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CHANGES IN THE FINANCIAL HEALTH OF THE ELECTRIC AND NATURAL GAS UTILITY INDUSTRIES SINCE THE PUHCA HEARINGS OF 2001

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Since 2001, we've seen the results of the so-called "reforms" of PUHCA in 1992 (creation of new PUHCA exemptions for Exempt Wholesale Generators—EWGs—and Foreign Utility Companies) and 1996 (Exempt Telecommunications Companies). The SEC staff, believing that they were promoting these "reforms," allowed first Enron Corp and then the entire industry to simply switch their electricity sales to affiliates via contracts and thereby avoid PUHCA regulation as "power marketers".

These "reforms" allowed utility holding companies and others to own wholesale power plants, extensive foreign utilities, and telecommunications companies without coming under PUHCA regulation of their financial interrelations. By an interpretation of "foreign utility companies" that even the SEC itself says was probably unintended by the Congress, foreign utility holding companies have been allowed to acquire U.S. utilities. In addition, the SEC expanded Rule 58 under PUHCA to allow easier ownership by utilities of a number of "non-utility" businesses.

As discussed in detail below, the results of these various "reforms" have resulted in a downgrading of the credit ratings of the entire utility industry, in addition to individual instances of bankruptcy, sell-off and destruction of 90-year old utilities, huge accumulation of debt by utilities, fire sales of power plants and whole utilities, and other financial disasters. Meanwhile, electric and natural gas bills of (voting) consumers are steadily (or hurriedly) climbing, with no relief in sight. Since there is currently substantial *overcapacity* of electric generation, electric rates should be plummeting according to economic theory. They are not.

Although these PUHCA "reforms" occurred some time prior to 2001, it has taken a number of years for the results to be felt and monitored by credit ratings agencies. However, a steady number of such credit downgrades for the utility industry since 2001 has cumulated in the analysis below.

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Standard and Poor's Concludes that PUHCA Promotes Utility Investment

In a February 19, 2004, research analysis titled "Is PUHCA Beneficial or Detrimental to U.S. Utilities' Credit?," Standard & Poor's concludes that PUHCA may provide some level of credit protection for bondholders, particularly in restricting utility investment in nonrelated entities. S&P also concludes that the SEC's "relaxation" of PUHCA's restrictions on non-utility business ownership over the past few years "has not helped utility investors."

S&P's notes the arguments made by PUHCA repeal advocates that PUHCA deters financial investment in utility infrastructure, but concludes that this argument "does not seem to hold much water after the power generation market imploded."

S&P's February 2004 study summarizes by stating that "existing utility credit would be best served from [sic] enforcement of PUHCA's provisions and restriction of utility investment in outside businesses."

EWGs Took Electric Power Generation Away from States

The power generation market, which has "imploded" according to S&P's report (and many others) was made possible, of course, by the 1992 "reform" to allow PUHCA-exempt Exempt Wholesale Generators or merchant plants, a "reform" that also took a majority of the country's power generators out from under the control of state regulators and put them under control of the FERC, despite the fact that the FERC still has no jurisdiction over such generators under the Federal Power Act. However, FERC does have exclusive control over wholesale power *rates.* Thus, FERC has allowed wholesale power sellers to sell at whatever price they can negotiate with each other under "market rate" tariffs, and the states are required to pass through such rates by the Supremacy Clause and federal preemption doctrines of the U.S. Constitution.

Details of the various individual events in the "implosion" and credit downgrading of the electric and natural gas utility industries since 2001 are given below.

I. Wave of bankruptcies resulting from PUHCA-exempt or "non-utility" businesses:

Utility holding company/utility bankruptcies in 2003 (this list does NOT include Enron and PG&E): [**Note**: Prior to PUHCA's enactment, there were 53 utility holding company bankruptcies and 23 bank loan defaults.]

1. **Mirant:** Southern Company spun off PUHCA-exempt utilities; Mirant declared bankruptcy.
2. **NRG:** Xcel put PUHCA-exempt utilities into partially-owned subsidiary; NRG went bankrupt; nearly took Xcel down, too, despite four, financially healthy PUHCA-regulated subsidiaries.
3. **Montana Power Company:** Sold off its profitable utility assets to out-of-state "power marketer;" it transmission and distribution to neighboring NorthWestern Corp; kept telecommunications assets; went bankrupt. (See,

CBS 60 Minutes show entitled: "Who Killed Montana Power?" CBS's view: it was investment bankers Goldman Sachs who promoted sell off.

4. **NorthWestern Corp:** Purchaser of Montana Power's transmission and distribution assets itself invested in telecommunications business that failed; declared bankruptcy.
5. **NEG (National Energy Group):** When PG&E declared bankruptcy during the California deregulation fiasco, it sought to protect its non-PUHCA businesses by "ring-fencing" them from the effects of its utility business! Despite these efforts, NEG also went bankrupt.
6. **Westar Energy:** Utility executives attempted to "spin off" the utilities' assets a la Montana Power Company, keep the telecom business, and retire on their earnings. The telecom business went bankrupt, and the Kansas Corporation Commission stopped the executives from selling off the utility. Westar took a hit of 50 cents on the dollar from sale of its Protection One (telecommunications) business in the U.K., and was left with huge debts. One executive has been convicted in a related bank loan fraud, and two more are under indictment for utility frauds. E-mails uncovered in the bank loan fraud investigation reveal a plan, apparently successful, to give money to congressional campaigns in exchange for getting an exemption from the Investment Company Act (after repeal of PUHCA) to allow the utility executives to carry out their plans.

II. Utility Holding Company/Utility Near Bankruptcies:

1. **Allegheny Energy:** Despite PUHCA regulation, Allegheny Energy has nearly become the first electric utility holding company to declare bankruptcy since PUHCA was enacted because of failures of its newly PUHCA-exempt power marketing and merchant plant businesses. Allegheny Energy remains on the edge, with substantial debt.
2. **Dynegy:** This company is also near bankruptcy because of its PUHCA-exempt businesses. As a result, it is selling off Illinois Power Company to another holding company. **Chevron/Texaco** owns the majority interest in Dynegy under pending PUHCA applications that the SEC has taken no action on.
3. **Numerous other utilities:** Many other utilities have written off huge amounts, such as **Duke Energy**, which this year (2004) wrote off $3.3 *billion* worth of merchant plants, exempt from PUHCA under the 1992 Exempt Wholesale Generator exemptions. Many more have simply pushed off huge amounts of debts for a number of years. **(See attached S&P report.)**

III. Utility "Fire Sales;" Purchases by Speculators, "Buy-out" Firms, Investment Bankers

1. **Portland General Electric,** the largest utility in Oregon, has been put on the auction block as a result of Enron's bankruptcy. The proposed purchaser is a Texas "buy-out" firm, with an Oregon "front" company. The buy-out firm is clearly not going into the utility business; it is speculating—most likely on PUHCA repeal. Texas Pacific Group must now be a passive investor with no

"control" because of PUHCA; if PUHCA is repealed, it will be free to show its true colors and sell the utility to the highest bidder, whether in this country or abroad. So much for "local control" of utilities.

2. **Tucson Electric Power, Unisource:** No bankruptcy here; just a sell-out of another hundred-year-old utility, this time to Kohlberg Kravis Roberts & Co., KKR, the private buy-out specialist best known for its 1989 buyout of RJR Nabisco, portrayed in the best-selling 1990 book, *Barbarians at the Gate: The Fall of RJR Nabisco."*
3. **MidAmerican Energy:** Warren Buffett pretends (at least to the SEC) that he doesn't control this company although he owns 80% of the economic interests. To his shareholders, he can't help boasting that Berkshire Hathaway has the franchise to loan money to the utility (one of the classic abuses of holding companies that led to PUHCA's enactment; many utilities were bought, not for their steady but low utility profits, but so that the holding companies could collect fees for services rendered to the utilities).
4. **Investment banks**: FDR's report accompanying PUHCA to Congress noted: "Fundamentally, the holding company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry." (H.R., 74th Cong., lst Sess., Doc. 137, p. 6.) Yet today, investment banks, which still cannot sit on utility or utility holding company boards without special permission, are being allowed to OWN power plants, which they are buying up at fire sales, and, if PUHCA is repealed, full, franchise utilities.

IV. Enron:

Many claim that the Enron scandal had nothing to do with Enron's numerous PUHCA exemptions, but the facts show otherwise. The SEC, for example, has only at the end of 2003 found that Enron was not entitled to three different PUHCA exemptions that it has been enjoying for a number of years, and on March 9, 2004, Enron has finally "registered" and become subject to regulation under PUHCA. (Enron is still enjoying a number of other PUHCA exemptions by virtue of "no-action" letters from the SEC.) Notably, the complaints against Andrew Fastow and Jeffrey Skilling all involve manipulations with PUHCA-exempt entities, which include the infamous "JEDI", "RADR" and power marketing operations. Even the broad band business problems would have escaped PUHCA regulation because of the Exempt Telecommunications Company exemption passed in 1996. Had these various matters been subject to PUHCA regulation, the accounting and other manipulations would not have been possible because of PUHCA's strict financial regulations for registered holding companies and their subsidiaries.

V. The Antitrust Provisions of PUHCA:

All of the above discussion regards the financial regulation of utility holding companies, not the antitrust provisions. These provisions have probably received the most criticism by PUHCA's opponents, although the geographic integration requirements were designed to promote state utility regulation by requiring both the holding company and the utility to be incorporated in the same state.

If the exemption from PUHCA for EWGs is to remain, state commissions will lose control over 65% of electric rates (the generation portion) in any event. It may then make sense to simply require all utility holding companies to register with the SEC, which—despite is "relaxation" of PUHCA regulation—has still done a better job of protecting the credit of utilities, as discussed above. As for the antitrust provisions, a qualify antitrust commission made up of Federal Trade Commission and Department of Justice antitrust specialists should be convened to conduct a study on how PUHCA's antitrust provisions could be handled differently. The FERC should be included to reconcile the fact that the FERC is relying on increasing competition for electric supplies for its deregulation policies, whereas proponents of PUHCA repeal, such as David Sokol of MidAmerican, freely admit that PUHCA repeal would result in massive consolidation of the industry. As the new CEO of TXU, a registered holding company, put it in a recent interview: "There will be consolidation and it will be to the strong." The outcome of this study should clearly come BEFORE this part of PUHCA is changed.

Conclusion:

Shortly after the S&P analysis, Calpine had to cancel a bond issuance for lack of interest. Calpine owns PUHCA-exempt utilities. In short, the arguments that PUHCA is preventing needed utility investments are simply contentions by the same utilities and would-be utilities that have fought PUHCA for nearly 70 years. Joel Seligman, Dean of the University of Washing School of Law, a securities law expert and the unofficial historian of the SEC, has concluded after decades of studying the SEC that "the restructuring of the public utility industry historically has been the SEC's single most useful accomplishment." *The Transformation of Wall Street, A History of the Securities and Exchange Commission and Modern Corporate Finance*, Northeastern University Press, 3d edition, 2003, p. 127. He also states (at p. 147) that "[t]he enforcement of Section 11 of the Holding Company Act was the most effective antitrust enforcement program in United States history…."

Before this essential statute is discarded, not only investor and consumer interests must be shown to be otherwise protected, but so must the financial health of the United States.