utility asset encumbrances.<sup>73</sup>

[A]ny merger transaction that creates another affiliate opens the door to possible affiliate abuse or cross-subsidization concerns or pledges or encumbrances of assets. There are various ways we could address these concerns. We note that some state commissions, when reviewing a merger transaction, impose specific conditions designed to protect customers against unfair competitive practices, cross-subsidization, and affiliate abuse. Examples of these conditions include, among other things: reporting and information access requirements; restrictions on intra-corporate transactions that result in direct charges or cost allocations; a prohibition on the local utility bearing any of the merger acquisition premium, transaction costs, or merger transition costs; measures to protect the utility's financial position; a service quality program, under which the local utility would be subject to revenue requirement reductions if it did not meet certain performance targets established annually; and restrictions on a holding company's access to the local utility's power, natural gas assets, and its individual and aggregated customer information. Given Congress' amendment of Section 203, the Commission solicits comments on the adequacy of its present policies preventing affiliate abuse and cross-subsidization, and whether conditions such as those imposed by state commissions may need to be placed on Section 203 transactions.<sup>74</sup>

The final rules adopted under the amended section 203 are a sensible step in this direction.<sup>75</sup> The FERC will now require applications under section 203 to include an explanation of either: (1) how the applicant will assure that the proposed transaction will not result in cross-subsidization or improper pledges or encumbrances of utility assets; or (2) how cross-subsidization, pledges or encumbrances of utility assets are consistent with the public interest.<sup>76</sup> To address concerns that a merger may permit cross-subsidization with adverse effects on rates, the Commission will require applicants to offer protections to their captive customers that address the potential for cross-subsidization.

The Commission's order notes that in lieu of, or in addition to, any other explanation, the applicant may offer certain verifications that indicate that the transaction would not adversely affect captive customers. The applicant may verify that the proposed transaction does not result in, at the time of the transaction or in the future:

(1) transfers of facilities between a traditional utility associate company with wholesale or retail customers served under cost-based regulation and an associate company; (2) new issuances of securities by traditional utility associate companies with wholesale or retail customers served under cost-based regulation for the benefit of an associate company; (3) new pledges or encumbrances of assets of a traditional utility associate company with wholesale or retail customers served under cost-based regulation for the benefit of an associate company; (4) new affiliate contracts between non-utility associate companies and traditional utility associate companies with wholesale or retail customers served under cost-based regulation, other than non-power goods and services agreements subject to review under Sections 205 and 206 of the FPA.<sup>77</sup>

Holding companies that are not already subject to ring fencing requirements as a result of state regulation may wish to consider implementing a formalized

73. Notice of Proposed Rulemaking, *Transactions Subject to FPA Section 203*, F.E.R.C. STATS. & REGS. ¶ 32,589, 32,274 at P 17, 70 Fed. Reg. 58,636 (2005) [hereinafter Section 203 NOPR].

74. *Id.* at P 52 (footnote omitted).

75. See Order No. 669, *Transactions Subject to FPA Section 203*, F.E.R.C. Stats. & Regs. 31,200 (2005), 71 Fed. Reg. 1348 (2006) [hereinafter Section 203 Final Rules].

76. *Id.* at P 164 (18 CFR § 33.2(j)).

77. Section 203 Final Rules, *supra* note 75, at P 169.

ring fencing policy and internal systems that will assure that cross-subsidization does not have an effect on the rates paid by captive customers. A formalized program will have value the next time the holding company is before the FERC in a section 203 proceeding because an application must include "appropriate evidentiary support" for the explanation about the assurances in place to address cross-subsidization concerns.<sup>78</sup> Some elements of an effective ring fencing program are described below.

A valid criticism of PUHCA was that it stifled investment in the utility sector by discouraging investment by both traditional and non-traditional investors. Investors that could not tolerate registered holding company status under PUHCA, because of restrictions on diversification, the inability to bring all their utility assets within a single integrated system, or for other reasons, could not enter into transactions, or were forced to adopt complex ownership structures, known as "PUHCA pretzels," to separate economic ownership from voting control. Examples of potential non-traditional investors in the U.S. utility sector include private equity funds such as Kohlberg, Kravis, Roberts & Co. and Texas Pacific Group, diversified U.S. energy companies such as Chevron Corp. and Kinder Morgan Inc., and diversified foreign investors such as China National Offshore Oil Corporation, and certain foreign banks and pension funds interested in acquiring U.S. infrastructure assets. To avoid building new barriers to investment, the state commissions should follow the FERC's lead and refrain from re-enacting PUHCA-like restrictions such as the integration requirement, holding company financial requirements, or limitations on non-utility diversification. Regulation of holding companies will tend to discourage investment in worthwhile projects and raise the capital costs associated with them. Those increased costs will eventually be borne by public users of utility services.

The advantages of holding companies should not be overlooked in the desire to prevent possible holding company abuses. The most important advantage of a holding company is its ability to provide strong structural separation between the various operating sectors of a company. Properly structured, this separation provides significant protection for utilities from the risks of other utility and non-utility operations. Debt used to finance non-utility activities, for example, would not generally become an obligation of the utility subsidiaries. A public utility company that conducts non-utility businesses as a division within the utility or through subsidiaries of the utility exposes the utility's finances (and its customers) to the risks of the non-utility business.<sup>79</sup> Holding companies also can provide benefits to consumers through more efficient and less costly services, particularly in the context of industry consolidations. For example, the consolidation of nuclear generating plant ownership that has occurred over the past few years allows for the better use of specialized nuclear plant operations and administrative expertise. Natural gas pipeline expertise also may be transferable to the water supply and wastewater treatment industries. Imposition of utility integration requirements, or limitations on holding company diversification may have stifled the transfer of

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78. See generally Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. at 982-83.

79. See CHARLES F. PHILLIPS, JR., *THE REGULATION OF PUBLIC UTILITIES, THEORY AND PRACTICE* 628 (1988). See also HAWES, *supra* note 11 (particularly notable for its comprehensive treatment of public utility holding companies as a means for diversification).

this expertise to the public detriment. Finally, the increased scale of holding company systems can permit more efficient access to the capital markets, efficiencies in the purchasing of fuel and supplies, and the maintenance of a staff of experienced personnel in areas such as engineering and environmental services that individual utility subsidiaries could not afford to maintain on their own.

The FERC's recent rulemakings under PUHCA 2005 and section 203 of the Federal Power Act demonstrate an understanding that consumer protection can be consistent with policies that maintain and develop a vibrant market for utility investment.<sup>80</sup> A market with numerous investors will provide adequate capital at the lowest cost for utility investment. A market populated with many diverse investors also means that the utility system will be more robust (less susceptible to systemic risk) and able to withstand the financial collapse of holding companies and public utilities from time to time. Lastly, a broad pool of investors should bring more diversity of management and technologies that can be applied to the problems facing the industry. The current shortage of natural gas, for example, may be addressed through investment in LNG importation and re-gasification terminals, by constructing additional pipeline capacity to import gas from Canada, or through bio-gas digesters and land-fill gas projects. Minimizing regulation at the holding company level allows project participants with varied backgrounds, business strengths and asset mixes to come together in the most efficient manner. Expertise and investment funds are most likely to flow to geographic regions, infrastructure and technology that most need investment when regulatory barriers are low.

While barriers to investing should be low, few would disagree that the FERC and state public utility commissions should continue to protect public utility subsidiaries that provide monopoly network service such as electric distribution and transmission. Natural monopolies operated under a cost of service rate model should not absorb risks from associated nonutility businesses. Consistent with the FERC's jurisdiction under the Federal Power Act, to promote just and reasonable rates for public utility service, the FERC's efforts have been focused on ring-fencing transmission-owning public utility subsidiaries of holding companies through financial and structural protections imposed at the utility level. Similarly, state commissions should focus on ring-fencing distribution facility-owning public utility subsidiaries, rather than regulating entire holding company systems after the PUHCA model. Coordination between the FERC and the state commissions in areas such as reporting, accounting standards and regulation of affiliate transactions, is needed to make the most of limited resources and to reduce the compliance burden on industry.

That ring-fencing works is illustrated by the bankruptcy of the decade. A ring-fence largely built by the Public Utility Commission of Oregon (Oregon Commission) around Portland General Electric Company (PGE), effectively protected PGE from the adverse effects of the Enron bankruptcy.<sup>81</sup> The Oregon

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80. Section 203 Final Rules, *supra* note 75, at P 3.

81. At the time of Enron's bankruptcy the company was considered an exempt intrastate holding company under PUHCA and, accordingly, it was not subject to the extensive regulation imposed on registered holding companies. The case is particularly interesting because it illustrates that in the absence of PUHCA a state commission can protect a public utility subsidiary of a holding company by exercising its authority to

Commission imposed twenty-two conditions on the acquisition of PGE by Enron in 1997 ranging from access to information (particularly about affiliate transactions), prohibitions on the utility bearing merger costs, service quality standards, financial separation of the utility and holding company, and protections against cross-subsidization.<sup>82</sup> Although a full treatment of ring-fencing is beyond the scope of this article, some of the key provisions related to financial separation and cross-subsidization are summarized below.

1. The Oregon Commission may audit the accounts of Enron and its subsidiaries to determine the reasonableness of allocation factors used by Enron to assign costs to PGE.
2. The Oregon Commission shall have access to all books and records pertaining to transactions between PGE and affiliated companies.
3. PGE shall maintain a separate accounting system and local control over its books.
4. PGE shall maintain separate debt and preferred stock ratings.
5. PGE shall not make a distribution to Enron that would cause PGE's equity capital to fall below 48% of total PGE capital without Oregon Commission approval.
6. Enron and PGE shall provide the Oregon Commission unrestricted access to all written information provided to common stock, bond, or bond rating analysts which, directly or indirectly, pertains to PGE.
7. Enron shall notify the Commission of its intention to transfer more than 5% of PGE's retained earnings to Enron over a six-month period, or to declare a special cash dividend.
8. PGE shall adopt and implement certain service quality measures.
9. PGE and Enron agree to comply with certain affiliated transactions requirements, including application and reporting requirements.
10. PGE shall file quarterly reports regarding employee transfers between PGE and Enron and consulting and training activities conducted between the companies.
11. Enron shall not subsidize its activities by allocating to or directly charging PGE expenses not authorized by the Oregon Commission to be so allocated or charged.
12. PGE shall not give its affiliates preferential access to PGE's excess pipeline capacity, power and natural gas assets.
13. PGE shall not provide to affiliated company marketing personnel individual customer data and shall provide aggregated customer information to all entities on the same terms.
14. PGE and Enron agree to certain penalties in the event the conditions are violated.<sup>83</sup>

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condition a merger or acquisition. Effective ring fences can be designed even when the state has little or no direct authority over a holding company.

82. *In the Matter of the Application of Enron Corp. for an order Authorizing the Exercise of Influence Over Portland General Electric Company*, OR. P.U.C. 97-196 (1997) (reh'g denied Or. P.U.C. 97-377).

83. *Id.* at app. A, at 2.

These conditions were supplemented by an additional measure put in place shortly after Enron filed its bankruptcy petition. To increase the degree of insulation between PGE and Enron, in September 2002, PGE created a new class of Limited Voting Junior Preferred Stock and issued a single share of that stock to an independent party. The stock had voting rights which limited PGE's right to commence a voluntary bankruptcy proceeding without the consent of the holder of the share.<sup>84</sup> The power of an independent party to block a voluntary bankruptcy proceeding was important to credit rating agencies to protect against a holding company decision to put PGE into bankruptcy. The special share mechanism was a significant factor in preserving PGE's investment grade credit ratings throughout the bankruptcy proceedings of its parent.

Credit rating agencies look at ratings in a consolidated fashion based on the entire holding company system, including utility and nonutility subsidiaries. The consolidated credit rating, sometimes called a corporate or enterprise credit rating, is the basis for the ratings assigned to each company in the holding company group. "[I]n companies with multiple businesses, the affiliation between a stronger and a weaker entity will almost always affect the credit quality of both, unless the relative size of one is insignificant. The question is how close together the two ratings ought to be pulled on the basis of their affiliation."<sup>85</sup>

In ratings determinations, the presumption is typically that the utility subsidiaries will be affected by the nonutility businesses of a holding company unless insulating factors (i.e., ring-fencing) justify rating a utility subsidiary above or independent of the consolidated enterprise rating. Insulating factors that will be found in good ring-fencing include a structure that reduces the risk of a subsidiary being drawn into bankruptcy with its parent. The special share of preferred stock issued by PGE served that function, but structural protections can take other forms as well. Covenants such as restrictions on dividend payments, restrictions on asset transfers and inter-company loans designed to preserve the financial soundness of the utility also are important.<sup>86</sup> The holding company's ability to access utility assets for non-utility purposes also will be limited if the debt of the utility is secured by a pledge of substantially all of the utility's assets. Lastly, appropriate regulation can support the effective ring-fencing of a utility.<sup>87</sup>

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84. Portland General Electric Co., Annual Report (Form 10-K), at 86 n. 4 (Mar. 17, 2003).

85. Swaminathan Venkataraman, *Holding Company Diversification and its Impact on Regulated Operations*, NARUC Financing and Accounting Conference (Mar. 26, 2003) (on file with author).

86. Compare the effective insulation of PGE with the fate of Enron's gas pipeline subsidiaries Northern Natural Gas Company (Northern) and Transwestern Pipeline Company (Transwestern). In November 2001, Northern and Transwestern, at Enron's request, entered into revolving credit agreements with banks for \$450 million and \$550 million, respectively, pledging their pipeline assets as collateral. Enron and other Enron affiliates then borrowed substantially all of this \$1 billion amount in exchange for subordinated promissory notes. Shortly thereafter, Enron declared bankruptcy. Both Northern and Transwestern were left with virtually worthless Enron subordinated promissory notes and a continued obligation to pay the indebtedness they owed under the revolving credit agreements. The FERC review of these transactions concluded: "It appears that the loans made by Transwestern and Northern described above were imprudent. It further appears that Transwestern and Northern will experience an increased credit risk as a result of the loans and will have a significantly higher cost of capital." *In re Investigation of Certain Financial Data*, 100 F.E.R.C. ¶ 61,143 at P 16 (2002).

87. See Venkataraman, *supra* note 85. With regard to the effect of regulation on utility credit quality, Venkataraman notes that timely and adequate recovery of fuel and power costs is important and that utilities with power and fuel cost adjustment mechanisms are perceived as having better credit quality than utilities that

## CONCLUSION

The holding company is an effective tool to organize and finance large business enterprises. It is an important device to consolidate businesses and reap the efficiencies associated with size. History has show that it can also be an instrument of abuse. "The task of the legislatures, the courts, and the economists, in dealing with the holding company, is to understand and minimize the abuses to which it is subject, while recognizing and strengthening its social usefulness."<sup>88</sup> Today, it also is the task of utility and holding company management acting responsibly to police itself to prevent the re-imposition of holding company regulation.<sup>89</sup> Likewise, rating agencies, state utilities commissions and the FERC should encourage the effective insulation of utilities so that holding company financial distress, when it occurs, is of little consequence to utility operating companies in holding company systems.

Regulation must change as the business environment that it was designed to control evolves. The utility industry has changed dramatically since 1935, yet human nature remains essentially unchanged. It is appropriate that PUHCA is gone, but continued vigilance against the practices that gave rise to PUHCA remains prudent.

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are more exposed to fuel and power price volatility. *Id.*

88. Bonbright & Means, *supra* note 14, at 338.

89. "The greatest enemies of the holding company are not the critics who point to its present abuses, but rather those business men who stubbornly resist all efforts to bring it under governmental control and those judges who invoke the notion of separate corporate entities against all attempts to make it responsible for the acts of its subsidiaries." *Id.* at 339.