

private equity and the repeal of PUHCA

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The repeal of the Public Utility Holding Company Act of 1935, effective Feb. 8, 2006, is likely to have a profound effect on investment in the electric utility sector. The elimination of PUHCA's burdensome regulations and severe operational and geographic restrictions will encourage investment and acquisitions by a greater number of non-utility companies, including private equity firms and hedge funds that had previously been effectively precluded from investing in this industry. In addition, PUHCA's repeal will now allow combinations among electric utility companies, opening up new investment opportunities for private investors.

A major piece of New Deal legislation passed in the wake of the Great Depression, PUHCA was enacted in 1935 to curb the abuses of large public utility holding companies with concentrated market power. Before PUHCA, many holding company systems created risky financial structures by leveraging up their utility subsidiaries and using the cash proceeds to invest in higher-risk and speculative ventures. Many of the subsidiaries went bankrupt as a result of their highly leveraged capital structure, causing significant losses for investors. Effective regulation by individual states was extremely difficult because almost 75 percent of the electricity generation companies in the United States were controlled by 13 holding companies, creating complex holding company pyramids across several states.

PUHCA requires public utility holding companies with multi-state utility operations to register with the Securities and Exchange Commission (SEC) and comply with a comprehensive federal framework of regulation administered by the SEC. PUHCA

regulates many aspects of the operations of registered holding companies, as well as their subsidiaries and affiliates. For example, a registered holding company may only issue securities with the SEC's approval and compliance with an extensive set of rules relating to the type and amount of equity and debt securities that may be issued. PUHCA also limits the types of businesses in which a registered holding company may invest. The Act regulates loans, service arrangements and other transactions within the holding company system; dividend payments by the holding company; political contributions and lobbying;



and establishes certain director disqualification standards.

The definition of a holding company subject to PUHCA is quite broad. Absent an exemption, any company that owns, controls or holds 10 percent or more of the outstanding voting securities of a public utility is presumed

to be a public utility holding company subject to PUHCA's expansive restrictions and regulations. Further, PUHCA prohibits any person from acquiring 5 percent or more of the voting securities of a public utility if it already holds more than 5 percent of another public utility without prior SEC approval. This is known in the industry as the "two-bite rule."

The two-bite rule also provided a trap for the unwary institutional investor. For example, Cascade Investment LLC, an investment vehicle formed by Microsoft founder Bill Gates, had to apply to seek SEC approval after acquiring an ownership interest in 5 percent or more of the voting

securities of more than one publicly traded utility company purely for investment purposes.

Certain exemptions to PUHCA apply. For example, holding and subsidiary companies that are predominately intrastate in character and whose business is conducted intra-

state are exempt from PUHCA. Also exempt are holding companies whose utility operations do not extend beyond the state in which it is organized and in contiguous states. Still other exemptions allow ownership of certain energy efficient generation facilities, generation companies that sell power only at the wholesale level, and foreign utility companies.

Due to the limited nature, both in substance and number, of available exemptions, private investors motivated to invest in the public utility sector had to resort to complex and burdensome ownership structures to avoid regulation as a holding company. For example, in the first significant private equity investment in the electric utility industry, Berkshire Hathaway successfully acquired an interest in MidAmerican Energy Holding Company only after establishing a fairly complex ownership structure in which Berkshire purchased only 9.9 percent of MidAmerican's voting stock, but owned 81 percent of its overall equity, including preferred stock that allowed Berkshire to elect two of 10 MidAmerican directors and have veto rights over certain material corporate transactions. The balance of the voting common stock was held by individuals, including Walter Scott, Jr., a member of Berkshire's Board of Directors, who controls approximately 88 percent of the voting interest in MidAmerican.

The Energy Policy Act of 2005, signed by President Bush on Aug. 8, 2005, repeals PUHCA and amends the Federal Power Act, effective Feb. 8, 2006. Under the new regime, non-utility investors interested in purchasing utilities or investing in other utility assets, such as transmission facilities, will no longer have to adopt complex and burdensome ownership structures to avoid onerous PUHCA regulation and registration requirements and SEC review of proposed transactions. Passive institutional investors will be free to invest in publicly traded securities of more than one public utility company without seeking

prior SEC approval under the two-bite rule.

Moreover, the repeal of PUHCA eliminates the geographic and operational restrictions that required a public utility holding company system to constitute a single, integrated public utility system. This meant that the public utility assets within the system had to be physically interconnected, capable of economic operation as a single coordinated system confined to a single geographic area or region that is not so large as to impair the advantages of localized management, efficient operation and effective regulation. This change increases the possibility of mergers and acquisitions among non-contiguous utilities thereby facilitating consolidation within the utility industry. Much of the capital to effect these mergers and acquisitions may come from the private equity sector. For example, Warren Buffett has reported that Berkshire Hathaway would be willing to invest \$10 billion to \$15 billion into the energy sector if PUHCA was repealed.

The Energy Policy Act did more than repeal PUHCA. It transferred new authorities to the Federal Energy Regulatory Commission. The Act provides FERC and state utility commissions with access to books and records of holding company systems to the extent relevant to the costs incurred by its public-utility companies. The 2005 Act also provides FERC with additional merger review authority, review over generation acquisitions, an enhanced standard of review, and significant authority to impose civil penalties over expressed prohibition of market manipulation.

With respect to merger review, the 2005 Act increases the threshold for FERC approval required for the sale, lease or disposition of utility facilities and the purchase or acquisition of securities of utility companies from \$50,000 to \$10 million. Significantly, no threshold applies for the merger or consolidation of such public utility facilities. Additionally, FERC approval is now required for the purchase, lease or acquisition of ex-

isting generation facilities that have values in excess of \$10 million and that are used for interstate electricity wholesale sales and over which FERC has wholesale ratemaking jurisdiction.

Furthermore, the 2005 Act enhances the FERC standard of review. Previously, FERC would approve transactions if they were "consistent with the public interest." As a result of the 2005 Act, FERC will also need to assure that the proposed transaction "will not result in cross-subsidization of a non-utility associate company" unless such cross-subsidization is in the public interest. The new language allows FERC more flexibility in considering merger benefits while underscoring a concern over cross-subsidization, or the potential to transfer benefits from ratepayers to shareholders through transactions involving unregulated affiliates.

While PUHCA's repeal opens up many exciting investment and acquisition opportunities for private investors, in the short-run much remains uncertain with respect to the soon-to-be reshaped regulatory landscape. FERC must still issue rules to implement the new 2005 Public Utility Holding Company Act provisions and submit to Congress detailed recommendations and conforming amendments to federal law necessary to carry out the new PUHCA subtitle. Moreover, while SEC oversight of utilities will decrease, state regulators are likely to play an increasingly active role in the consideration of utility merger and acquisition transactions. Still, once FERC adopts rules to implement the Energy Policy Act of 2005, it is likely that significant investment by private investors will flow to our nation's electric utility infrastructure, paving the way for exciting investment opportunities that were previously unavailable to private investors. ●

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