

Breaking Down Barriers

BY VANESSA SUMO

On Feb. 8, the curtain fell on the Public Utility Holding Company Act of 1935 (PUHCA). The act was passed at the height of the Great Depression in response to the collapse of several electric and gas holding companies.

According to critics, these firms had been charging their utility subsidiaries high fees for service contracts and redirecting money to finance risky ventures — costs that were passed on to consumers. The size and complexity of many of these holding companies, usually spanning several states, helped to obscure some of their practices and made them difficult to regulate.

PUHCA granted powers to the Securities and Exchange Commission (SEC) to break up these massive interstate holding companies by forcing them to simplify their structures. Utility holding companies were required to shrink into single, integrated systems confined to particular geographic areas. This limited merger possibilities to utility companies that were physically interconnected or could operate under a single, coordinated system. For instance, it would have been virtually impossible for a utility in Illinois to justify a merger with one in California.

The act also greatly restricted the types of businesses in which holding companies could engage. An oil company was not permitted to own and control utilities unless it gave up its oil business, for example. The only way to avoid the SEC oversight eye was to become an exempt holding company, with the utility's operations limited to a single state or functioning predominantly as an operating utility.

The repeal of the PUHCA, which came as part of the Energy Policy Act of 2005, broke down these old barriers and opened the door to a variety of transactions. Utility holding companies will now find it easier to merge or acquire utilities in geographically distant locations. This was the case when Duke Energy of North Carolina acquired Cinergy of Ohio in April. In addition, Constellation Energy of Maryland and Florida Power and Light hope to complete their merger by the end of the year.

Nonutilities are likewise more free to acquire and control utility companies. Although the SEC permitted Berkshire Hathaway to acquire MidAmerican Energy Holdings in 2000 on the basis that it would have only one utility company, Berkshire Hathaway can now venture into other utilities, as it has done recently with its purchase of PacifiCorp in March.

Supporters of the repeal, including the SEC itself, the Federal Energy Regulatory Commission (FERC), and a number of economists, felt that PUHCA no longer made much sense in today's environment. Before the repeal,

changes in energy policy had been introduced that carved out some exemptions for independent generating companies and foreign ownership of U.S. utilities. Moreover, the SEC had begun permitting mergers between utility companies that were only loosely interconnected.

In effect, the deregulation process had already been set in motion. The development in accounting standards and securities markets has also come a long way since 1935, making the concern of inadequate financial reporting that originally motivated the PUHCA largely unnecessary. Today, audited financial statements must follow the rules set by the Financial Accounting Standards Board, and securities markets demand a tremendous degree of transparency from companies wishing to raise money.

But those who opposed the repeal worry that there could be a substantial weakening in regulation of utility holding companies. Lynn Hargis, a lawyer with Public Citizen, a nonprofit consumer advocacy organization, worries that new players like investment banks would be more interested in buying power plants and then flipping them than in providing quality service. "Our power plants are important basic public services. But these have now been left to the market, and the market has only one thing on its mind that is to make profits," Hargis says.

Economist Paul Joskow at the Massachusetts Institute of Technology, on the other hand, is not too concerned. "In the current environment, when a hedge fund comes in and seeks to acquire an operating company they will be subject to significant scrutiny by the state," Joskow says. "And once investors become familiar with state regulation they may decide that they don't want to be in this business." Thus, he thinks the main acquirer of utilities will be other utilities. "There are too many utilities, and some are better than others. If the repeal allows companies with more expertise to expand their capabilities, then that's a good thing."

Moreover, such mergers and acquisitions will still need to be approved by state regulators and a host of federal agencies. The repeal also hands over to FERC some of the SEC's previous responsibilities with respect to access to books and records and for prescribing caps on prices charged for non-power goods and services provided within the utility holding company system.

So what about prices? Like Joskow, economist Richard Gordon of Pennsylvania State University is relatively optimistic about PUHCA's repeal. "Anything that increases the flexibility of the industry will in the long run lower costs, and that's going to be reflected in prices that consumers pay," he says.

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