

PUHCA Repeal and the Challenges Ahead

Harvard Electricity Policy Group

41st Plenary Session

Atlanta, Georgia

December 8, 2005

Why Did Congress Repeal PUHCA?

- Utility industry and financial investor community lobbied for repeal.
 - “Lobbyists for such power companies as Cinergy, a big coal and gas company based in Ohio, and Entergy, a multi-state energy corporation, made no secret that the repeal of PUHCA was ‘a huge deal for us,’ which would allow companies to merge and expand.”
– *Public Citizen*
- The Bush administration recommended PUHCA repeal in its 2001 Report of the National Energy Policy Development Group.
- SEC had recommended PUHCA repeal since the 1980s.

PUHCA's Problems

- PUHCA was widely perceived as:
 - A barrier to increased investment in utility companies and utility infrastructure,
 - Outdated in its focus on utility “integration” – the interconnection and single region requirements,
 - Surpassed by the FERC and state commissions in the area of consumer protection, and
 - Surpassed by other securities laws in its investor protection function.

Opposition to PUHCA Repeal

- Public Citizen –
 - “For nearly 70 years, PUHCA regulations have protected utility ratepayers by preventing bankruptcies, financial instability and consolidation and mergers among power companies.”
- Rating agencies such as S&P expressed concern that bondholders could be exposed to increased risk without PUHCA’s restrictions on investments in diversified businesses.

Ralph and Kindred Spirits

- Ralph Nader –
 - “While the repeal of PUHCA might initially make the electricity sector more attractive to investors such as yourself, it surely will result in the use of utility revenues to finance other businesses, ensuring the flow of capital *away* from the sector. * * * Given the recent corporate crime wave, there is no reason to believe that executives of energy companies today will behave any more ethically or act more in the interest of their shareholders than they did in the pre-PUHCA era of the 1920s and 1930s.” *Sept. 24, 2003 letter to Warren Buffet.*
- The ghosts of James Bonbright and Gardiner Means –
 - In 1932, they argued that holding companies’ complete freedom from regulation had become “a major public menace.” The Holding Company: Its Public Significance and Its Regulation.

On Balance, Repeal Makes Sense

- Utility industry continues to be regulated by FERC, state commissions, DOJ, FTC and NRC.
 - “[T]oday we have some 5,000 very capable State regulatory employees, who are in fact protecting [utility] assets. And yet, people think that the mirage of 24 employees at the Securities and Exchange Commission in the PUHCA section are in fact doing that job. The reality is the States are doing it.” *David Sokol, March 4, 2003 testimony before Senate Committee on Energy and Natural Resources.*

A Changed Industry Requires Different Regulation

- Industry has matured.
 - Utility infrastructure is universal and coordinated.
 - Generation is more competitive.
 - FERC regulation of transmission and generation and the market will determine the best asset combinations, not the SEC.
 - Improvements in securities regulation.
 - Full disclosure system – better transparency.
 - Better accounting.
 - Credit rating agencies, equity analysts and other institutions monitor industry and exert influence.

Post-PUHCA Observations

- By some estimates, \$100 billion of equity capital has been excluded from the industry due to regulatory barriers.
 - Berkshire Hathaway has indicated an interest in investing \$10-\$15 billion (*e.g.*, PacifiCorp acquisition).
 - Babcock & Brown is acquiring Cross Sound Cable in a recently announced transaction.
 - KKR-UniSource and TPG-Portland General are examples of failed private-equity-financed utility acquisitions. (The M&A model needs some fine tuning.)

Statistics

- ❑ Mergers in the electric utility industry from 1917 to 1930 averaged in excess of 200 per year.
- ❑ The utility industry today remains highly fragmented, with approximately 3,500 separate electric systems.
- ❑ The largest 200 utility systems serve approximately 80% of the retail customer load and hold approximately 90% of U.S. electric generating capacity.

No Consolidation Tsunami

- Statistics suggest opportunities for consolidation, but realities will likely prevent a wave of consolidations.
 - Fundamental business reasons must support a combination.
 - Opportunity to capture efficiencies.
 - Strategic advantage.
 - Agreement on valuation, control and other issues.
 - Receptive state regulatory environment.

For Every Action, There is an Equal and Opposite Reaction

- With PUHCA repeal, FERC can be expected to be more vigilant in the areas of:
 - Cross-subsidization.
 - Encumbrances of utility assets.
 - Holding company diversification and financial soundness.
- The FERC will not approve a transaction under FPA section 203 that will result in cross-subsidization of a non-utility associate company or pledge or encumbrance of utility assets for the benefit of an associate company unless that cross-subsidization, pledge, or encumbrance will be consistent with the public interest. - *Proposed new 18 CFR 2.26(f)*.

State Regulators are Considering Ring Fencing

- Reps. Dingell and Markey – recommending strengthened state utility regulation to protect against increased risks after PUHCA is repealed.
- NJBPU – new proposal on holding company diversification.
 - Proposal would prevent a holding company whose primary businesses are not utility related from purchasing a NJ electric or gas utility.
 - Limits diversified activities to 25% of total utility related assets, although NJBPU may lower to 15% or increase to 35% if appropriate to ensure safe, adequate and proper service.
- NARUC – considering whether additional protections are necessary.

Holding Companies: Not All Bad

- Don't stamp out the benefits holding companies provide:
 - They provide structural separation between utility and nonutility operations, debt and risks.
 - They make possible beneficial consolidation in the utility industry.
 - Providing more efficient and less costly services through economies of scale and scope.
 - Consumers may benefit by spreading fixed costs and by an increased breadth of service offerings.

Ring Fencing

- FERC and state PUCs generally have limited jurisdiction over holding companies.
 - PUHCA 2005 gives them books and records access
 - FERC also has authority to determine cost allocations for affiliate transactions involving service companies.
 - FERC and state commissions generally have no statutory authority over holding company non-utility investments or holding company financing. (Wisconsin and possibly New Jersey are exceptions.)

What is Ring Fencing?

- Legal measures intended to insulate a regulated utility from the potentially riskier activities of an unregulated affiliate.
 - A combination of prohibitions, limitations, structure requirements, and monitoring.
 - Can be imposed by statute, regulation, or on a case-by-case basis, by order.
 - Continuum of rigid to tailored and flexible.
 - Utility focused to holding company focused.

Four Examples

- Wisconsin Utility Holding Company Act is statutory, inflexible, confusing and may discourage beneficial investment.
 - Generally limits holding company diversified investments to an amount not to exceed 25% of associated public utility assets.
 - Legislative definitions of “acceptable diversification” are inflexible. It would be better to give PUC discretion.
- NJBPU proposed rule is more flexible, but still discourages acquisitions by diversified acquirers that may be beneficial.

Examples

- FERC proposed section 203 prohibitions on cross-subsidization and utility asset encumbrance standards can be overcome with public interest showing and are more flexible.
- OPUC ring fencing of Portland General from Enron was imposed by order and worked well.
 - Flexible and appropriate to the circumstances.
- Should industry voluntarily adopt ring fencing “best practices” to substitute for or preempt other, less flexible, ring fencing methods employed by regulators?

Addressing Regulators' Concerns

- Working more cooperatively with regulators improves standing with stakeholders, including:
 - Shareholders that value good corporate governance, *e.g.*, public employee pension funds.
 - Credit rating agencies that consider regulatory risk as one component of overall corporate risk.
- Transparency and cooperation may create an environment supportive of creative regulation such as performance-based or incentive rates.
- Cooperation improves credibility and helps to speed regulatory approvals, allowing a company to grow faster.



Learning from Experience

- KKR-UniSource

- Benefits of acquisition:

- Improved utility capital structure,
 - Increased liquidity,
 - Continued local utility presence, and
 - Retention of current management.

Ring Fencing Helps, But it is Not Enough

- KKR offered extensive ring fencing assurances and submitted to most of the provisions recommended by the PUC staff.
 - Safeguarding the financial integrity of the utilities,
 - Service quality and reliability,
 - Affiliate transactions,
 - Corporate governance (*e.g.*, separate utility boards with independent directors),
 - Community presence, and
 - Non-recoverability of merger costs.

What Went Wrong?

- The ring fencing protections and benefits were insufficient to offset concerns with:
 - Increased leverage.
 - Acquisition debt was projected to be non-investment grade. PUC was concerned that high leverage would lead to pressure to increase utility cash flows and expense cutting with negative effects on service quality and safety.
 - A partnership structure with an inexperienced general partner.
 - Maintaining investment adequate to preserve service quality.
 - Adequate PUC oversight of the new entities.
 - PUC noted that the “limited partnership structure is not as conducive to the disclosure of information as a publicly traded corporate structure.” Effective oversight and access to information is necessary because “the activities of non-utility affiliates can have a grave impact on public service corporations.”

Net Benefits Test

- Potential risks and unknowns with the proposed acquisition made staff and the Commission look for positive benefits. (No harm vs. public interest standard.)
- Benefits need to be:
 - Sufficiently tangible (reduction in utility leverage offset by increased holding company leverage – not a persuasive benefit),
 - Attributable to the transaction (no credit given for local presence and retaining management), and
 - Substantial enough to outweigh perceived risks of the transaction.

Trust Matters

- Investors had tried to shield information from the PUC.
 - “The Investors’ refusal to disclose certain materials does not give us confidence that the relationship between the Commission and the Investors would enable the Commission to retain the same level of oversight that currently exists.”
 - Whether the acquirer is trusted makes a big difference in how risks are perceived by the PUC and staff.
 - Utility and holding company boards should be populated by experienced and independent persons that provide a breadth of opinion to formulate corporate policy.
 - Can acquirer be trusted to maintain investment levels adequate to preserve service quality?
 - PUC staff sought independent management and operations audit.

Avoiding Surprises

- PUC and staff concerned with risks of nonutility ventures that the holding companies may undertake.
- A mechanism to share information with the staff on a *real-time basis* about financial and operating information at the utility and holding company levels can provide transparency, increase trust, and lessen concerns about the level of utility investment and holding company diversification.

Texas Pacific Group's Failed Acquisition of Portland General Electric Company

- “Public interest”, “net benefit” standard applies to Oregon PUC review of utility acquisitions.
- PUC finds that large amount of Oregon Electric (i.e., acquirer) debt:
 - Makes it possible that PGE will not be able to raise capital as cheaply as it would as a stand-alone company,
 - Produces a weakened financial structure,
 - Encourages imprudent cost cutting and reduced capital expenditures, and
 - Increases the possibility of higher rates and decreased service/reliability.

Once Again, Ring Fencing is Not Enough to Address All PUC Concerns

- Oregon Electric debt was likely to be rated speculative grade.
- But, PUC finds that risk of Oregon Electric bankruptcy is small and would not likely lead to a PGE bankruptcy. “We have confidence that the ring fencing conditions included in the application would protect PGE customers.”
 - Ring fencing covered (i) maintenance of separate books and records, (ii) limitations and notice with regard to dividends, (iii) exclusion of costs of acquisition from rate recovery, (iv) maintenance of separate ratings, and (v) service quality measures.

Align Owner Incentives with PUC Concerns

- Possible harms from short-term ownership:
 - “Since TPG plans to sell PGE, it has an interest in improving earnings in the short term to make PGE more attractive to potential buyers. The issue here is whether TPG’s intention to sell PGE affects its ability to profit from cost cutting and investment decisions that might eventually degrade customer service or lead to higher costs. We find it does because due diligence by the next buyer and oversight by the Commission cannot catch all instances of TPG’s spending and investment decisions that may have harmful effects after it sells PGE.”
 - This again illustrates that efforts to improve trust, such as providing the PUC staff with the ability to monitor utility investment and performance metrics in real time are important elements of successfully obtaining PUC authorization.
 - “Trust, but verify.” – *Ronald Reagan*

Financial Acquirers May Find it Difficult to Generate Operational Synergies

- Rate credit of \$43 million offered without any causal link to identified synergies. Application lacked analysis supporting the claim that savings are available from the acquisition.
 - Rate credit would be offset by future savings, from any source, even avoided cost growth. *Perceived as too speculative and of little value.*
 - Savings must be attributable to the transaction and supported by evidence and analysis to be counted as a benefit.

Some “Benefits” Get Little Weight

- A commitment to meet certain Service Quality Measures with rate reductions if PGE fails to meet the standards was deemed a benefit of the transaction, although it was noted that this is what a prudent, well managed utility would already provide to its customers.
- No benefit found from a commitment to maintain local representation on PGE board. This is viewed as a given by the PUC.

Lessons from KKR and TPG

- PUHCA did not matter. Even though not repealed at the time of these transactions, it was already largely irrelevant long before it was repealed. PUCs demonstrated robust ability to protect utility and customers and to reject transactions deemed to be unsound.
- Financial acquirers are at a disadvantage because they:
 - Are not trusted,
 - Do not have utility management expertise,
 - Are perceived as short-term investors that will not maintain appropriate investment levels but will be cutting maintenance and investment expenses to increase short-term profit,
 - Are perceived as contributing to financial instability with leveraged acquisition vehicles,
 - May not have significant operating synergy savings to offer to consumers (compare to what may be possible in a transaction that involves a utility acquirer that can combine operations or administrative functions).

Wrap-Up

- It may be more difficult for financial investors to generate net benefits, as compared to strategic investors.
- At a minimum, an acquirer needs:
 - (i) a structure that is not over-leveraged,
 - (ii) an experienced utility management team at the acquirer level (see Berkshire-MidAmerican model),
 - (iii) good ring fencing and transparency so that regulators have adequate oversight.

Wrap-Up

- While PUHCA “integration” standard no longer applies, as a practical matter acquisitions that exhibit economies and efficiencies and a sound corporate and capital structure will be favored.
- The first battle (PUHCA repeal) has been won, but a guerilla war in 50 states may follow.
- Be proactive: Industry needs to cultivate a regulatory environment at the state and federal level that allows the benefits of industry consolidation and investment to be obtained while recognizing and responding to regulators’ legitimate concerns with holding companies.

Markian Melnyk

1875 Connecticut Avenue, N.W.

Washington, DC 20009-5728

202-986-8212

LeBoeuf, Lamb, Greene & MacRae llp
a limited liability partnership including professional corporations