

**“Implications of a “Paradigm” Shift: Policy
Management and Implementation”**

Panelist: Lynn Hargis, Public Citizen
Author, “PUHCA for Dummies”

January 21, 2004

“[T]he enforcement of Section 11 of the Holding Company Act was the most effective antitrust enforcement program in United States history....”

Joel Seligman, Dean of Washington University School of Law, “The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance,” Northeastern University Press, 3rd Ed. 2003, p. 247.

Dean Seligman also concluded in his history of the SEC that: “The restructuring of the public utility industry historically has been the SEC’s single most useful accomplishment;” (p. 127) and “[T]he SEC’s geographic integration and simplification of the utility holding companies historically has been the agency’s single most significant achievement.” (p. 247).

Why did a securities lawyer and treatises author come to the conclusion that PUHCA enforcement was the best thing the SEC has done? Well, it turns out that in writing his history, Seligman got an appointment to talk to Abe Fortas, then a law firm partner, who had worked for William O. Douglas when Douglas was chairman of the SEC. Fortas extended a 30 minute interview with the young researcher into several hours, and Seligman got a flavor of what it was like to have worked on the transformation of an entire industry. Like many who have learned something about PUHCA, he got hooked and went on to learn more.

Here’s how PUHCA has affected investors: prior to PUHCA, from 1929 to 1936, there were 53 utility holding company bankruptcies and 16 loan defaults. Did PUHCA work? Since PUHCA became effective in 1938, there has been not one single PUHCA-regulated electric utility holding company that has declared bankruptcy. And this is *in spite of* the holes punched in PUHCA by Congress in 1992: EWGs and FUCOs; and in 1996: exempt telecoms. And, perhaps the biggest hole of all, the SEC staff’s no-action letters (from Enron’s in 1994 on) to allow power marketers who owned “only” contracts to avoid PUHCA.

Why repeal PUHCA if it has worked so well?

SEC Chairman Arthur Levitt stated, in a letter sending the SEC staff's June 20, 1995 Report to Congress recommending conditional PUHCA repeal:

“Today, this comprehensive control [under PUHCA] has become something of an anachronism. As a result of prudent administration of the Public Utility Holding Company Act, and the development of comprehensive federal securities regulation, the conduct that gave rise to the Act has all but disappeared.”

“The Regulation of Public-Utility Holding Companies,” June 1995 report to Congress, Division of Investment Management of SEC, transmitting letter.

When I read this to a co-worker, he noticed the first problem right away: If the bad conduct has disappeared “as a result,” even in part, of the prudent administration of PUHCA, why would you repeal PUHCA? We certainly don't see huge pyramids of utility holding companies controlled by a small number of stock holders today, but that's *because* PUHCA doesn't allow it. We don't see three holding companies controlling 50% of the electric utilities in the country, again *because* PUHCA doesn't allow it.

Indeed, once PUHCA is gone, as we will discuss later, the breakup of the massive holding companies can reoccur immediately, since PUHCA not only broke them up, but insures that they cannot rebuild. Sections 9(a)(2) and 10, the so-called Watchdog provisions, require SEC approval under section 11 for a second utility acquisition.

As has been often noted by PUHCA advocates, you don't take away the watchdog because he has successfully guarded the bank for many years (or anyway, you don't unless you don't care if the bank may be robbed).

For the moment, we skip happily over Enron (the Fast Andys and Skilled Jeffreys did indeed display some of the “conduct that gave rise to the Act”, at least according to the Department of Justice) and we skip over the California Debacle (from the number of settlements the FERC is entering into with parties from that deregulation experiment, we must assume that there was some display of pre-PUHCA type conduct involved there also).

But let's move on and see the results in 2003 alone of allowing public utility companies to own newly PUHCA-exempt utilities: EWGs, FUCOs, exempt telecoms, and power marketers.

The results: Utility bankruptcies: Mirant, NRG, Northwestern Corp (& the remains of Montana Power), NEG, and more. Those barely hanging on by refinancing substantial debt: Dynegy, Reliant, Allegheny Energy, and more. Those barely escaping include: Westar Energy, saved by the Kansas Corporation Commission (this is how PUHCA is supposed to work: Westar Energy incorporated in Kansas to become exempt from PUHCA, so the Kansas Commission had jurisdiction), but still taking a 50% hit selling off its exempt telecom business. (With PUHCA gone, of course, Westar can be acquired by an out-of-state parent company, and the Kansas Commission's authority over it may not continue to exist. The Alliant case established that states cannot force a utility parent to incorporate in the same state as the utility, yet this same state incorporation has been the basis for state utility regulation since 1935.)

So, if this is what followed from the partial PUHCA repeals of EWGs, FUCOs, power marketers and exempt telecoms, it gives you just a flavor of what FULL PUHCA REPEAL can do to our electric and gas industries and to our 401(k) plans.

And how about that Enron? It's still very much with us because of the ongoing criminal trials and plea bargains. How did Enron achieve such a gigantic, utility-related collapse, even with PUHCA in place? Well, let's see: how many PUHCA exemptions did Enron get? There was the 1994 power marketing no-action letter (the very first one), the FUCOs, the EWGs, the exempt telecoms, a no-action letter for Energy Services, and, of course, the 3(a)(1) "single state" exemption obtained by reincorporating in Oregon. (PUHCA meant that Enron could only have one traditional utility to exploit and that the Oregon PUC could have some control over it.) The SEC has recently found Enron was not entitled to this exemption, nor to the sections 3(a)(3) and 3(a)(5) exemptions, which really were sought to allow Enron to own 100% of QFs (legally). And, the most recent application for PUHCA exemption, filed about two weeks ago, the section 3(a)(4) exemption, another one that does not appear to apply. So Enron is STILL avoiding PUHCA regulation.

And who pays for all the bankruptcies, high debt costs, failed power marketers, energy traders, and merchant plants sold at a loss, and the failed exempt telecom companies? The electric utility consumers, since all these costs are ultimately reflected in electric rates.

Here's an election year question: What do electric utility ratepayers have in common with voters? Answer: Everything; they are the same people.

But we are talking antitrust law here, not the collapse of our national economy. Why do I think they are related? Here's why.

From 1929-1932, 16 major holding company systems produced 76.4% of the electricity generated by privately-owned utility plants, and 3 holding company systems produced 44.5 percent of the electric output. (SEC Report, p. 3, note 8.) The result? Not only high electric and gas rates, with affiliates selling properties and services back and forth for highly excessive amounts, but also excessive debt that resulted in the 53 utility holding company bankruptcies and 16 loans defaults pre-PUHCA.

At the time of the SEC staff's 1995 Report to Congress on PUHCA, there were 15 registered holding companies, all but three electric holding companies. With PUHCA repeal apparently on the horizon, and the SEC's "flexible" interpretation of the single, integrated system standard, the number quickly nearly doubled to 28, although a number of these themselves own registered holding companies so the official number is 65. Once PUHCA is repealed, none of the owners of these interstate holding companies will be constrained by the control of state commissions because none is incorporated in the same state in which all its material utilities are operating.

In other words, if PUHCA is repealed, the utility holding companies will be home free, with only the FERC's asserted, but never legally tested, claim that it has jurisdiction over the parent companies of utilities under section 203. Even if it does, the "consistent with the public interest" standard of section 203 is so weak that it has never really caused FERC to deny a merger, although FERC has conditioned a few. FERC has no authority even mildly equivalent to the "death sentence" of PUHCA, section 11, that flatly prohibits ownership of more than a single, integrated utility system (capable of geographic integration) and requires the divestiture of other utilities and of non-utility businesses, among other things. Section 11, by the way, also gives the SEC first review of any reorganization plan in a bankruptcy, which may be what Enron is currently trying to avoid.

The antitrust laws? I believe both DOJ and the FTC have testified before Congress that the antitrust laws do not have any of the structural antitrust provisions of PUHCA (section 11). And, it seems clear, that the antitrust laws didn't do anything to stop the "power trusts" of the 1920s that led to PUHCA.

Transmission and Antitrust: This is sort of a joke. No one has EVER claimed that transmission lines could be competitive; it is hard enough to build one. And yet, Warren Buffett is lobbying Congress to allow him not only to own such lines, but to make BIG profits on them. The pending energy bill would actually go in and change the definition of “just and reasonable” to allow Warren and his successors to collect high monopoly rents off our transmission grid.

Now, FERC seems to be claiming that PUHCA will get in the way of RTOs, which is nonsense. First of all, integrated utility systems under PUHCA can be made up of “one or more units of generating plants *and/or* transmission lines *and/or* distribution facilities...” (Definition of integrated public-utility system, section 2(29).) In other words, a single integrated public-utility system could be made up of ONLY transmission lines. Moreover, if it were obvious that none of the title owners of such lines could control them, none of those owners would be “holding companies” under PUHCA, which deals with real-life control.

Finally, I would like to point out the vast disconnect between what the FERC is claiming to do with electricity deregulation and the result of repeal of PUHCA. FERC claims that, despite a statute to the contrary, it can deregulate wholesale rates and allow “the market” (read: utility owners) to set rates because there is increasing competition among suppliers of electricity. But PUHCA repeal will unquestionably result in massive consolidation of ownership and control over suppliers of electricity, which is the opposite of competition. FERC thinks it can handle this problem by providing open transmission access, but that is like saying that as long as we have open access to highways and trains, there can be no antitrust problems with owners of supplies moved by trucks or trains.

Another interesting disconnect: FERC is administering its merger provisions to allegedly prevent dominance by any one electricity supplier in any one part of the country; the SEC under PUHCA is supposed to be *confining* electricity suppliers to one geographically connected system in order to promote local control and state regulatory supervision. In other words, they have totally opposite “antitrust” goals. YET BOTH AGENCIES APPROVED THE MERGER OF AEP WITH CSW. Of course, the court of appeals sent back the SEC approval as inconsistent with PUHCA, even though AEP and CSW successfully made their case to the SEC that the merged systems would operate as a single “integrated public-utility system.”

Still another disconnect: Section 305 of the Federal Power Act still prohibits interlocking directors between different public utilities, banks or firms authorized

to underwrite public utilities, and electrical equipment suppliers to public utilities without FERC approval after a showing that neither public nor private interests will be adversely affected thereby. The proposed PUHCA repeal, without changing this provision in the Federal Power Act, would allow these entities, with their obvious conflicts of interest, to OWN public utilities, not just have interlocking directors!

The competition/reliability disconnect: Pro-deregulation lobbyists are claiming that the recent blackouts demonstrate that PUHCA must be repealed and FERC given more power over the grid, yet most students of the utility industry, as well as a recent poll of utility executives, are convinced that it is the very fact of competition among grid users that has resulted in lack of reliability of the grid.

And a final disconnect: An article appeared in the project finance newsletter of my former law firm in September 2000 that has turned out to be the most prophetic thing I have read about the potential of electricity deregulation to be successful. The article was titled: “US Heading for Merchant Plant Overdevelopment,” and it was written by two economists, Christopher Seiple and Dr. Arnold Leitner, with RDI Consulting Boulder, Colorado. After discussing the economics of merchant plants, the article concluded:

“Our analysis indicates that slight changes in the supply-demand balance can cause large changes in electricity prices. Markets with a 2% capacity shortfall have experienced significant price spikes, but regions with a 2% surplus have experienced very low electricity prices.” (emphasis supplied.)

One of the authors explained to us what this meant in plain English: Electricity suppliers in markets with a 2% capacity shortfall can charge anything they choose, whereas in markets with even a 2% surplus, the merchant plant owners can't pay their debt costs.

The August 2003 edition of that same newsletter (“Project Finance Newswire”) has a cover story entitled: “The ‘End Game’ For Merchant Power.” In it, lenders and developers and lawyers are having a semi-off-the-record candid discussion like this one, and one of the lenders, in a mock debate, says at p. 8:

“Just listen to these numbers: 45,44,41,40. No, these are not the respective IQs of the poor hapless [developer] debaters opposite. (Laughter.) No, these are the projected 2004 summer reserve margins in the SPP, ERCOLT, SERC and MAIN respectively.”

So, what do we see in reality? We see this week news reports that El Paso Corporation is selling off 25 U.S. “merchant plants” to AIG, an insurance company. The week before we read that Duke Energy was writing off \$3.3 billion in merchant plant and other energy trading business, and selling its plants. There are merchant plant fire sales all over the country.

Our electricity should now be free, under economic theory. Unfortunately, electric retail rates are going up around the country.

But, as that same 2000 article noted, sooner or later there will be another boom period (when there is a capacity shortage) and these insurance companies, and whoever else has bought the plants at fire sale prices, will be able to charge whatever they like. Is this a prospect for which utility ratepayers will be willing to exchange reliable electric service?

The ratings agencies have been warning that merchant plant owners won’t do well on Wall Street unless they develop a “business strategy.” Well, guess what a successful “business strategy” means: they have to make sure that there is a capacity shortage. Then merchant power plant owners can charge whatever they wish, while if there is a surplus, they can’t pay their debt costs. Is this game plan consistent with reliability? No. Is this strategy inconsistent with electric utility customer (and voter) happiness? No. Is this industry structure even vaguely consistent with a public policy that protects consumers and the national economy? No.

Now, here’s the big question: In what conceivable way is this “competitive,” “market-based” scenario, where power suppliers can’t make money unless there is a capacity shortfall, equal to, much less superior to, the electric utilities selling at cost and their regulated utility holding companies that we had prior to the FERC’s decision to deregulate wholesale rates and Congress’ decision to exempt merchant power plants from PUHCA?

And we are here today to debate whether this “market based” scenario is okay even if it results in blackouts in the cause of competition? Seriously?

I will conclude by saying that, from my point of view after 27 years in electric utility regulation and business, the greatest disconnect of all is between the promoters of electric deregulation and political/economic reality.

