

A Brave New World: Congress Repeals the Public Utility Holding Company Act of 1935

"The Public Utility Holding Company Act of 1935 (15 U.S.C. 79 et seq.) is repealed." Rarely does Congress do as much with so few words, and these, set forth in the Energy Policy Act of 2005, bring down the curtain on the 70 year reign of the most radical of the New Deal securities legislation. When the repeal of the Public Utility Holding Company Act of 1935, or PUHCA, becomes effective six months from now, Congress will have unleashed upon public utilities the deregulated market forces that have remade the airline, telecommunications and banking industries. Instead of the comprehensive system of holding company regulation administered under PUHCA, Congress has instead adopted a new Public Utility Holding Company Act of 2005 which has all but dismantled that system, taking the Securities and Exchange Commission ("SEC") out of the utility regulatory business and shifting a more limited regulatory prerogative to the Federal Energy Regulatory Commission ("FERC").

Adopted in the wake of corporate scandals which in their day rivaled those of recent years, PUHCA overhauled an industry that was rife with abuse and fraud. Unlike other major New Deal legislation such as the Securities Act and Securities Exchange Act, which were directed at disclosure, PUHCA authorized the SEC to restructure the gas and electric utility industries by forcing complex multi-state utility companies to dismantle their systems, spin off their subsidiaries and reorganize their capital structures so that they would be limited to a single, geographically integrated utility system that could be more easily regulated by state

public utility commissions. Those companies that could not or would not pare themselves down, were required to register under PUHCA and were, as a result, subjected to intrusive regulatory scrutiny by the SEC of almost every significant corporate transaction. Moreover, registered holding companies were limited to business activities directly related to the conduct of their utility operations which discouraged non-utilities from becoming holding companies or acquiring significant interests in more than one utility. In addition, PUHCA forced utility

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holding companies to become single state holding company systems because so called "intrastate systems" were largely exempted from PUHCA. This exemption, however, required that a holding company and each of its material utility subsidiaries limit their activities to a single state.

In particular, PUHCA prohibited any utility company affiliate (an entity owning 5% or more of the voting securities of a utility or a utility holding company) from becoming an affiliate of another utility unless first obtaining SEC approval. That approval, usually involving a lengthy open ended process, was conditioned upon meeting a strict set of criteria, designed to

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advance PUHCA's policy objectives (as they existed in 1935). This so called "two bite rule" acted as a legislative shark repellent, effectively discouraging utility acquisitions by other holding companies or any investor seeking to consolidate the industry. Only those combinations able to meet the prescribed standards of promoting geographically integrated and interconnected utility systems could be approved by the SEC.

Moreover, PUHCA effectively split the energy industry between electric utilities and gas utilities. Utility holding company systems in which both electric and gas utilities were combined were severely limited, if not prohibited, by PUHCA. Along with the intrusive regulation applicable to registered holding companies and the prohibition on registered companies engaging in non-utility businesses, PUHCA has largely shielded public utilities from the consolidation trends that have remade so many of our key industry sectors.

As with other industries that have seen the elimination of artificial checks on market forces, we should expect that PUHCA's repeal will trigger vigorous utility acquisition activity. By eliminating the need for an intrastate exemption, utility entities organized in one state will be able to acquire utilities in another. For the same reason, it will be possible for one utility company to also own utilities in multiple states. Industrial and financial services companies will also be able to acquire utilities in a variety of states without fear of PUHCA regulation and the loss of the ability to conduct non-utility businesses. Private equity firms will be able to participate in the market for utility properties just as they do for almost every other industry.

From the other direction, existing registered utility holding companies will be able to diversify into non-utility businesses, thus allowing them to leverage their substantial cash flows and capital

resources to bid for and acquire a variety of non-utility enterprises. In addition, registered holding companies will be able to play more freely in the exempt wholesale generator and foreign utility company markets without the financial limitations imposed by PUHCA.

The bottom line is that electric and gas utilities will be newly vulnerable to acquisition, will have increased pressure to perform financially and will increasingly look to acquisitions as a means to grow and improve financial performance through the synergies derived from consolidation. Moreover, public utilities and their holding companies should draw the attention of national and multinational conglomerates seeking to tap into the steady cash flows and valuable assets offered by utilities. This means that utilities should be reviewing their anti-takeover protections while identifying targets of opportunity (both utility and non-utility).

This is not to suggest that we will see a totally unfettered utility merger market. The new legislation provides FERC with increased regulatory authority over utility mergers, including authority over mergers and acquisitions of generation facilities used for interstate wholesale sales of electricity. FERC can be expected to apply its merger guidelines rigorously to protect consumers from the anticompetitive effects of utility mergers and acquisitions that would permit the exercise of horizontal or vertical market power. In addition, holding companies will be subject to enhanced information reporting to both FERC and state utility regulators to facilitate rate regulation and protection of ratepayers from abusive affiliate company transactions. Of course, state utility commissions will continue to regulate local public utility activity, including mergers and acquisitions.

Despite its enhanced regulatory role, FERC's oversight should not be nearly as intrusive as was the SEC's under PUHCA. The new legislation, which will be implemented through FERC rulemaking, appears to limit the scope of FERC's review to antitrust-related and cross-subsidization issues rather than the wide-ranging review required by the SEC under PUHCA. Moreover, Congress has limited FERC's merger review process to 180 days (absent a showing of good cause) in striking contrast to the open-ended SEC process in which some utility mergers simply died from SEC inaction.

In sum, with the repeal of PUHCA, it appears that the world of public utilities is moving forward to the past, returning to a regulatory environment that should foster merger and consolidation activity that has been suppressed for nearly 70 years.

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