Time to Repeal the Public Utility Holding Company Act

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The Public Utility Holding Company Act of 1935 (PUHCA)[1] was passed during the Great Depression in response to the failure of a number of utility holding companies and subsequent investor losses. Many investors were defrauded due to information problems peculiar to the holding company structure. The utility holding company structure undoubtedly helped disguise unscrupulous practices, such as the bilking of subsidiaries through service contracts, inappropriate depreciation techniques, and the use of inflated property values, all of which contributed to the collapse of the holding companies (Hawes 1987).

Numerous holding-company activities are subject to regulation under PUHCA, including the acquisition and sale of securities, the acquisition of utility assets, intercompany transactions, service, sales and construction contracts, and reports and accounts. Importantly, PUHCA places restrictions on mergers involving registered holding companies.

An important aspect of policy analysis is the review of old regulations in light of economic change and technological progress. The character of the electric utility industry has changed, and will continue to change, in a way that makes the Act more costly:

- Financial analysis and accounting standards have evolved in such a way as to make its provisions unnecessary.
- PUHCA limits the choice of organizational structure for many firms, both utilities and non-utilities.

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[1]Pub. L. No. 74-333, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. §79a *et seq.*).

- It restricts the market for corporate control and protects entrenched managers.
- It limits the ability of utilities to diversify, both across regions and across industries.

PUHCA imposes substantial costs on shareholders and customers of the electric utility industry with no offsetting benefits; it is time for its repeal.

The Features of PUHCA

PUHCA was designed to "integrate and simplify" the structure of utility holding companies. The Act defines a utility holding company as "any company which directly or indirectly owns, controls, or holds with the power to vote, 10 per centum or more of the outstanding voting securities of a public utility."[2] A utility that becomes a holding company is potentially subject to the full provisions of PUHCA and must register under the Act.

PUHCA established two broad categories of utility holding companies: registered holding companies and exempt holding companies. Firms can apply to become exempt holding companies under any of five statutory exemptions. Of the five, the two main exemptions are (1) if the utility's operations are predominately in a single state or (2) if the utility is predominately an operating utility. Those requirements encourage exempt utilities to operate in a single state and to maintain relatively simple organizational structures if they wish to retain their exemptions.

An important provision of PUHCA, known as the "two-bite rule," that does apply to exempt firms is Section 9(a)(2). This section prohibits any firm that owns 5 percent or more of the voting securities of any public utility from acquiring 5 percent or more of the voting securities of another public utility without prior SEC approval. An exempt holding company also is precluded from organizing under a non-utility parent company. Thus, if PUHCA were repealed, both exempt and registered holding companies would have more organizational flexibility than they do today.

PUHCA regulates a number of registered holding company activities, including financing through the issuance of securities, the acquisition of utility assets, various intercompany transactions, record-keeping and accounts, and contracts between operating and service companies. Registered holding companies must file numerous routine and transaction-specific reports with the Securities and Exchange

[2]Section 2(a)(7)(A) of PUHCA.

Commission, some of which must be certified by independent public accountants.

Registered holding companies must obtain prior SEC approval for most types of securities issuances and for ensuring that acquisitions are not detrimental to the goal of integrating and simplifying holding companies. Regarding non-utility acquisitions, Section 11(b)(1) of PUHCA greatly restricts registered holding company activities. It states that a registered system can retain a non-utility system only if it is "reasonably incidental or economically necessary or appropriate to the operations of [an] integrated public-utility system." This provision has been interpreted to mean businesses that supply or serve the utility system, such as coal mines or rail lines (SEC 1982). Section 11(b)(1) also requires that each registered system be limited to a "single integrated public-utility system." This provision has been interpreted as placing a virtual ban on the acquisition of geographically distant utility assets through holding companies. Thus, registered holding companies are confined to one geographic area, which greatly limits merger activity among utilities (Harvard University 1995).

This overview suggests that PUHCA differs fundamentally from classic utility regulation. The Act attacks the use of the holding company structure in the electric and gas utility industries by restricting and micromanaging the *organizational form* that managers choose for their firm. While PUHCA restricts a part of the economic *process*, classic rate-of-return regulation is typically concerned with regulating *outcomes*, such as prices and service levels. Today, this constraint on a particular organizational form is outdated and unnecessary.

Recent Legislation and PUHCA's Obsolescence

The structure of the electric utility industry has changed significantly during the past two decades as a result of policy changes on both the state and federal levels. The Energy Policy Act of 1992[3] facilitated the development of wholesale power markets where power is bought and sold for resale over large grid networks, often covering several states. These markets are growing rapidly and continue to evolve. Under the Energy Policy Act, the Federal Energy Regulatory Commission required investor-owned utilities to provide access to their transmission grids to all wholesale customers and other utilities (SEC 1995: 19).[4] The provision of these transmission services, known as "wheeling"

[3]Pub. L. 102-486, 106 Stat. 2776 (1992).

[4]In March 1995, the FERC required utilities to provide users access to their transmission grids at the same price they would charge themselves.

services, has increased the amount of power bought and sold in a market setting and increased competition. On the wholesale level, the Energy Policy Act ended utilities' 90-year-old monopoly status. Moreover, any person, including a registered holding company, can acquire an "exempt wholesale generator" without seeking prior approval from the SEC (ibid.: 20).

Although PUHCA no longer restricts entry into the wholesale electricity business, it continues to do so for retail business. The Energy Policy Act, however, left end-user deregulation to the states, so competition is increasing on the retail level as well, through state regulatory commission decisions. The California Public Utilities Commission recently approved a plan under which large retail customers can shop for power by 1998, and all other customers can do so by 2003 (Holden 1995). Under the plan, California soon will have a system of mandated retail wheeling in which all customers can contract with their supplier of choice. Other states, such as Rhode Island, Wisconsin, and Michigan are considering similar plans.

Mandates requiring common carriage of power over the grid, however, need to be recognized for what they are: a taking of private property for public use requiring compensation under the Fifth Amendment. Perhaps because of a fascination with classic theories of regulation, many commentators have tended to ignore the private nature of utility property. Conventional economic theories of regulating the grid as a natural monopoly leave little room for compensation of the regulated party.

Growing competition has led to new types of organizational forms, including cogenerators and small independent power producers. Called "non-utilities," these facilities enjoy substantial regulatory advantages over other utilities and constitute an important alternative source of energy. Non-utility generation increased rapidly in the 1980s; by 1992 it accounted for 10 percent of total U.S. generation (Baumol and Willig 1995: 4). Non-utility generators added more net capacity in the 1991–92 period than did utilities. Today additional units of generating capacity are as likely to be provided by non-utility generators as by utilities, and forecasts suggest that the importance of non-utility generation will increase in the future. The rise of these new generators means that the structure of the industry is changing so as to include new organizational forms. The traditional vertically integrated operating utility is no longer the sole provider of energy.

Many of the concerns addressed in PUHCA reflect the structure of the industry in 1935.[5] Indeed, the integration and simplification

[5]For example, the SEC (1982: 4) stated, "Continuation of the 1935 Act constitutes, in effect, a judgement that the industry today should conform to a structure deemed best in 1935. The Commission believes that the Congress should consider whether the Act now

requirements have been described as "the very heart" of the statute (SEC 1982: 17). Electricity then was considered to be strictly a natural monopoly, which led regulators to grant legal monopolies. With such legal monopolies there was a substantial concentration of power, so limits on a firm's geographic boundaries and its outside investments made sense. The changes described earlier suggest that market power is being reduced both by the introduction of market forces and by new organizational forms. Competition is increasing rapidly in the utility industry and will continue to increase in the foreseeable future, thus making irrelevant the concerns that motivated PUHCA.

It is not necessary to wait for complete retail competition before repealing PUHCA. Rather, PUHCA repeal logically follows from deregulatory efforts that have already occurred. The Act essentially exposes the subset of firms subject to its full provisions to unfair, onerous regulatory requirements that are inconsistent with the rule of law and the level playing field required for a fully competitive market.

PUHCA and the Choice of Organizational Form

In a monopolistic, rate-of-return regulated environment, a substantial amount of inefficiency can be accommodated in the firm's organizational structure before the firm suffers financially. In a competitive environment, however, inefficiently structured firms are more likely to suffer. As the utility industry becomes more competitive, the market process will replace the regulatory process in the determination of managerial decisions.

Managers typically have the most information about their firm's environment and seek to maximize their firm's value subject to existing organizational rules. As market conditions become more critical to the success of public utilities, managers will have an incentive to use holding companies to diversify and lower transactions costs.

Diversification through Holding Companies

The holding company structure is a modification of the limited liability company that provides a way for firms to "compartmentalize" the risk associated with various business activities. For example, a subsidiary can go bankrupt, while the assets of the holding company are protected. A firm can lower the risk, and therefore the cost, of utilizing its financial, managerial, and engineering capabilities in other businesses, both utility and non-utility. With a minimum of internal

locks the public utility industry into a structure that is no longer responsive to changing market conditions in the nation's energy needs." If that was true more than 15 years ago, it is certainly the case today.

organization costs, a firm can diversify across regions and across industries.

There are a number of benefits of utility diversification across geographic regions. First, by diversifying across regions, utilities are able to efficiently manage electricity demand and more fully utilize their expensive "peaking power" so units are not left idle. Second, geographic diversification allows the utility to efficiently manage its entire mix of generating capacity in a way that will minimize the total cost of meeting its requirements (Joskow and Schmalensee 1983). Such geographic diversification also allows the utility to diversify its fuel sources so the utility will not be dependent on a single coal mine or gas pipeline for fuel.

Third, diversification across jurisdictions allows "regulator diversification," as firms are able to minimize the risk of idiosyncratic decisions. If utilities are limited to one or two state regulatory jurisdictions, they must tolerate the sentiment and policies of those regulators. Regulatory risk is well recognized in the literature as one of the most important risks facing utilities. Regulators may prevent utilities from recovering the costs of large investments by denying rate increases or dictating accounting methods that adversely affect profits. There is wide diversity in policy across regulatory jurisdictions.[6] The restrictions on geographic diversification in PUHCA force utilities to bear risk inefficiently.

There are additional benefits of geographic diversification that are not risk-related. For example, mergers between utilities are important because the regulatory process required to approve new facilities is lengthy. A firm that needs new capacity often can acquire it more quickly (and less expensively) through acquisition. Utility mergers can also be viewed as a way to speed up the process by which firms adjust to new market conditions. While there are substantial benefits associated with geographic diversification, the costs appear to be minimal. Indeed, some utilities that utilize the divisional structure to diversify, such as UtiliCorp and PacifiCorp, currently operate disbursed systems with no visible harm to the public (Harvard University 1995).

There are many non-utility activities that utilities are likely to participate in intensively under PUHCA repeal, because they have a comparative advantage in these activities. An important example lies in cable TV and telecommunications. The electric utility industry currently has a strong comparative advantage in those markets, because it has

[6]This diversity has created a market for firms such as Duff and Phelps that specialize in rating the favorability of regulatory commissions to the utility.

already laid more than 10,000 miles of fiber optic cable, with much existing slack capacity (Carpenter and Graves 1995). Utilities will expand this capacity, particularly with the advent of home energy services such as "real-time pricing" of electricity. Provision of these services requires the installation of cable into the home. Installation would allow utilities to compete directly with cable TV providers as a side benefit of providing energy services, thus reducing cable prices to the consumer. The benefit is critical because direct competition in cable TV services currently is limited.

Internal Transactions Costs

The holding company structure is also helpful in lowering transaction costs within a firm. The lower transactions costs stem mainly from the compartmentalization of activities that is possible under the holding company form. Such transparency allows management to avoid internal cross-subsidies, and the concomitant efficiency losses, between business activities. Second, the separation of entities allows managers to allocate resources among various parts of the business more carefully, an activity that assists in capital budgeting. Profit maximization dictates that new investments be made only when the expected rate-of-return for the activity exceeds its cost of capital. The separation of subsidiaries allowed by the holding company structure facilitates this type of calculation, because managers can more easily scrutinize various activities.

The holding company structure also assists with financing. A holding company may be able to obtain financing for a non-utility activity, or for a particular utility subsidiary, that it could not obtain otherwise, because the lender has assurance that other aspects of the business will not interfere with the financed activity. Potential lenders can more easily assess the costs and benefits of the particular activity. Additionally, financiers have more flexibility, because they can fund particular units of an enterprise without interfering with other divisions.

Further evidence of the value of the holding company form stems from the fact that utilities continue to organize under this structure despite the substantial regulatory costs imposed by PUHCA. Four mergers have been announced which, if approved, would increase the number of registered holding companies to 16.[7] Thus, the perceived

[7]Presently only 12 systems are regulated under PUHCA, of which nine are electric and three are gas systems. In 1935, PUHCA applied to over 200 registered holding companies. The announced mergers are Union Electric and CIPSCO, Inc.; Public Service Company of Colorado and Southwestern Public Service; Northern State Power and Wisconsin Energy Corporation; and a three-way merger of WPL Holdings, IEC Industries, and Interstate Power Corporation.

benefits of the structure must outweigh the regulatory costs. As noted, PUHCA has been rendered obsolete by the development of accounting standards and financial analysis. I shall now discuss those changes in detail.

The Development of Securities Analysis

Several studies of utility holding companies, requested by Congress, were undertaken before the passage of PUHCA. Overall, the studies imply that inadequate disclosure and analysis were the main concerns in enacting PUHCA. Therefore, in considering repeal of the Act, one should focus on how information regarding holding companies' operations has evolved. In this section, I discuss how this has occurred through enhanced accounting standardization, improved accounting techniques, more sophisticated financial analysis, and the growth of expert financial intermediaries (SEC 1982: 30).

A major goal of PUHCA was to standardize accounts and increase financial disclosure. In 1935, this goal was a legitimate concern because the accounts of utilities were sometimes manipulated and often difficult to read, and accounting practices varied widely across firms. However, numerous developments in the accounting and investment professions have rendered these requirements unnecessary. Financial analysis is now much more sophisticated. There is a large degree of financial disclosure demanded of any firm, but particularly those listed on national exchanges with large amounts of stock, as is typical of utilities.

The accounting profession has matured substantially since the Depression. For example, the Financial Accounting Standards Board (FASB) has developed uniform accounting standards that must be used by all accountants who are members of the American Institute of Certified Public Accountants. All financial statements certified by a member of the AICPA must follow rules established by FASB. The strict accounting standards envisioned by the framers of PUHCA for the utility industry have thus been spontaneously assimilated into the accounting profession and are now widely enforced by it. Any utility wishing to enjoy the benefits of audited financial statements must meet the standards.

Any company wishing to obtain financing through organized securities markets must also meet FASB's norms for disclosure and uniformity. The growth of securities analysis as a profession and the adoption by that profession of strict standards ensures that a firm not willing to abide by them will be effectively prohibited from using the markets. Because of the benefits of adopting FASB's rules, particularly for asset-intensive firms, there is a strong incentive to meet the prevailing

standards. Apart from securities analysis, the growth of expert intermediaries between firms and individual investors, such as mutual and pension funds, ensures that firms are subject to a high level of financial scrutiny. Moreover, expert rating agencies such as Duff and Phelps, Moody's, and Standard and Poor's, provide a heightened level of scrutiny.

PUHCA and the Market for Corporate Control

PUHCA has profound effects on the market for ownership of both utilities and non-utilities. The market for corporate control is the market in which the ownership, and thus control, of corporations changes hands. In this market various managerial teams compete for the right to manage corporate resources (Jensen and Ruback 1983). Incumbent managers are often replaced when ownership changes hands; they have an incentive to use corporate resources more efficiently knowing that they can be replaced. Both an actual takeover and the threat of a takeover are important in encouraging managers to maximize firm value (Manne 1965).

Firms with skilled managerial teams create value by acquiring poorly managed firms and increasing their market value. Statistical evidence substantiates the view that takeovers create social benefits and improve corporate performance (Jensen and Ruback 1983; Jarrell, Brickley, and Netter 1988). An active market for corporate control is particularly important in the electric utility industry. PUHCA imposes costs by limiting the market for corporate control; the market would be more efficient if PUHCA were repealed.

Utilities and the Market for Corporate Control

In most industries, the competitive forces of the marketplace help discipline corporate managers. If the firm is inefficiently managed, the price of the firm's product will not be competitive and the firm will lose market share. In industries that are rate-of-return regulated the firm is granted a geographic monopoly by law. The competitive forces of the marketplace are absent. Theoretically, regulators are to substitute for market forces in the enforcement of managerial discipline.

Regulators are unlikely to be effective substitutes for market forces, however, for several reasons. They will react only with a lag, at least as long as the regulatory proceeding, and typically intervene only when the utility requests a rate review. Market forces affect the firm much more rapidly. Moreover, regulators are loath to make politically unpopular decisions that harm consumers or shareholders. Instead,

regulators are likely to respond to the force of organized pressure groups (Peltzman 1976).

It is therefore desirable to supplement the efforts of regulators with an active market for corporate control. Unfortunately, there are currently many regulatory bodies that simultaneously oversee utility mergers,[8] so takeover activity in the electric and gas utility industry has historically been quite limited. In the period from 1960 to 1986, for example, there were only nine hostile takeover attempts and none were successful (McLaughlin and Mehran 1995). In the five years from 1986 to 1990 (when there was a belief that deregulation would enhance the chance of success), there were 13 takeover attempts but only one was successful.

It could be argued that there is no incentive to acquire utilities, as the regulatory process would remove any gains (Ray and Thompson 1990; Ray et al. 1992). However, McLaughlin and Mehran (1995) show that the stock returns around the time of the announcement of a utility merger are positive, but are significantly smaller than if the target were not regulated. Thus, even though the takeover market for public utilities is greatly weakened by regulation, the gains from takeovers still persist.

Delay of takeovers, such as occurs through the lengthy regulatory approval process, is also harmful. First, incumbent managers of the target firm benefit from long delays between the announcement of an intended takeover and its consummation. This delay allows them to arrange takeover devices. Second, numerous pressure groups (such as environmentalists and consumer advocates) have an opportunity to coalesce and have an incentive to slow or subvert the regulatory process to gain concessions that would normally not be granted. The problem occurs even if the merger is socially beneficial. In an unregulated setting, those groups are less likely to affect the outcome of the merger.

For those reasons, an active market for corporate control is particularly important in the utility industry. Emphasis should therefore be placed on repealing PUHCA to facilitate the market.

PUHCA's Effects on the Market for Corporate Control

PUHCA creates a substantial barrier to utility takeovers. Indeed, that federal law has been cited by researchers as a critical barrier to utility takeovers. While there are other barriers (such as takeover defenses, state regulations, and competing offers) federal law remains, if not the most, certainly one of the most significant barriers. In a

[8]Regulatory bodies include the Securities and Exchange Commission (through PUHCA), the Federal Energy Regulatory Commission, and the Department of Justice.

study examining the nine hostile utility takeover attempts that occurred between 1960 and 1986, Robyn McLaughlin and Hamid Mehran (1995: 184) found that six failed "primarily because of federal regulatory procedure based on the Public Utility Holding Company Act of 1935."

PUHCA affects the market for corporate control by discouraging non-utilities from bidding for utilities. As noted earlier, a firm that acquires more than 10 percent of the equity of a utility must register as a holding company, with all the regulatory constraints that implies. The Act then requires that the firm be "simplified" into a single, unified utility system. The requirement applies to utilities as well as non-utilities and is typically not an attractive option for a potential bidder.[9] Thus, PUHCA discourages non-utilities from entering the utility market. If the costs of utility ownership were reduced, more non-utilities would undoubtedly compete for the ownership of utility assets. Non-utilities would likely become significant players in the market for utility control and improve the efficiency of utility managers.[10]

PUHCA also discourages takeovers from other utilities. The Act discourages the acquisition of utility assets or securities by other utilities that are not physically interconnected or capable of such interconnection.[11] Under this regime, utility managers are essentially limited to takeover pressure from other firms in their state, a situation that constitutes a severe restriction on corporate ownership.[12] If U.S. utilities were able to acquire any other utility, contiguous or not, the opportunity would increase the pressure on utility managers from takeovers and consequently increase their efficiency.

An additional degree of corporate control benefits obtains from foreign utilities (and foreign non-utilities) buying U.S. utilities. Currently, the cost to foreign companies of buying U.S. utilities is increased by PUHCA because the firms must also meet its requirements. Foreign firms face SEC regulatory oversight and until recently no foreign

[9]The SEC has not been amenable to industrial firms acquiring utilities (see McLaughlin and Mehran 1995).

[10]Although it is difficult to predict precisely which firms would acquire utilities, it is likely that firms in similar "network" industries, such as telecommunications or cable TV, in which managers have experience that can be applied to utilities, would be candidates.

[11]Section 11(b)(1) of PUHCA.

[12]McLaughlin and Mehran (1995: 188) write: "Because of the provisions of the 1935 Act and its interpretation and implementation by the SEC, the principal threat of a hostile takeover is from utility firms in the same state. Same-state utilities do not trigger the 'two-bite,' multiple jurisdiction rule of Section 9 of the 1935 Act, and, post-acquisition, they will satisfy the requirements of a 'simplified' utility system. Thus, they avoid the major federal regulatory impediments to the acquisition."

acquisitions were allowed.[13] While the SEC has the discretion to allow such acquisitions, the regulatory process imposes substantial costs and uncertainty on them. Repeal of PUHCA would remove the additional layer of regulatory oversight and lower the cost of foreign acquisitions in the corporate control market.

By allowing utilities currently affected by PUHCA to enter non-utility businesses more freely, repeal of PUHCA would have benefits in enhancing corporate efficiency in other non-utility industries. Given the substantial cash flows and limited growth prospects in some utility markets, utility managers have the resources to effectively compete for control in many industries.

In sum, there are a number of reasons to believe that reform of PUHCA would result in increased efficiency through a more fluid market for corporate control. Both direct administrative costs and the chilling effect caused by uncertainty over regulatory approval would be eliminated. Heightened pressure on managers due to intensive takeover threats has been shown to improve the operation of firms. Managers of utilities are currently insulated from market pressures by the regulatory process; many control mechanisms that motivate unregulated managers are absent here. It is thus important to ensure that the market for corporate control operates as smoothly as possible in this industry.

Conclusion

Given the large number of potential competitors and the homogeneity of electricity, the provision of power has the potential to become one of the most competitive industries in the United States. Such competition would have vast social benefits, but major steps must be taken to achieve it, chief among which is the repeal of obsolete and counterproductive regulations.

PUHCA unfairly penalizes certain utilities because of their organizational structure. Repeal is necessary to create a level playing field and a genuine free market in electricity. It is not necessary to wait for complete retail competition in the industry to enjoy the benefits of PUHCA repeal. Benefits such as a more active corporate control market, more entrepreneurial managers, and firms that can efficiently manage risk would be forthcoming immediately.

[13]In 1994, the SEC for the first time allowed the acquisition of a U.S. utility (a gas utility in Vermont) by a foreign utility, a Canadian pipeline (*Gaz Metropolitain, Inc.*, Holding Co. Act Release No. 26170, 23 November 1994). This case suggests that there is interest by foreign firms in acquiring U.S. utility assets.

The laws governing corporate form should be adjusted to the technology, information, and market structure of the time. Substantial changes in utility markets, in the methods and costs of corporate control, in financial markets, in transmission technology, and in regulatory techniques since 1935 have made PUHCA a costly anachronism.

The Public Utility Holding Company Act imposes substantial direct and indirect costs on society, with no concomitant benefits. It is no longer in the public interest. Diligent public policy assessment requires review of old regulations as well as consideration of new ones. It is clear that PUHCA is a law that is no longer appropriate for the utility industry. Indeed, the SEC stated that its goals were achieved more than 20 years ago (SEC 1982). Of all the laws regulating utilities today, PUHCA may well be the most antiquated. Its detailed provisions continue to inhibit the market discovery process and to ward off hobgoblins that have long ceased to exist.

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