

Corporate Structure Regulation After PUHCA: Challenges for Regulators

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I. PUHCA 1935 Restrictions on Industry Structure

A. 1935 Congressional concerns

1. Market power (electric markets and non-electric markets)
2. Diversification risk
3. Distant management
4. Securities abuses
5. Corporate complexity
6. Concentration of political power
7. Ineffectiveness of state regulation

B. 1935 statutory principles

1. "integrated public utility system"
 - a. interconnected or capable of interconnection
 - b. single area or region
2. geographic restrictions
3. type-of-business restrictions
4. financing reviews
5. prohibitions and limits on interaffiliate transactions

C. Application of the principles to corporate transactions: limits or bans on --

1. investments by utilities in other utilities
2. investments by utilities in nonutility businesses

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3. investments by nonutilities in utilities
4. interaffiliate financial transactions
5. interaffiliate transactions in goods and services (other than electric power)

D. Standards: examples from PUHCA 1935

1. An **acquisition** of a utility, through the holding company form --
 - a. must not "tend[] towards interlocking relations or the concentration of control of public-utility companies, of a kind or to an extent *detrimental to the public interest or the interest of investors, or consumers.*" 10(b)(1).
 - b. must bear a "*fair relation to the sums invested in or the earning capacity*" of the property acquired. 10(b)(2).
 - c. must not "*unduly complicate the capital structure of the holding company system.*" 10(b)(3).
 - d. must not be "*detrimental to the public interest or the interest of investors or consumers or the proper functioning of*" the holding company system. 10(b)(3).
 - e. must not be "detrimental to the carrying out of the provisions of" Section 11 (relating to *simplification of holding company systems.* 10(c)(1).
 - f. must "serve the public interest by tending towards *the economical and efficient development of an integrated public-utility system.*" 10(c)(2).²

² Section 2(a)(29)(A) in turn defines an "integrated public-utility system," as applied to electric utility companies, as

"a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more states, not so large as to impair (considering the state of the art

2. Utility investment in non-utility businesses, through the holding company form

a. Registered holding companies

(1) Sec. 11(b)(1) generally requires a registered holding company to limit its operations to "a *single integrated public-utility system*."

(2) The "other business" exception: The holding company may retain "such other businesses [i.e., other than the business of a public-utility company] as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system...." Section 11(b)(1).

(3) Any other assets or operations must be divested.

b. Exempt holding companies

Investments in nonutility businesses allowed only if they are not "detrimental to the public interest, or the interest of investors or consumers." Section 3(a)(1).

3. **Issuances of debt or equity**

Section 7(d)(1) of PUHCA 1935, 15 U.S.C. sec. 79g(d)(1) (2000), prohibited the SEC from approving a securities issuance that triggered one or more of six negative findings:

(1) the security is *not reasonably adapted to the security structure* of the declarant and other companies in the same holding-company system;

(2) the security is *not reasonably adapted to the earning power* of the declarant;

(3) financing by the issue and sale of the particular security is *not necessary or appropriate to the economical and efficient*

and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation."

operation of a business in which the applicant lawfully is engaged or has an interest;

(4) the *fees, commissions, or other remuneration*, to whomsoever paid, directly or indirectly, in connection with the issue, sale, or distribution of the security are not reasonable;

(5) in the case of a security that is a guaranty of, or assumption of liability on, a security of another company, the circumstances are such as to constitute the making of such guaranty or the assumption of such liability an *improper risk* for the declarant; or

(6) the terms and conditions of the issue or sale of the security are *detrimental to the public interest or the interest of investors or consumers*.

4. **Interaffiliate transactions**

- a. financial transactions (loans, guarantees of indebtedness, extension of collateral)
- b. sales of goods and services (other than electric power)
- c. Applied only where the affiliates are members of a registered holding company system, are subject to PUHCA
- d. **Goal:** prevent holding company from "milking" utility affiliates.
- e. **Techniques:** prohibitions, advance reviews, permitted transactions must be "at cost."

E. **Summary of major PUHCA 1935 provisions, organized by category of Congressional concern**

1. **Market Power**

- a. Review of acquisitions for "concentration of control." Section 10(b)(1) (emphasis added).

- b. Prohibition on acquisitions that do not "serve the public interest by tending towards the economical and efficient development of an integrated public-utility system." Section 10(c)(2) (emphasis added).
- c. Restrictions on combined ownership of gas and electric utilities. Section 8 (applies to "registered" holding companies only) (emphasis added).
- d. Requirement that interaffiliate, non-power supply contracts be "at cost" or otherwise in the public interest. Section 13 (applies to "registered" holding companies only)

(emphasis added).

2. Diversification Risk

- a. "Registered" holding companies: Prohibition on acquisition of any business not "reasonably incidental to, or economically necessary or appropriate to the operations of [an] integrated public-utility system." Section 11(b)(1) (emphasis added).
- b. "Exempt" holding companies: Exemption (from the registereds' prohibition on diversification), "unless and except insofar as [the Commission] finds the exemption detrimental to the public interest or the interest of investors or consumers." Section 3(a)(1) (emphasis added).

3. Distant Management

- a. Prohibition on acquisitions which do not "serve the public interest by tending towards the economical and efficient development of an integrated public-utility system." Section 10(c)(2) (emphasis added).
- b. Requirement of divestiture of any company not incidental to, or economically necessary or appropriate to, the operations of an integrated public-utility system. Section 11(b)(1) (applicable to "registered" holding companies only) (emphasis added).

4. Securities

- a. Review of issuances of securities. Sections 6 and 7 (applies to "registered" holding companies only).
- b. Review of acquisitions: amount paid must bear a fair relation to the sums invested in, and earning capacity of, the underlying utility assets. Section 10(b)(2).
- c. Prohibition on holding company borrowings from utility subsidiaries. Section 12 (applies to "registered" holding companies only).
- d. Review of holding company loans to utility subsidiaries. Section 12 (applies to "registered" holding companies only).

5. Concentration of Political Power: prohibition against campaign contributions. Section 12(h) (applicable to "registered" holding companies only).

6. Corporate Complexity

- a. Review of securities issuances. Sections 6 and 7 (applicable to "registered" holding companies only).
- b. Review of acquisitions for corporate and capital complexity. Section 10(b)(3), 11(b)(2).

7. Effectiveness of State Regulation

- a. Limitation of holding companies to a size reflecting an "integrated public-utility system." Section 10(c)(2), Section 11(b)(1) (emphasis added).
- b. "Registered" status for multistate and other holding companies. Sections 3, 4, 5.

II. EAct 2005 on Mergers, Acquisitions and Market Structure

- A. Repeal of PUHCA 1935. Section 1263 of EAct 2005.
- B. Federal, state access to affiliate books and records. Sections 1264 and 1265 of EAct 2005.
- C. Preservation of state and federal authority to review interaffiliate transactions. Section 1267 of EAct 2005.
- D. FERC allocation of service company costs among the utility subsidiaries. Section 1275 of EAct 2005.
- E. Amendments to FPA Section 203. Amended Section 203, added by Section 1289 of EAct 2005 (hereinafter Sec. 203).
 - 1. obligation to obtain FERC permission. Sec. 203(a)(1).
 - 2. application to --
 - a. public utility dispositions of jurisdictional facilities. Sec. 203(a)(1)(A).
 - b. public utility merger of its jurisdictional facilities with those of any other public utility. Sec. 203(a)(1)(B).
 - c. public utility acquisitions of the stock of any other public utility. Sec. 203(a)(1)(C).
 - d. public utility acquisitions of an existing generation facility [Sec. 203(a)(1)(D)] --
 - (1) "that has a value in excess of \$10,000,000 [Sec. 203(a)(1)(D)(i)]; and
 - (2) "that is used for interstate wholesale sales and over which the Commission has jurisdiction for ratemaking purposes." Sec. 203(a)(1)(D)(ii).
 - e. "No holding company in a holding company system that includes a transmitting utility or an electric utility shall purchase, acquire, or take any security with a value in excess of \$10,000,000 of, or, by any

means whatsoever, directly or indirectly, merge or consolidate with, 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, with a value in excess of \$10,000,000 without first having secured an order of the Commission authorizing it to do so." Sec. 203(a)(2).

3. \$10 million exclusion. Sec. 203(a)(2).
4. revised standards. Sec. 203(a)(4).
 - a. is consistent with the public interest [Sec. 203(a)(4)], and
 - b. 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. Sec. 203(a)(4).
5. procedures for expedition. Sec. 203(a)(5).

F. ***No Congressional intent to preempt state enactment of corporate structure statutes.***

III. A Century of Structural Change: Establishing, then Phasing Out, the Integration Requirement

- A. 1900-1935: No limits on holding company acquisitions
- B. 1935: Congress imposes integration requirement on all utility activities, both wholesale and retail
- C. 1978: PURPA repeals the acquisition review requirement (including the integration requirement) for wholesale generators meeting the definition of "qualifying facility"
- D. 1992: EPACT repeals the acquisition review requirement (including the integration requirement) for wholesale generators meeting definition of "exempt wholesale generator"
 - 1. "ministerial" review by FERC
 - 2. no restriction on utility ownership
 - 3. FERC continues to have rate jurisdiction over wholesale seller
- E. 1997-2000: State enactment and implementation of retail competition statutes
- F. 2005: Elimination of PUHCA and its restrictions on non-integrating retail acquisitions

IV. Post-2005 Implications

A. Structural Options for Utilities and Nonutilities

1. *Acquisitions of other utilities without geographic or physical integration requirement, subject in part to amended FPA Section 203*
 - a. *Acquisitions of utilities by other utilities*
 - b. *Acquisitions of utilities by non-utilities*
2. *Acquisitions by utilities of non-utilities without limitation or review*
3. *Interaffiliate transactions without limit and without advance federal review*
4. *Financing transactions without limit and without federal review (except for limited FERC review under Section 204 per the Westar standard)*
5. *Six possible motivations for post-PUHCA transactions:*
 - a. *operational efficiencies*
 - b. *market share*
 - c. *financial strengthening*
 - d. *utility-level diversification*
 - e. *shareholder-level diversification*
 - f. *transaction fees*

B. Options for State Regulators

1. *Prohibitions, limitations or full permission? See attached table.*
 - a. *Utility acquisitions of other utilities without geographic limit or physical integration requirement*
 - b. *Acquisitions by utilities of non-utilities*
 - c. *Acquisitions by non-utilities of utilities*

d. Interaffiliate transactions

e. Financing transactions

2. Regulatory coordination

a. What is the logical federal-state relationship?

b. What are the risks and benefits of multiple state regulatory efforts?

C. Constitutional Limits on State Regulatory Responses

1. Commerce Clause³
2. Contract Clause
3. Takings Clause
4. Supremacy Clause
5. Due Process Clause

³ *Alliant Energy Co. v. Bie*, 330 F.3d 904 (7th Cir. 2003). The Court upheld (a) a state limit on amount of utility holding company investment in non-utility businesses and (b) an in-state incorporation requirement for utilities serving in the state. The Court invalidated as discriminatory against interstate commerce an in-state incorporation requirement for holding company of utility serving in the state). The Court also upheld (a) a takeover provision requiring PSC approval prior to the sale of more than 10% of the utility holding company's stock regardless of where the involved parties are located or incorporated; and (b) a requirement of PSC approval prior to issuance of securities by a public service corporation, without regard to whether the securities are entering into interstate commerce.

V. Creation of Regulatory Action Plan

- A. Define acceptable industry structure
- B. For each type of transaction, determine:
 - 1. prohibit
 - 2. permit without limit
 - 3. permit with conditions
- C. Obtain necessary statutory authority
 - 1. Analyze existing state statutory authority
 - 2. Draft new statutes
- D. Determine appropriate procedures
 - 1. advance rulemaking
 - 2. case-by-case

VI. Other Advice

- A. Determine regulatory policy prior to proposed transactions
- B. Focus on long-term effects, not only on short-term benefits
 - 1. competition
 - 2. physical operations
 - 3. quality of service, including innovation
 - 4. financial health
 - 5. reasonable rates
 - 6. no exposure to harmful business risks
 - 7. no interaffiliate relationships that impede achievement to the foregoing objectives
- C. Treat each case as precedent for the next
- D. Identify the necessary skill sets and train for them now

E. Analyze transactions comprehensively

1. rates and costs
2. quality of service
3. competitiveness
4. ease of regulation
5. worker morale
6. management focus

Corporate Restructuring by Public Utilities: How Should Regulators Prepare and Respond?

Corporate Restructuring by Public Utilities: How Should Regulators Prepare and Respond?			
		Regulatory Action	
Corporate Event	Prohibition?	Reviews, Limits and Conditions?	Permission w/o Review?
1. Utility merger with another utility			
a. operationally integrated			
b. not operationally integrated			
2. Utility acquisition of nonutility			
a. for utility purpose			
b. not for utility purpose			
3. Nonutility acquisition of utility			
a. acquirer has operational relationship to utility			
b. acquirer has no operational relationship to utility			
4. Interaffiliate transactions			
a. goods and services: sale to utility			
b. goods and services: sale by utility to nonutility			
c. financing: loan or guarantee to utility			
d. financing: loan or guarantee from utility to nonutility			
5. Issuance of debt or equity			
a. at the holding company level, for utility purposes			
b. at the holding company level, for nonutility purposes			
c. at the utility level, for utility purposes			
d. at the utility level, for nonutility purposes			
e. at the nonutility level, for utility purposes			
f. at the nonutility level, for nonutility purposes			