

EFFECTIVE STATE REGULATION OF ENERGY UTILITY DIVERSIFICATION

JEFFREY W. KNAPP†

Many utility customers would be surprised to learn that the company providing them with gas or electricity might also be involved in the insurance, banking, or real estate business. Yet, more and more energy utilities are diversifying¹ from traditional natural monopolies into a number of unregulated fields in the competitive sector of the economy. This trend toward diversification, while by no means purely a recent development, shows signs of acceleration² and presents a sig-

† B.A. 1984, Washington and Lee University; J.D. Candidate 1989, University of Pennsylvania.

¹ Any business activity falling outside of the traditional utility functions of generation, transmission, and distribution of electrical or gas energy is considered a diverse activity. See Ferrar, *Business Diversification: An Option Worth Considering*, PUB. UTIL. FORT., Jan. 7, 1982, at 13, 17.

² See Murray & Closterman, *How Utilities Are Becoming New Conglomerates*, PUB. UTIL. FORT., Aug. 7, 1986, at 11, 11 ("The number of mergers and acquisitions completed by [all utilities] in 1985 was 38 per cent higher than in 1984. . . . In fact, since 1983, the number of utility mergers and acquisitions has increased 63 per cent versus a 35 per cent increase for all industries."); Sponseller, *An Overview of Utility Reorganization Activity*, PUB. UTIL. FORT., Oct. 15, 1987, at 42, 42.

Analysts generally offer two explanations for this flurry of activity. Some observers believe the primary catalyst is the utilities' strong cash position upon completion of construction programs. See, e.g., Murray & Closterman, *supra*, at 11 (financial position of electric utilities is improving due to the expected continuation of the downward trend in construction expenditures); Trebing, *The Impact of Diversification on Economic Regulation*, 19 J. ECON. ISSUES 463, 464 ("The imbalance between lower capital needs and higher cash flow" provides management with the opportunity to diversify.); Daniels, *Utilities Are Branching Out*, N.Y. Times, Feb. 19, 1987, at D1, col. 2, D6, col. 2 (Utilities, after canceling plans for more than 150 generating plants in last decade, are "not about to start a new building cycle."); Tucker, *Utilities Diversify for Profits*, Wash. Post, Sept. 8, 1986, at WB1, col. 3, WB1, col. 5 ("Utilities have become cash cows largely because growth in electricity demand has slowed from about 7 per cent annually in the 1970s to about 2 per cent today, which means they don't need to build new plants but still collect ratepayer dollars."); Rose, *Utilities, Flush With Cash, Enter New Fields*, Wall St. J., July 1, 1986, at 6, col. 1, 6, col. 1 ("Except for those troubled by half-finished nuclear plants, utilities are expected to enjoy cash surpluses for some years to come.").

Other commentators believe that the diversification trend is a result of the utilities' desire to avoid a hostile regulatory environment, and at the same time, seek greener (unregulated) pastures. See, e.g., Andrews, *Diversification and the Public Utility Holding Company Act*, PUB. UTIL. FORT., Dec. 23, 1982, at 24, 26 ("Inflation, poor regulatory performance, and nuclear power have all [increased] the perceived risk to investors. . . . Diversification . . . can . . . help increase earnings or decrease risk."); Daniels, *supra*, at D6, col. 1 ("One response to the regulatory situation . . . is diversification."); Paul, *Utilities' Cash Surpluses Spur Investments*, Wall St. J., March 26,

nificant challenge to those bodies charged with regulating public utilities.³

The challenge stems from the decision of many utilities to diversify through the formation of holding companies, and the resulting segregation of the nonutility subsidiaries from the utility subsidiary. This corporate structure often enables the utility holding company to shield its nonutility operations from scrutiny by the traditional guardians of utility consumer interests—the state public service commissions (“PSCs”).⁴ Having avoided the regulator’s scrutiny, the management of a utility holding company is in a position to abuse its discretion to the detriment of ratepayers.⁵

In fact, the prevalence of these abuses through the 1920’s compelled Congress to pass the Public Utility Holding Company Act of 1935 (“PUHCA” or “Act”).⁶ Considered to be “as [complex] a piece of legislation as Congress perhaps has ever enacted, . . . [b]y means of [which] the Securities and Exchange Commission completely restructured a huge complex industry,”⁷ the PUHCA has been acclaimed as a success beyond all expectations.⁸ Some view the Act as the paragon of the sort of obsolete regulation that the Reagan administration was elected to purge.⁹ Others, such as the Justice Department, the National

1986, at 6, col. 1, 6, col. 1 (“[N]ever has the industry been so opposed to [building] new plants—mainly out of fear that state regulators . . . won’t authorize the full recovery of future plant expenditures.”). Still, it is important to recognize that the aggregate dollar value of diversification is small. See Levy, *Utility Diversification, Other Subjects, and the Public Utility Holding Company Act of 1935*, in DIVERSIFICATION, DEREGULATION, AND INCREASED UNCERTAINTY IN THE PUBLIC UTILITY INDUSTRIES 544 (Mich. St. U. Pub. Util. Papers 1983) [hereinafter 1983 MSU PAPERS] (Diversification “has been modest,” and for most utilities “is still at initial or programmatic stages.”); Murray & Closterman, *supra*, at 12 (non-utility activity profits seldom exceed five percent of a diversified utility’s consolidated profits).

³ “A public utility is a monopoly enterprise that renders a public service and so is invested with a public interest; the nonutility company is not. This union leads to regulatory complications and potential risks affecting consumers that need to be understood and acknowledged.” Levy, *supra* note 2, at 563.

⁴ The name given to these public service commissions is not nationally uniform. For simplicity and consistency, they will be referred to as PSCs in this Comment.

⁵ The existence of a profit motive enhances the potential for abuse. See *infra* text accompanying notes 38-40; see also *infra* notes 45-76 and accompanying text (detailing potential abuses of the holding company structure).

⁶ Pub. L. No. 74-333, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. §§ 79-79z-6 (1982)).

⁷ Sommer, *Public Utility Holding Company Act: Is There a Dance in the Old Girl Yet?*, N.Y.L.J., Dec. 12, 1983, at 28, col. 1, 28 col. 1.

⁸ See *infra* notes 84-90 and accompanying text. The restrictions of the PUHCA have compelled many utilities to dissolve their holding companies or to restructure their operations in such a way as to qualify for one of the exemptions under the Act. To the extent that this restructuring has curbed the potential for the abuses that prompted passage of the PUHCA, the Act is considered a success. See *id.*

⁹ See *id.*; Brown & Bink, *Special Report: The Movement for Repeal of the Public*

Association of Regulatory Utility Commissioners, and consumer lobbying groups argue for retention of the PUHCA.¹⁰ The debate over the propriety and fate of the PUHCA remains muted, probably because consumers have yet to feel much direct impact of the diversification trend. Meanwhile, most states approach regulation of diversification by utility holding companies on an ad hoc basis, if at all.

The time to define the permissible scope and form of utility diversification is now, before public utilities commit large amounts of resources and before regulators are faced with a crisis situation.¹¹ Part I of this Comment explores the pros and cons of public utility diversification, concluding that under the proper conditions, diversification can benefit both the ratepayers and the utility shareholders. Part II summarizes the inadequacies of existing diversification regulation, suggesting that effective regulation depends upon access to information that utilities are reluctant to provide and that this paucity of information hampers state regulatory efforts. Finally, Part III proposes a model statute, enumerating the powers essential to effective state regulation of utility diversification.

I. PUBLIC UTILITIES AND DIVERSIFICATION

A. *Should We Permit Diversification At All?*

Diversification is neither such an obvious evil as to warrant its outright prohibition nor such an unmitigated good as to justify regulatory inaction. It seems that for every industry argument in favor of diversification, there is an opposing regulatory response.¹² As a general matter, the principal focus of the proponents of diversification is the investment community. Opponents, on the other hand, are primarily

Utility Holding Company Act, PUB. UTIL. FORT., May 13, 1982, at 42, 42-43.

¹⁰ See *id.* at 43-44. Absent the existence of the PUHCA, utility holding companies would have little incentive to simplify their organizational structures. The resulting complex structures, particularly those extending across state lines, would be outside the effective regulatory reach of state PSCs. See Buchanan, *The Public Utility Holding Company Problem*, 25 CALIF. L. REV. 517, 541 (1937) (asserting that "holding companies are not usually incorporated in, or doing business in, the states where their subsidiaries operate [and this fact] raises further legal barriers to direct state regulation").

¹¹ Furthermore, uncertainty regarding the permissible extent and forms of diversification may be costing consumers money. See Buck & Groth, *Regulatory Uncertainty and the Cost of Capital for Utilities*, PUB. UTIL. FORT., Feb. 20, 1986, at 23, 24-25. Buck and Groth conclude that "perceived uncertainty about regulation will add to capital costs regardless of the regulatory decisions that materialize [and] absent an external subsidy, the costs must flow through to the final consumer." *Id.*

¹² See D. HAWES, *UTILITY HOLDING COMPANIES* §§ 6.02-03 (1987) (listing opposing utility and regulatory views on specific reasons for and against diversification).

concerned with ratepayer interests. Specifically, the opponents assert that diversification into risky businesses may needlessly subject the utility and its ratepayers to financial loss. It may be appropriate, therefore, for legislation to contain some limitation on acceptable areas for diversification.

Proponents cite numerous potential benefits from diversification—some economic, others less quantifiable. Among the economic benefits, the following are frequently mentioned:

1. synergies with other corporate resources such as land, computer programs, and customer bases;¹³
2. use of nonutility earnings to exploit tax benefits earned through utility investments and operations;¹⁴
3. increased demand for utility power resulting from construction of buildings that will consume the power produced by the utility;¹⁵
4. stabilization of utility earnings through investments in industries countercyclical to the utility business;¹⁶

¹³ See, e.g., Andrews, *supra* note 2, at 27 (“Corporate resources such as land, computer programs and customer bases may be very worthwhile utility assets that have the potential to be used in other profitable businesses.”); Catalano, *Utilities Begin to Show Profits From Diversification Ventures*, POWER, Aug. 1984, at 73, 74 (discussing consulting work, which “would provide an efficient use of the company’s personnel and equipment assets”); Trebing, *supra* note 2, at 465 (“[P]roponents of diversification claim that management can achieve an operational synergism by combining different skills, expertise, and resources to raise productivity and earnings . . .”).

¹⁴ See, e.g., Andrews, *supra* note 2, at 27 (“In certain situations, nonutility earnings can have an extra plus in those utilities that are currently unable to take full advantage of liberal tax benefits earned through utility investments and operations.”); Shaw, *Diversification: Risks and Rewards*, in 1983 MSU PAPERS, *supra* note 2, at 515, 518-19 (“[D]iversification can be used to provide income to offset tax credits generated by the core business.”).

¹⁵ See Daniels, *supra* note 2, at D6, col. 3. The Florida Progress Corporation is a minority partner in a group seeking to bring a major league baseball team to its service area. “Company officials said that they were interested in baseball because St. Petersburg and Pinellas County have pledged to build an air-conditioned domed stadium for the team. That stadium would be a big user of electricity.” *Id.*; see also Tucker, *supra* note 2, at WB17, col. 2 (utilities’ real estate investments “lead[] to increased use of electricity”).

¹⁶ See, e.g., *Public Utility Holding Company Act Amendments: Hearings on H.R. 2994 Before the Subcomm. on Energy Conservation and Power and the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 45 (1983) [hereinafter 1983 House Hearings] (statement of John W. Barr, Principal, Morgan Stanley & Co., Inc.) (“Diversification can provide another base of earnings to reduce the risks associated with exposure to a single line of business.”); D. HAWES, *supra* note 12, § 6.02, at 6-2 (“Diversification into countercyclical businesses can improve market performance.”). *But see* NATIONAL ASS’N OF REGULATORY UTIL. COMM’RS, 1982 REPORT OF THE AD HOC COMM. ON UTIL. DIVERSIFICATION 27 [hereinafter 1982 NARUC REPORT] (This argument is limited to diversification into fields “that are subject to very different exter-

5. ability to attract investors and reduce the cost of securing capital by offering the combination of stable earnings from the low-risk utility business and variable earnings from a riskier business.¹⁷

Analysts also tout less quantifiable benefits such as the ability to attract more ambitious and effective managers, lured by the exciting prospects of managing a diversified conglomerate rather than a staid utility.¹⁸ This latter argument, however, breaks down under closer scrutiny.

Some utility executives make much of the exciting possibilities in (what is for them) the new frontier of unregulated businesses.¹⁹ Others argue that “[g]etting into areas that aren’t energy-related isn’t smart if the buyer has to rely on the management of the company he acquires.”²⁰ But it is not clear that diversifying utilities follow this advice. Take, for example, Florida Power & Light’s acquisition of Colonial Penn Insurance Co. for \$566 million in 1985, ostensibly to take advantage of the synergies inherent in the fact that both were service-oriented businesses.²¹ Although interaction between utility and nonutility executives purportedly can “tone up management through new challenges

nal economic shocks” and are, unfortunately, fields where the utility is less likely to enjoy special expertise over others.).

¹⁷ See D. HAWES, *supra* note 12, § 6.02, at 6-2; see also 1983 House Hearings, *supra* note 16, at 45-46 (acknowledging the attractiveness of diversification, but noting that utilities are far riskier than they were decades ago); Andrews, *supra* note 2, at 26-27 (same). Some analysts argue, however, that the status of a utility’s nuclear program is a more important determinant of its perception among investors than its decision to diversify. See Trebing, *supra* note 2, at 466; see also Phillips, *The Changing Structure of the Public Utility Sector*, PUB. UTIL. FORT., Jan. 9, 1986, at 13, 20 (“[E]xcept for a few—and well-known—electrics with nuclear problems, the financial integrity of the public utility sector has improved.”); Tracy, *A New Power-Company Problem: Too Much Cash*, FORTUNE, Apr. 30, 1984, at 160, 160 (same).

¹⁸ See D. HAWES, *supra* note 12, § 6.02, at 6-2; Andrews, *supra* note 2, at 27; Kahn, *Utility Diversification*, 4 ENERGY J. 149, 153 (1983).

¹⁹ For particularly effusive commentary, see the statement of Thomas A. Page of San Diego Gas & Electric in *Electric Utility Commissioners Forum: Corporate Structure*, PUB. UTIL. FORT., May 28, 1987, at 82, 87. See also NATIONAL ASS’N OF REGULATORY UTIL. COMM’RS, 1972 REPORT OF THE AD HOC COMM. ON NON-UTILITY INVESTMENTS: DIVERSIFICATION BY UTILITY COMPANIES 5 [hereinafter 1972 NARUC REPORT] (utility argument that new employees may be easier to recruit if business enters fields offering enlarged opportunities for challenge and advancement).

²⁰ Tucker, *supra* note 2, at 17, col. 3 (quoting Donald J. Heim, Chairman, Washington Gas Light Co.).

²¹ See Rose, *supra* note 2, at 6, col. 3. It is difficult to believe that synergies exist between FPL and all service-oriented industries. Indeed, that statement proves too much, particularly in light of the comments of the Colonial Penn CEO concerning the acquisition. See *infra* text accompanying note 23. It is not surprising, then, that the whole notion of management synergies is being questioned. See Trebing, *supra* note 2, at 467 (“There appear to be few areas [for energy utilities] . . . where the expertise associated with administering a large-scale, capital intensive firm will be of unique value when combined with that of a nonregulated manufacturing or retail firm.”).

and the introduction of new people and skills,"²² the comments of Colonial Penn's CEO soon after the announced acquisition suggest that no such benefit will materialize: "It's really a natural move for us. We'll be under the leadership of the holding company. We'll be completely independent and we'll maintain our headquarters and our management. [The management of FP&L neither] knows anything about the insurance business [nor] pretends to know anything about the insurance business."²³ One also wonders how much interaction will occur between Colonial Penn's employees in Philadelphia and FP&L's employees in Florida.²⁴

The real motivation behind much of this diversification is the desire to divert surplus cash into unregulated industries in pursuit of higher profits than are currently available from traditional utility fields.²⁵ Given adequate safeguards for ratepayers, such a motive is ac-

²² See D. HAWES, *supra* note 12, § 6.02, at 6-2. The utilities cite the lack of ferment in their industry to explain their inability to attract bright young minds. See Sommer, *Is the 1935 Act a Barrier to Diversification?*, in 1983 MSU PAPERS, *supra* note 2, at 533, 537 ("Many companies confined to the utility industry sensed difficulty in recruiting young executives and motivating them in the face of the restraints on the activities in which utility employees could engage."). Other observers, however, point out unprecedented challenges to the utility industry, which one assumes might stimulate interest. See Phillips, *supra* note 17, at 14 (summarizing 11 major changes in the industry's operating environment during the course of the 1970's).

If there is so little challenge in the industry, why has performance been so dismal? See *A High Risk Era for the Utilities*, BUS. WEEK, Feb. 23, 1981, at 76, 76 (utility industry "going from bad to worse"). It is true that some pin the blame on the regulators. See *infra* note 25 and accompanying text. Ironically, there are signs of improvement just as the utilities are citing their poor prospects to justify forays into unregulated fields. See Shepherd, *Comments*, in 1983 MSU PAPERS, *supra* note 2, at 592 ("[m]ost of these problems now appear to be past or solved"); *The Utilities' Biggest Fan*, FORTUNE, Sept. 15, 1986, at 164, 164 ("[f]or the most part those problems have disappeared"); Tracy, *supra* note 17, at 160 (discussing strong cash position of utilities).

²³ *Colonial Penn Chief Welcomes Utility Tie*, N.Y. Times, Oct. 30, 1985, at D2, col. 5, D2, cols. 5-6.

²⁴ One proponent of diversification advises utilities "to build physical/geographical barriers [between utility and nonutility personnel] to minimize the tendency of the utility people to 'look over their shoulders.'" Shaw, *supra* note 14, at 531.

²⁵ For example, the president of a diversifying utility recently stated:

[T]his nation has been sending the utility industry a message . . . that says, "You build at your own—enormous—risk." . . . So, what have we been doing? We've been looking for ways to diversify. My own company has created a subsidiary for the specific purpose of seeking out new opportunities . . . in ventures that offer a chance to earn better returns than we can expect in our traditional regulated business.

Address by A.W. Dahlberg, President, Southern Co. Servs. Inc., Energy Technology Conference, Wash., D.C. (Mar. 19, 1986), *reprinted in* 52 VITAL SPEECHES OF THE DAY 442, 444 (1986); *see also* Shaw, *supra* note 14, at 518 ("[M]ost utility managers would not even consider diversifying if they could earn a reasonable return on their utility assets.").

ceptable to regulators because success in the venture could translate into reduced energy costs for ratepayers.²⁶

Unfortunately, it is clear that the potential for failure also exists:

A McKinsey & Co. study of 58 corporate acquisitions between 1975 and 1985 found that only six were successful. The remainder were about equally split between clear failures and indeterminate results. The acquisitions that worked best, the study found, were small purchases in a line of business similar to the acquiring company.²⁷

While it is true that this survey considered diversification into all business fields, many of which are riskier than areas utilities might enter, it remains open to question whether utility executives can outperform their counterparts in unregulated industries when it comes to picking prospects for acquisition.²⁸ In addition, there is other evidence that "mergers tend to be associated with an unexpected increase in the levels

²⁶ For example, it has been observed that the economics of energy utilities permit "increases in inputs [to be] accompanied by greater than proportional increases in production." K. HOWE & E. RASMUSSEN, *PUBLIC UTILITY ECONOMICS AND FINANCING* 36 (1982). Additionally, "[w]ith greater diversity of customer groups, capacity is better utilized and average costs are lower." *Id.* at 37. It follows that a utility diversifying into businesses that somehow enhance production demand (e.g., land development) may also reduce the cost of producing energy to the overall community. The proposal to finance the building of a domed baseball stadium is an example of this kind of economy. *See supra* note 15.

²⁷ Rose, *supra* note 2, at 6, col. 3.

²⁸ Some opponents of diversification contend that "nonutility business investment 'is almost certain to be more risky than utility investment.'" Answer of Wisconsin's Environmental Decade to Response of Applicant to Comments and Request for Hearing at 12, WPL Holding, Inc., SEC Admin. Proc. 70-7385 (Nov. 25, 1987) (quoting Douglas Randall, Senior Vice President of Standard & Poors, testifying before the Economic Development Committee of the Wisconsin Legislature (June 12, 1985)). Wisconsin's Environmental Decade is contesting WPL's application for exemption of its holding company from the PUHCA. The group cited WPL's investment in Ciphrex, Inc., a firm that bought rights to certain toll-free (800) numbers that were the acronyms of major corporations, as an example of the dangers of diversification. *See id.* Ciphrex would sell the number to the corporation when, and if, it decided it needed an 800 number with its acronym. The result has been "little profit" and a protracted legal battle—with Ciphrex litigating a claim against WPL for \$75 million. *See id.*

The reasons utility diversification is riskier include:

substitution of freely competitive markets for an exclusive franchise; the presence of products, services and customers which differ from traditional utility products, services and customers; and the need for management skills, like entrepreneurship, which differ from those needed to operate a utility business. . . . [Also, it is] the nature of non-utility business startups to suffer losses in the early years, and to experience high rates of failure.

Id. at 13.

of risk for the consolidated enterprise."²⁹

In a worst-case scenario, failure of the diversification enterprise could lead to the utility's inability to raise capital.³⁰ Some opponents argue that ratepayers will not share commensurately in the benefits if the nonutility venture succeeds, and they will surely suffer when the nonutility business falters.³¹ This danger is greatest where the utility is not insulated from the diversification ventures, for instance, when the diversification is carried out *within* the utility, or by a subsidiary of the utility.³² On the other hand, an essential characteristic of the holding company structure is the ability to segregate the finances of the utility from the nonutility business; but this characteristic depends on the use rather than abuse of the holding company structure.³³

Of course, no rational person enters a business expecting failure, and utility ratepayers and investors *can* profit from properly managed diversification. In light of the potential benefits, the 1982 Report of the National Association of Regulatory Utility Commissioners ("NARUC") summarized the issue best in concluding:

Prohibiting diversification eliminates the possibility of harm to ratepayers. This action is drastic and most likely not warranted. . . . [T]here is no reason to assume that all diversification ventures will be to the detriment of ratepayers. . . . The regulatory decision on utility diversification is, there-

²⁹ Trebing, *supra* note 2, at 466. For a general discussion of recent studies evaluating the benefits and risks of diversification, see *id.* at 465-67.

Although it is beyond the scope of this Comment to give attention to diversification schemes other than direct investment, firms seeking to reduce risk and increase return might construct a diversified stock portfolio rather than invest in diversified operations. See *id.* at 467 (suggesting a strategy for individual investors). This is the approach taken by Consolidated Edison, which recently sought state regulatory approval to form an in-house investment company to manage a \$300 million portfolio. See Paul, *supra* note 2, at 6, col. 1. This strategy has the advantages of providing greater liquidity in the event that an investment starts to falter or the utility faces unexpected capital needs. See Tucker, *supra* note 2, at 17, col. 2.

³⁰ See FLORIDA PUB. SERV. COMM'N, STAFF REPORT ON ELECTRIC UTILITY DIVERSIFICATION AND TRANSACTIONS WITH AFFILIATED COMPANIES 14 (n.d.) [hereinafter FLORIDA REPORT]; Levy, *supra* note 2, at 565-66.

³¹ See 1972 NARUC REPORT, *supra* note 19, at 23 ("[T]he consumer bears the risks of failure without any commensurate participation in the benefits of success."). But see York, Dube, & Malko, *Electric Utility Diversification: A State Regulatory Perspective*, in 1983 MSU PAPERS, *supra* note 2, at 577, 588 (an "important question for the regulator is how to allow the investor to keep the results of successful diversification without having regulators siphon off these benefits to the monopoly rate payer.").

³² See *infra* note 35 and accompanying text.

³³ See *infra* notes 38-44 and accompanying text; see also R. RITCHIE, INTEGRATION OF PUBLIC UTILITY HOLDING COMPANIES 12 (1955) ("The justification of the holding company, of course, lies in its use and not in its abuse.").

fore, a question of nature, degree, and process.³⁴

B. *The Challenge of Regulating Diversification*

As guardians of the public interest, regulators are protectors of the ratepayers. While the holding company structure is the ideal form for safeguarding the integrity of the utility business, this structure permits management to abuse its discretion, posing severe consequences for consumers. The regulator's challenge is to preserve the protections of the holding company format while minimizing the opportunities for abuse.

1. The Holding Company Structure

One of three structural options available to utilities planning to diversify is the holding company.³⁵ It is the one that presents the great-

³⁴ 1982 NARUC REPORT, *supra* note 16, at 76; *see also* Kahn, *supra* note 18, at 150 (“[D]octrinaire opposition to utility company diversification makes no more sense than . . . completely abandoning all regulatory protections against its possible harmful consequences.”).

³⁵ *See* O'Connor, Bussa, & Olson, *Competition, Financial Innovation and Diversification in the Electric Industry*, PUB. UTIL. FORT., Feb. 20, 1986 at 17, 20. The two alternative corporate structures available to utilities planning to diversify are diversification within the utility and creation of a diversified corporate subsidiary to the utility. *See id.*

The choice of corporate structure depends largely on the degree of diversification contemplated, and whether the diversified operations are functionally related to the utility business. Diversification within the utility is the preferred form when the activity is functionally related to the utility operations and small in relation to the size of the utility operations. *See id.* at 20. The records of the diversified activity are “consolidated into the utility accounts and [will be] treated by regulators as a part of the regulated utility operations.” *Id.* at 20; *See* OFFICE OF CHIEF ECONOMIST OF THE PUB. SERV. COMM'N OF WISCONSIN, ENERGY UTILITY DIVERSIFICATION, HOLDING COMPANIES, AND REGULATION 9 (1981) [hereinafter WISCONSIN REPORT]. Because regulators have full jurisdiction over the diversified activity and any benefits of the diversified venture necessarily flow to the ratepayers, this arrangement does not present any novel regulatory problem of consequence. The problem of fair and accurate cost allocation, discussed *infra* notes 47-53, arises under this structure. However, the PSC will necessarily have more information to use in evaluating cost allocations because of its access to the books of the utility and utility subsidiaries engaged in nonutility businesses.

The second option similarly presents only limited problems for regulators. Under this structure, the diversified operation is separately incorporated, with the management of the subsidiary either reporting to or being identical to the management of the utility. *See* WISCONSIN REPORT, *supra*, at 9. This organization allows greater autonomy in the management of the diversified venture and a more complete separation of subsidiary accounts, offering regulators a clearer view of the success or failure of the venture. The disadvantage of this structure is the difficulty of separately identifying the cost of capital attributable solely to the utility—a necessary step in the rate-making process. *See* O'Connor, Bussa, & Olson, *supra*, at 20. Where the subsidiary truly does keep separate accounts from the parent corporation, it is possible to impute a cost of capital to the subsidiary.

For example, in *Peoples Natural Gas Div. v. Public Util. Comm'n*, 193 Col. 421,

est challenge to regulators and is the primary focus of this paper. Holding companies are frequently formed for the very purpose of *avoiding* regulation,³⁶ and the debate rages as to whether the holding company structure is in the best interest of the consumer. In adopting the PUHCA, Congress clearly thought it was not.³⁷

A former member of the SEC, charged with enforcing the PUHCA, expressed the fear that management would be tempted to channel funds into the more attractive nonutility operations "and away from a utility whose earnings and rate of return are considered inadequate."³⁸ The Maryland Office of the People's Counsel echoed these concerns, stating that the holding company structure makes it "easier to funnel money from the utility to other operations."³⁹ Furthermore, "if nonutility subsidiaries incur substantial amounts of debt, and . . . consolidated equity is thereby reduced [to unacceptably low levels], the holding company might be precluded from raising capital the utility

567 P.2d 377 (1977), the court, although wary of using hypothetical capital ratios, held that the PSC properly imputed a capital structure. There, the gas distribution division of a gas utility had no independent capital structure or corporate existence, and all the distribution subsidiary's capital requirements were provided by the parent. *See id.* at 424-25, 567 P.2d at 379. The Colorado utilities commission had concluded:

When a utility engages in non-utility operations and finances those operations through its capital structure, of necessity its capital structure changes and under present conditions those changes ultimately result in a higher total cost of capital than if there were no non-utility operations, which materially affects and prejudices the utility ratepayers, because if no adjustments are made, a higher rate of return is required. Therefore, *adjustments should be made to the capital structure of [the parent utility] so that only the utility operations of [the consolidated entity] will be reflected in the capital structure.*

Id. at 425-26, 567 P.2d at 380 (quoting the state PSC findings). The court concluded that it was "within the power of the [PSC] to pierce corporate structures of corporations which also operate nonutility divisions or subsidiaries to impute a capital structure for the utility operation, which is reflective of the capitalization actually backing the utility operation." *Id.* at 426, 567 P.2d at 380. Where there is a holding company structure, the process of imputing a capital structure is easier because of the clear separation between the accounts of the regulated versus the unregulated operations of the consolidated entity.

³⁶ *See Shaw, supra* note 14, at 519 ("Moving some of the business outside the regulator's reach is often cited by utility executives as reason for diversifying."); Trebing, *supra* note 2, at 465 (formation of holding company places "portions of the enterprise outside the scope of regulatory authority"); Tucker, *supra* note 2, at WB 17, col. 4 ("Much of the diversification trend has been accompanied by utilities forming holding companies to essentially remove competitive businesses from regulatory scrutiny.").

³⁷ *See infra* note 85 (discussing abuses leading to passage).

³⁸ Levy, *supra* note 2, at 565.

³⁹ Tucker, *supra* note 2, at WB17, col. 5; *see also* Levy, *supra* note 2, at 565 ("It is not unreasonable to assume that [when diversification leads management to become more oriented toward nonutility businesses] there will be temptations to channel more capital into the nonutility company and away from a utility whose earnings and rate of return are considered inadequate.").

needs"⁴⁰ to maintain service at reasonable levels and prices.

On the other hand, there are also protections for consumers inherent in the holding company form. Under proper conditions,⁴¹ the holding company format facilitates regulation by clearly segregating utility accounts from nonutility subsidiary accounts and can prevent cross-subsidization.⁴² However, access to the records of the nonutility venture is critical and is commonly resisted by the holding company. The strongest argument in favor of the holding company format is that the holding company can act independently from the utility when raising capital for the diversified activity. If the diversified activity is risky, the cost of capital will rise. But as long as the diversifying entity is segregated from the utility, the utility can continue to raise its own capital based on its own level of risk, and not on that of the potentially riskier diversified subsidiary. Moreover, the cost of capital attributable to the utility (and ultimately passed on to ratepayers) is easier to determine if the accounts of the utility are separate from those of the nonutility venture.⁴³

The most important protection for ratepayers under the holding company structure only materializes when the diversified activity fails completely. If the diversified activity is consolidated into the accounts of the utility, failure of the diversified operation results in a direct charge to utility earnings and has an immediate impact on the financial health of the utility. With a holding company, however, the utility is insulated from the setbacks of the diversified operations: "the assets (financial or real) of the utility cannot be claimed to satisfy the liabilities of the non-utility businesses in the event of poor performance."⁴⁴

⁴⁰ Levy, *supra* note 2, at 565-66.

⁴¹ See *infra* note 155 and accompanying text (discussing various conditions state PSCs attach to diversification activities by holding companies).

⁴² See 1983 House Hearings, *supra* note 16, at 58 (statement of William Grigg, Exec. Vice Pres. of Duke Power Company).

⁴³ See O'Connor, Bussa, & Olson, *supra* note 35, at 21.

Under this approach,

the utility balance sheet is evaluated without regard to the holding company to insure that capital structure ratios fall within acceptable ranges for an [energy] utility. . . . [T]he utility cost of capital can be determined in isolation from the holding company, which is consistent with the goal of having neither the utility subsidize the non-utility business, nor the converse.

FLORIDA REPORT, *supra* note 30, at 15-16.

⁴⁴ O'Connor, Bussa, & Olson, *supra* note 35, at 21. This is probably also true if the utility sets up a subsidiary to conduct diversified operations, but the holding company structure virtually requires this insulation and has the additional attraction of improved financial flexibility allowing the holding company to pursue diversification objectives. See 1983 House Hearings, *supra* note 16, at 316-17 (statement of Stanley York, Chairman of 1982 NARUC Ad Hoc Committee on Utility Diversification);

2. Forms of Abuse⁴⁵

So long as it is insulated from regulatory scrutiny, the holding company diversification structure allows management to divert capital from the utility enterprise to the unregulated venture. Because these transfers enhance the unregulated enterprise while depleting the utility's resources, they are an abuse of managerial discretion. Abuse also takes place when the diversified enterprise enjoys an unfair advantage over competitors by virtue of the powerful backing of the utility.

a. *Cross-Subsidization*

"Cross-subsidization" is the term describing any number of practices that benefit utilities or their subsidiaries at the expense of ratepayers, consumers, or other businesses competing with the utility in the unregulated field. "There are four primary ways in which a subsidy can pass from the regulated business to a nonregulated activity: improper cost allocation, inflated transfer prices, capitalization of a nonregulated venture, and below market pricing."⁴⁶ A brief description of each of these potential subsidies follows.

(i) Cost Allocation

A fundamental precept to the effective regulation of diversifying utilities is that "[t]he costs of running a nonregulated venture should be borne by the customers of that activity, not by the ratepayers."⁴⁷ In practice, this requirement means that the utility should not perform services for the unregulated subsidiary without being compensated. For example, if the subsidiary shares office space rented by the utility, the subsidiary should contribute its pro rata share of the expense. When officers common to the utility and the unregulated subsidiary work on subsidiary affairs, that subsidiary should pay the portion of their salary properly apportionable to their efforts.⁴⁸ Resource-sharing between the

FLORIDA REPORT, *supra* note 30, at 3.

⁴⁵ The ratepayer is susceptible to the abuses outlined in this section no matter what the corporate structure. However, the nature of the holding company format, where a substantial portion of the utility's business may be with an affiliate beyond regulatory purview, requires special vigilance on the part of the regulator. Where diversification is organized within the utility or as a wholly-owned subsidiary, the PSC has access to all the records of the firm. But when the diversification takes the form of a holding company, the PSC may have trouble gaining access to the business records necessary to evaluate the fairness of transactions between the utility and its affiliates.

⁴⁶ Friedlein, Finger, & DeLaney, *Utility Companies Expand into New Markets*, N.C. INSIGHT, Jan. 1984, at 13, 16.

⁴⁷ *Id.*

⁴⁸ *See id.*

utility and its unregulated subsidiaries should not be eliminated completely, however, for the availability of the utility's underutilized assets can represent one of the greatest benefits of diversification.⁴⁹

The North Carolina Public Utilities Commission uncovered an example of cross-subsidization through improper cost allocation in a case involving Piedmont Natural Gas.⁵⁰ The utility allowed unregulated subsidiaries to use utility property without paying rent.⁵¹ These and other subsidies resulted in an overallocation to the utility of \$467,000 in 1982.⁵² While the surcharge worked out to only sixty-nine cents per customer on an average annual bill of \$486,⁵³ the potential for abuse is clear where PSCs are less vigilant than in North Carolina.

(ii) Transfer Prices

The second variation of cross-subsidization arises when the utility establishes a subsidiary that sells a product or service that the utility itself consumes.⁵⁴ The subsidiary has a guaranteed customer base, and usually a large one at that. If the utility pays higher prices to its own subsidiary than it would on the open market, the ratepayers in turn pay higher prices than necessary, effectively subsidizing the unregulated firm.

This sort of subsidy arises most often in the case of vertical integration; for example, when an energy utility buys coal from a mining subsidiary. However, there is some concern that this particular type of cross-subsidy may be spreading as utilities set up "separate corporations which deal in 'unregulated' products and services, and sell these services back to the utility. A prime example is the billing, collection, and data processing corporations now being set up by some electric utilities to sell such services back to the utility."⁵⁵ The regulator's task, of course, is to make sure that the utility buys back those services at a

⁴⁹ See FLORIDA REPORT, *supra* note 30, at 8-9 (unavoidable "slack" resources should be shared with affiliates and priced at market prices); Herzog & Lipman, *Utility Asset Use in Nonutility Lines of Business and the Revenue Allocation Problem*, PUB. UTIL. FORT., Aug. 6, 1987, at 9, 10 ("use of existing utility assets to produce ancillary nonutility services permits a diversified utility . . . to produce unregulated services and products at lower incremental cost than those services would require if produced with separate assets").

⁵⁰ See Friedlein, Finger & DeLaney, *supra* note 46, at 16.

⁵¹ See *id.*

⁵² See *id.* at 17.

⁵³ See *id.*

⁵⁴ See *id.*

⁵⁵ Letter from Michael M. Tischer, Deputy Attorney General, State of Delaware, to Jeffrey Knapp (Nov. 10, 1987) (copy on file at the *University of Pennsylvania Law Review*).

reasonable price.

(iii) Capitalization of a Nonregulated Venture

There is some question whether the practices falling under this heading actually represent a subsidy. The underlying concern is that the start-up funds for the unregulated activity will come from the ratepayers, but any profits from that activity will be enjoyed exclusively by shareholders.⁵⁶ The degree of concern one expresses for this particular subsidy depends in large part on one's view of the relative stakes of shareholders and ratepayers in the utility. The majority view seems to be that the "utility is allowed to make a certain return on its franchise business. . . . Normally, a company returns 60 to 70 percent of its earnings to its common stockholders, to keep them happy. What the company does with [the remaining] 25 to 30 percent is more or less their own business."⁵⁷ Proponents of this view contend that denying the ratepayer any benefit from the profits realized by the diversified activity is not a subsidy because the ratepayer has no claim to the funds invested to produce those profits.

Consumer advocates adamantly oppose this view of the utility's obligation. One consumer advocate claims that the only reason utilities can even think about diversification is because they "are sitting on

⁵⁶ See 1982 NARUC REPORT, *supra* note 16, at 18 ("If funds are provided through the utility, especially if provided by the ratepayers, ratepayers may want a share of the diversified earnings."); Friedlein, Finger & Delaney, *supra* note 46, at 18 (same).

⁵⁷ Friedlein, Finger & DeLaney, *supra* note 46, at 19 (quoting Joe Smith, Director of Finance, Statistics, and Planning for the North Carolina Utilities Commission); see also 1983 House Hearings, *supra* note 16, at 309 (statement of Stanley York, Chairman of 1982 NARUC Ad Hoc Committee on Utility Diversification) ("[The retained earnings] don't belong to the ratepayer. They have already in a sense been paid to the stockholder, and the stockholder has said, 'Instead of paying me cash for what you owe me, hang onto some of it and [re-invest it].'"); Shaw, *supra* note 14, at 525-26 ("If cash which would otherwise be used to pay dividends is used to finance equity in new businesses, then the utility customers have . . . no claim on the returns from those businesses. . . . Once the return is earned, management can decide how to use it in the stockholders' interest."). Of course, depending on the degree of its statutory authority, a PSC might still try to prevent a utility from diversifying into extraordinarily risky ventures. See *supra* notes 28-29 and accompanying text.

The Supreme Court spoke on this issue in the context of telephone utilities in *Bd. of Pub. Util. Comm'rs v. New York Tel. Co.*, 271 U.S. 23 (1926). The Court stated:

The customers are entitled to demand service and the company must comply. The company is entitled to just compensation and, to have the service, the customers must pay for it. . . . Customers pay for service, not for the property used to render it. . . . By paying bills for service, they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company.

Id. at 31-32.

piles of cash that they got because they milked us' to pay for new plants."⁵⁸ The argument is that funds that currently appear to be unnecessary for the construction of new plants should be returned to ratepayers.

Similarly, although most regulators adopt the view that investment of retained earnings is the company's business, the vote is not unanimous. In a rate case involving the Duke Power Company, North Carolina Commissioner Leigh Hammond, an economist, dissented from the commission's decision to grant an electric utility's request to invest in a uranium venture.⁵⁹ A provision in the plan approved by the commission permitted the utility to charge off to electric operating expense any exploration expenses that were not successful.⁶⁰ In other words, the ratepayers in this case did far more than provide start-up capital; they effectively agreed to guarantee the entire venture.⁶¹ Commissioner Hammond urged that the majority's approval of the plan "takes the commission another step in the direction of forcing the customers of public utilities to assume risks and provide financing for activities that should be pursued by nonutility business firms, and supported by the venture capital market."⁶²

Capitalization of an unregulated subsidiary amounts to an impermissible subsidy under nearly every view of "ownership" if utility management, at the behest of the dominant holding company, authorizes dividends so excessive as to jeopardize the capital position of the utility.⁶³ It may be that "the important variable is the net capital flow to the utility."⁶⁴ One would expect the holding company to require some return on its investment in the utility. At the same time, "the utility must have access to a sufficient flow of equity capital, either from equity contributions [from the parent] or retained earnings, to achieve a desirable [sic] balance between debt and equity financing."⁶⁵

Regardless of how one views the ownership stake in the utility, it is clearly possible for utility ratepayers to suffer when utility management invests large amounts of retained earnings in nonutility ventures.

⁵⁸ Paul, *supra* note 2, at 6, col. 2 (quoting Sylvia Siegel, Exec. Dir., Toward Utility Rate Normalization).

⁵⁹ See Friedlein, Finger & DeLaney, *supra* note 46, at 19.

⁶⁰ See *id.*

⁶¹ In the words of Commissioner Hammond, "This is a clever mechanism to provide a 'guarantee against loss' for a high risk non-utility subsidiary." *Id.*

⁶² *Id.*

⁶³ In the normal situation, the holding company owns close to 100% of the utility's stock. See FLORIDA REPORT, *supra* note 30, at 13. Thus, dividends represent a direct cash infusion into the holding company from the utility.

⁶⁴ *Id.* at 14.

⁶⁵ *Id.*

If the nonutility venture is successful, there is a temptation to neglect the utility in pursuit of higher returns elsewhere. Sudden increases in demand may leave ratepayers either without power or subject to curtailments. If the nonutility ventures fail and capital ratios decline, then customers are likely to face higher rates as a result of higher capital costs in the utility.⁶⁶

Whether these effects are labeled "subsidies" or something else, the need for ratepayer protection is apparent.

(iv) Below-Market Pricing

While the three categories of cross-subsidization discussed above have their primary impact on the ratepayers of the utility, this last example primarily affects established businesses in unregulated fields that now face a daunting new competitor in the utility.⁶⁷ "When a utility company uses its capital assets, retained earnings, market credit, or sheer size to help it underprice the competition, it is engaging in 'below-market pricing.'"⁶⁸ In North Carolina, a utility propane operation was in competition with approximately 200 small propane businesses within the state. The utility commission said, "If a utility engages in a nonutility operation and hurts another business, that operation is not in our jurisdiction."⁶⁹ The concern is that "[i]f the utility is allowed to transfer any of its financial strength or stature to a non-regulated but related business operation, . . . a publicly licensed monopoly is being allowed to compete with special advantage or to pass on that advantage to a related firm through a holding company structure."⁷⁰ Business people in unregulated markets are especially wary because utility-related competitors might be able to use the utility's "access to every single house, factory, [and] commercial building [to their] massive [marketing] advantage."⁷¹ Whether this particular abuse is classified as an anti-trust problem or a cross-subsidization problem, it seems clear that

⁶⁶ See *supra* notes 38-46 and accompanying text; see also York, Dube, & Malko, *supra* note 31, at 588 ("[T]he bond rating of the utility may be impaired as a result of bad experiences with nonutility businesses.").

⁶⁷ See Kahn, *supra* note 18, at 152 ("[T]he diversifying company itself may, by virtue of its regulated monopoly operations, be in a position to compete unfairly in the unregulated areas with independent businesses that enjoy no such affiliation.").

⁶⁸ Friedlein, Finger & DeLaney, *supra* note 46, at 20.

⁶⁹ *Id.* at 21.

⁷⁰ 1983 House Hearings, *supra* note 16, at 400 (statement from National Electrical Contractors Association); see also Friedlein, Finger & DeLaney, *supra* note 46, at 21 ("[A] utility may have a willingness to live with very low profits in the nonregulated area in the short term in order to use one monopoly . . . to create another.").

⁷¹ 1983 House Hearings, *supra* note 16, at 402 (statement of Mr. Patrick C. O'Connor, Public Affairs Counsel, American Supply Ass'n).

an effective statute designed to regulate diversification should address the issue.

b. *"Milking" the Utility*

In addition to the "cross-subsidization" problems discussed above, there are other ways for a holding company to treat the utility subsidiary as a cash cow. For example, the holding company could arrange low-interest or no-interest loans from the utility to its unregulated subsidiaries. Indeed, some regulators argue that *any* long term loan from a utility to a parent should be treated as a direct reduction in utility equity.⁷² Since the cost of utility debt tends to be lower than the cost of equity, the net effect is a decrease in the allowed rate of return for the utility and a reduction (to some small degree) of the cost to ratepayers.⁷³

Another potential area of concern is a variation on the transfer pricing issue discussed above, where there are ongoing transactions between the utility and unregulated subsidiaries. A similar concern arises when the transaction involved is an isolated one, such as a purchase or sale of property between the utility and a subsidiary. "[I]f the . . . utility records the transaction at original cost or net book value, this treatment would not recognize the current market value of the property or the possibility that the ratepayers may have been providing a return on the property prior to its transfer."⁷⁴

A practice that may never result in a direct cash drain to the utility, but which can involve uncompensated exploitation of a utility asset, is having the utility guarantee the debt of a subsidiary or of the holding company itself.⁷⁵ This practice simply should not be permitted, whether the utility is compensated for the guarantee or not, because it violates the insulation of the utility from the risk of the unregulated business. That insulation is one of the primary justifications for the formation of the holding company.

A related intangible benefit, and one not susceptible to easy quan-

⁷² See FLORIDA REPORT, *supra* note 30, at 12.

⁷³ See *id.* The PSC could use a hypothetical capital structure to calculate a fair rate of return, treating the capital infusion to the subsidiary as a reduction in utility equity and passing this on to consumers through lower rates. "By employing a higher than actual debt ratio (a lower equity ratio), a lower computed cost of capital is obtained because the cost of debt is generally lower than the cost of equity . . ." K. HOWE & E. RASMUSSEN, *supra* note 26, at 101. A lower cost of capital means a lower revenue requirement and, theoretically, a lower general rate level. See *id.* at 64-109.

⁷⁴ FLORIDA REPORT, *supra* note 30, at 10.

⁷⁵ See, e.g., *id.* at 13 ("If the utility secures any debt on behalf of its affiliates, then a financial failure of the affiliate can adversely affect the utility.").

tification, is the unregulated business's ability to "trade off" the (usually) well-known name of the utility. Ratepayers should be compensated for any benefits flowing to unregulated firms by virtue of association with the utility.⁷⁶

II. THE CURRENT STATUS OF REGULATION

In exchange for receiving permission to conduct a monopoly business enterprise, utilities subject themselves to intensive scrutiny from governmental regulatory bodies.⁷⁷ Regulation substitutes for competition and prevents utility-monopolies from receiving "excess" economic profits.⁷⁸ Most federal regulation is carried out by the Federal Energy Regulatory Commission ("FERC"), which regulates rates of wholesale gas and electricity transactions between utilities.⁷⁹ As already mentioned, Congress also empowered the Securities and Exchange Commission to regulate utility holding company structures through the PUHCA.

However, the front line of rate regulation is traditionally conducted at the state level through the PSCs whose function is to ensure that the utility does not exploit its monopoly position to overcharge captive ratepayers.⁸⁰ Given this role, the PSCs are the logical bodies to look to for the regulation of diversification. Indeed, the drafters of the PUHCA expressed a preference for state regulation, and contemplated that the PUHCA would be the first arm of a coordinated effort between federal and state authorities.⁸¹

⁷⁶ Anyone who doubts the existence and value of this "invisible" subsidy need only look to the lengths and expense to which companies will go to protect their names from use by competitors.

⁷⁷ See *Munn v. Illinois*, 94 U.S. 113, 126 (1876) ("when . . . one devotes his property to a use in [the public interest, he] must submit to be controlled by the public for the common good"); see generally C. PHILLIPS, *PUBLIC UTILITY REGULATION: THEORY AND PRACTICE* 3-31 (1984) (presenting the theory of public utility regulation).

⁷⁸ See K. HOWE & E. RASMUSSEN, *supra* note 26, at 62 (PSCs' "mandate is to ensure adequate service at minimum cost to consumers consistent with a reasonable return to creditors and owners"); Buck & Groth, *supra* note 11, at 24 (regulators must estimate returns at a level high enough that investors will risk capital while maintaining the lowest possible price to consumers).

⁷⁹ See Federal Energy Regulatory Act, 42 U.S.C. § 7172(a) (1982). Congress originally granted this authority to the Federal Power Commission (now FERC) in response to the limitations of effective state regulation. See C. PHILLIPS, *supra* note 77, at 533-34 ("State commissions were limited in their control of electric utilities in two specific ways: (a) by the interstate transmission of power, and (b) by development of holding companies.").

⁸⁰ See generally C. PHILLIPS, *supra* note 77, at 109-48 (discussing the role of independent regulatory commissions).

⁸¹ See 15 U.S.C. §§ 79f(b), 79g(g), 79i(b), 79m(d) (1982) (sections contemplating

Unfortunately, although the current regulatory scheme is quite detailed, it is still inadequate. The PUHCA essentially addresses its limitations on diversification to interstate holding company systems. Significantly, those holding companies that are predominately intrastate in character fall outside the jurisdiction of PUHCA and SEC surveillance.⁸² At the same time, state regulation, when it exists, generally relies on a seemingly broad grant of jurisdiction, which many courts have chosen to interpret narrowly.⁸³ Given the current need for adequate regulation, states must engage the legislative process to protect ratepayers' interests.

A. Federal Regulation of Diversification

Congress has been concerned with diversification and the holding company structure since at least 1935, when the Public Utility Holding Company Act⁸⁴ was enacted. The PUHCA was enacted in response to significant abuses in the energy utility industry, which had resulted in extremely cumbersome, uneconomic corporate structures and a perceived potential for significant harm to ratepayers and investors.⁸⁵ Prior to passage, it was not at all unusual for utility holding companies to operate subsidiaries in highly speculative industries, wholly uncon-

joint federal and state regulation); S. REP. NO. 621, 74th Cong., 1st Sess. 11 (1935) ("purpose of section 11 [15 U.S.C. 79k] is simply to provide a mechanism to create condition under which effective Federal and State regulation will be possible"); Buchanan, *supra* note 10, at 548 (describing PUHCA as "both a supplement to state regulation of public utilities and a further step in the program of securities regulation"); *infra* notes 88 & 95 and accompanying text.

⁸² See *infra* notes 103-04 and accompanying text.

⁸³ See *infra* notes 134-83 and accompanying text.

⁸⁴ Pub. L. No. 74-333, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. §§ 79-79z-(6) (1982)).

⁸⁵ See 15 U.S.C. § 79a(b) (1982) (PUHCA was necessary for protection of investors and interests of consumers). For contemporaneous accounts of the abuses leading to passage of the Act, see generally SECTION OF PUB. UTIL. L., A.B.A., REPORT OF THE SPECIAL COMMITTEE ON THE REGULATION OF HOLDING COMPANIES AND THE RELATIONS BETWEEN SUCH COMPANIES AND AFFILIATED OPERATING COMPANIES 2-6 (1933) (detailing two classes of abuses); Buchanan, *supra* note 10, at 531 (public utility holding companies' activities arguably injurious to the public well-being as well as to consumers and investors); Comment, *Federal Regulation of Holding Companies: The Public Utility Act of 1935*, 45 YALE L.J. 468, 468 (1936) ("deep-rooted social, economic, and legal causes contributed to [PUHCA's] enactment").

In fairness, it should be pointed out that, at least in the early years, holding companies did serve positive, perhaps essential functions. See, e.g., R. RITCHIE, *supra* note 33, at 10-11 (listing four advantages to the holding company structure); Lilienthal, *The Regulation of Public Utility Holding Companies*, 29 COLUM. L. REV. 404, 404 (1929) (citing rural electrification, advances in "telephone," rise of super-power systems, and an "unprecedented flow of capital . . . making possible extension and improvements of service").

nected to their utility operations.⁸⁶ The Act sought to curb “growth and extension of holding companies [that] bear[] no relation to economy of management and operation or the integration and coordination of related operating properties.”⁸⁷

Today, there remain only twelve holding company systems registered under the Act—nine electric and three gas.⁸⁸ In contrast, there are 103 holding companies, with 793 nonutility subsidiaries, exempt from the PUHCA.⁸⁹ The fact that the PUHCA continues to apply to only twelve systems is taken by some as conclusive evidence that the legislation was a success and that the PUHCA has outlived its usefulness.⁹⁰ On the other hand, exemption from the PUHCA tends to shift the regulatory burden from the SEC to the state PSCs.⁹¹

1. The Public Utility Holding Company Act

The Act presumptively applies to all public utility holding company systems. Unless a reprieve is granted by one of the Act's exemption provisions, holding company systems are required to register with the SEC.⁹² These registered holding companies are subject to the Act's simplification requirements.⁹³ To this end, Congress directed the SEC to order the registered holding companies to limit their operations to a “single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operation of . . . [the] system.”⁹⁴ The intent of the Act was to facil-

⁸⁶ See R. RITCHIE, *supra* note 33, at 14.

⁸⁷ 15 U.S.C. § 79a(b)(4) (1982).

⁸⁸ See OFFICE OF PUB. UTIL. REGULATION, DIV. OF INV. MANAGEMENT, SEC, FINANCIAL AND CORPORATE REPORT: REGISTERED PUBLIC UTILITY HOLDING COMPANY SYSTEMS 1 (March 31, 1986). The registered electric systems account for some 20% of the operating revenues of all electric utilities in the United States. See *id.*

⁸⁹ See OFFICE OF PUB. UTIL. REGULATION, DIV. OF INV. MANAGEMENT, SEC, FINANCIAL AND CORPORATE REPORT: HOLDING COMPANIES EXEMPT FROM THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935 UNDER SECTION 3(a)(1) AND 3(a)(2) PURSUANT TO RULE 2 FILINGS OR BY ORDER 44-48 (Aug. 31, 1987); *infra* notes 101-05 and accompanying text (discussion of exemptions under the Act).

⁹⁰ See, e.g., Sommer, *supra* note 7, at 28, col. 1 (Many believe “that the [SEC] had long ago completed the principal task thrust upon it in 1935 when it completed the restructuring of the industry, and that developments since 1935—economic, legal, and regulatory—had rendered needless or duplicative the remaining activities of the commission under the act.”).

⁹¹ See *infra* notes 101-05 & 107-33 and accompanying text.

⁹² See 15 U.S.C. § 79b(a)(7) (1982) (“[h]olding company” means *any* company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company”) (emphasis added).

⁹³ See *id.* § 79k (1982).

⁹⁴ *Id.* § 79k(b)(1) (1982). The holding company was permitted to retain any subsidiaries for which it could show that affiliation with the holding company promoted

itate state regulation⁹⁵ and to compel utilities to stay close to their fields of expertise.⁹⁶

In determining what other businesses could be retained (or initiated) by registered holding companies, the SEC formulated a "functionally related" test.⁹⁷ Naturally, the SEC's view of functional relation changes over time, but some examples of activities found not to satisfy the test in the past include housing construction, land development, electrical instruments, pulpwood, and cable television.⁹⁸ In other words, the diversification potential for registered companies is strictly circumscribed by the PUHCA.⁹⁹ Because the SEC must give prior approval before the registered systems can make any acquisition, and the acquired business must be "functionally related," state regulators are relieved of the duty of watching those systems as carefully as they watch exempt holding companies or utilities that diversify without using the holding company structure.

It comes as no surprise that Congress chose to make interstate companies the focus of the federal legislation.¹⁰⁰ The PUHCA provides for exemptions¹⁰¹ for those companies which, in Congress's judgment, were structured so as not to give rise to the sorts of abuses the PUHCA

"substantial economies," or which were located in contiguous states, or where continued affiliation did not hamper effective regulation or "advantages of localized management." *Id.* at § 79k(b)(1)(A)-(C).

⁹⁵ See *id.* § 79a(b)(3) (1982); see also *North American Co. v. SEC*, 327 U.S. 686, 704 n.14 (1946) (quoting S. REP. NO. 621, 74th Cong., 1st Sess. 11 (1935)).

⁹⁶ See, e.g., S. REP. NO. 621, 74th Cong., 1st Sess. 11 (1935) ("single system . . . not mixed up with any extraneous businesses such as real estate, hotels, and operations in foreign countries"); *id.* at 12 ("The argument of diversification of risk is an attempt to justify as a matter of economic principle, the accumulation of unrelated operating properties in a completely accidental way for immediate reasons of financial opportunism.").

⁹⁷ See Hawes, *Utility Diversification*, 14 REV. OF SEC. REG. 949, 950 (March 19, 1981). In effect, the functionally related test has two parts, both of which must be satisfied: the other business must be functionally related as well as in the public interest. See D. HAWES, *supra* note 12, § 3.05[1], at 3-30; Hawes, *supra*, at 950.

⁹⁸ See D. HAWES, *supra* note 12, § 3.05[1], at 3-30.

⁹⁹ In fact, frustration born of watching exempt holding companies and independent utilities diversify seemingly at will over the past several years was part of the impetus for the movement to amend substantially or repeal outright the PUHCA in 1981, 1982 and 1983. See 1983 *House Hearings, supra* note 16, at 162-65 (testimony of Guy Nichols, on behalf of registered utility group); Sommer, *supra* note 7, at 28, cols. 2-3; see also Sommer, *supra* note 22, at 539 ("inherent inequity" in differing treatment of exempt companies, registered companies, and diversified companies not organized as holding companies—"customers and investors of each deserve the same protections").

¹⁰⁰ See C. PHILLIPS, *supra* note 77, at 533 ("[s]ince the largest holding company systems were interstate, they were not within the state commissions' jurisdiction").

¹⁰¹ "Exempt" companies are still subject to limitations on acquisition of utility securities. See 15 U.S.C. § 79i (1982); D. HAWES, *supra* note 12, § 3.04[1], at 3-10 n.k. The exemption criteria are found in section 3 of the PUHCA. One commentator

was meant to address. The exemptions fall into three principal categories:¹⁰² (1) when the holding company, and every public utility subsidiary thereof, is predominantly intrastate in character and organized in the same state;¹⁰³ (2) when the holding company is itself an operating public utility, and its operation is confined to the state of organization and contiguous states;¹⁰⁴ and (3) when the holding company is only incidentally a holding company, derives a material part of its income from a public utility subsidiary, is only temporarily a holding company, or is a holding company only with respect to foreign public utilities.¹⁰⁵

2. The Degree of Reliance on State Authorities

The SEC is directed to grant an exemption to any holding company meeting the section 3 criteria "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers."¹⁰⁶ The proper interpretation of the "unless and except" clause remains a point of contention to this day.

"Prior to 1971, holding companies that were exempt under the [PUHCA] generally believed that they were free to operate in any manner so long as they did not disturb the characteristics that brought them within the objective criteria for exemption."¹⁰⁷ This interpretation was not an implausible one—after all, they *were* exempt from the Act. Another plausible reading of the PUHCA, however, in light of its broad and strong statement of purpose, would forbid even exempt holding companies from diversification ventures. When two cases addressing

noted:

[T]he [SEC] staff has encouraged electric and gas utility companies that set up holding companies to do so through the exemption procedure provided by rule 2 [17 C.F.R. § 250.2 (1987)]. That is, companies that meet the objective exemption criteria of section 3(a)(1) or (2) [15 U.S.C. § 79c(a)(1) or (2) (1982)] need not apply for a Commission order to obtain an exemption, but may simply file a form . . . on becoming a holding company and an updated form . . . on or before March 1 of each year thereafter. . . . One reason the staff has encouraged this procedure is that it avoids the necessity of the SEC's specifically endorsing any type or degree of diversification.

Hawes, *supra* note 97, at 952.

¹⁰² This description of the Act is taken from Hawes, *Public Utility Holding Company Act of 1935—Fossil or Foil?*, 30 VAND. L. REV. 605, 612 (1977).

¹⁰³ See *id.* (citing PUHCA § 3(a)(1), 15 U.S.C. § 79c(a)(1) (1970)).

¹⁰⁴ See *id.* (citing PUHCA § 3(a)(2), 15 U.S.C. § 79c(a)(2) (1970)).

¹⁰⁵ See *id.* (citing PUHCA §§ 3(a)(3)-(5), 15 U.S.C. §§ 79c(a)(3)-(5) (1970)).

¹⁰⁶ 15 U.S.C. § 79c (1982).

¹⁰⁷ D. HAWES, *supra* note 12, § 3.05[1], at 3-34 to -35. For a comprehensive analysis of the four types of exemptions available under the Act, see *id.*, § 3.04[1], at 3-9—3-18.

this issue were decided by the SEC on the same day in 1971, neither of these interpretations was able to command a majority.

The first case, *In re Pacific Lighting*,¹⁰⁸ involved a gas public utility holding company system that had been exempt by a SEC order since 1936.¹⁰⁹ In 1936, the SEC had found that Pacific Lighting came under the section 3(a)(1) exemption as being predominantly intrastate and concluded that there was no basis for requiring registration under the "unless and except" clause.¹¹⁰ In this latter proceeding, the SEC's Division of Corporate Regulation urged "that the exemption be modified so as to require Pacific to dispose of those of its non-utility interests not functionally related to its gas distribution business."¹¹¹ The SEC described Pacific's diversified subsidiaries as follows:

1. four subsidiaries that the company classified as "utility-related" whose primary purpose was to promote the use of gas through loans to contractors and equipment leasing;¹¹² and

2. six businesses concededly unrelated to the utility business engaged in real estate development and agriculture.¹¹³

As of December 31, 1970, non-utility investments, including guarantees of subsidiary debt, constituted 14% of the holding company's assets.¹¹⁴

The Division of Corporate Regulation argued that the "unless and except" clause restricts diversification by exempt holding companies to the same extent that section 11(b)(1) of the Act limits diversification by registered systems, i.e., to functionally related activities that are in the public interest.¹¹⁵ Two commission members, Casey and Loomis, re-

¹⁰⁸ 45 S.E.C. 152 (1973).

¹⁰⁹ *See id.* at 152.

¹¹⁰ *See id.* at 153.

¹¹¹ *Id.*

¹¹² The broad aim of these subsidiaries was to promote the use of natural gas. Two subsidiaries "were organized to construct and operate central gas-fired heating and cooling plants." *Id.* at 154. A third subsidiary "was formed to guarantee loans to builders and developers using gas air-conditioning," but had expanded its scope to include general construction financing without regard to the use of gas. *Id.* A fourth subsidiary was organized "to distribute a conversion kit which permits motor vehicles to operate on compressed natural gas interchangeably with gasoline." *Id.*

¹¹³ The real estate subsidiaries acquired underdeveloped land, developed it for commercial or industrial use, and sold or leased completed projects that were located primarily in California and Hawaii. *See id.* at 155. One agricultural subsidiary was engaged in "farming, packing, and marketing of citrus fruits and pistachio nuts in California." *Id.* The other agricultural subsidiary was formed to acquire 28 existing entities operating in six or seven states, engaged in the business of fruit farming, packing, and marketing. *See id.* at 156. The company justified the functionally unrelated acquisitions as compelled by the stagnant demand for gas service, saturation of the service area, uncertainty of gas supplies, and declining earnings. *See id.* at 154.

¹¹⁴ *See id.* at 156. This figure represents significant diversification relative to the investments of other firms. *See Murray & Closterman, supra* note 2, at 12.

¹¹⁵ *See Pacific Lighting*, 45 S.E.C. at 158; *supra* notes 97-99 and accompanying

jected this “*per se* interpretation of the statute which would equate the retention of an unrelated non-utility business with detriment to the . . . interests” the PUHCA seeks to protect.¹¹⁶ According to Casey and Loomis, the PUHCA was designed to treat registered and exempt holding companies differently, because “Congress did not consider there was need for . . . pervasive Federal regulations in the case of intrastate holding companies which were already subject to effective state regulation.”¹¹⁷ Also, Casey and Loomis imply, holding companies that can meet the section 3 exemption criteria are already subject to effective state regulation.¹¹⁸

Casey and Loomis did not think that diversification should be allowed to proceed completely unfettered, and they proposed several fairly restrictive conditions on diversification through holding companies.¹¹⁹ The purpose of the proposed Casey and Loomis conditions was “to insulate the utility business to the [greatest] extent possible from being adversely affected by losses in non-utility operations and to prevent the diversion of utility resources for non-utility purposes”¹²⁰ These guidelines are considered more carefully later in this Comment because these are the same goals to be achieved by our model state statute.

text (discussing the functionally related test). “The staff was of the opinion that the prescribed [functional relation] limits . . . were so firm and pervasive in the regulatory structure of the Act that they should be applied to exempt holding companies as well.” Levy, *supra* note 2, at 557.

¹¹⁶ *Pacific Lighting*, 45 S.E.C. at 158. Because the commission was evenly divided, 2-2, the status quo was maintained and Pacific Lighting retained its exemption. See *id.* at 166 (“The absence of a majority position on [the exemption] issue has the effect of permitting the existing exemption to continue.”).

¹¹⁷ *Id.* at 159 (opinion of Chairman Casey and Commissioner Loomis).

¹¹⁸ See *id.* at 158-59.

¹¹⁹ *Id.* at 161-62. The restrictions included: (1) separation of non-utility activities from utility activities through separate corporate subsidiaries; (2) prohibition of services and contracts between the utility and other subsidiaries except where such contracts are subject to the supervision of state regulatory agencies; (3) strict separation of utility from non-utility management, credit, and funds; (4) keeping the non-utility investments as a relatively small component of the entire system; and (5) requiring that non-utility activities be either complementary to existing utility activities, or have an established record of profitability. See D. HAWES, *supra* note 12, § 3.05[2], at 3-36.

These restrictions have become known as the Casey/Loomis guidelines and continue to exercise some influence in divining to what extent and under what conditions the SEC will permit diversification. See *id.* However, the guidelines are not binding on the present commission—which, in any event, has advocated total repeal of the PUHCA. See Andrews, *supra* note 2, at 25 (statement of SEC chairman that statute has “served its purpose” but future federal regulation is “unnecessary and inappropriate”); Brown & Bink, *supra* note 9, at 43 (SEC was early proponent of statute’s repeal); *supra* notes 9 & 90 and accompanying text.

¹²⁰ *Pacific Lighting*, 45 S.E.C. at 161 (opinion of Chairman Casey and Commissioner Loomis).

The other two commissioners, Owens and Herlong, argued for a much more restrictive interpretation of the PUHCA and its exemption provisions. Owens and Herlong agreed with Casey and Loomis that there *was* a difference between registered and exempt holding companies under the PUHCA, and that a *per se* rule was not an accurate interpretation of the Act.¹²¹ Owens and Herlong also supported the Casey and Loomis guidelines designed to insulate utility interests.¹²² The two opinions differ, however, in the extent to which each would permit the utility business holding companies to diversify. For Owens and Herlong, the test for retention of nonutility activities was less restrictive for exempt than for registered systems,¹²³ but any such non-utility operation had to be "related" or "complementary" to the utility business.¹²⁴ Owens and Herlong believed that acceptable diversification included businesses tending to promote the use of the utility's product, and even such "complementary" activities as marketing the utility's existing surplus computer billing capacity to third parties.¹²⁵ Owens and Herlong would not have permitted Pacific Lighting to retain its exemption unless it divested itself of its agriculture, real estate, and financing activities unrelated to promoting the use of gas.¹²⁶ These two commissioners asserted that these types of businesses were

in the same category and fraught with the same danger of injury to the public utility investor and consumer interests as the scattered and risk-laden ventures that led to the abuses described in Section 1(b) of the Act, the recurrence of which [we] view the "unless and except" clause clearly directs this Commission to prevent.¹²⁷

The commissioners split along these same lines in *In re National Utilities & Industries Corp.*,¹²⁸ an order promulgated on the same day as *Pacific Lighting*. This second adjudication also involved a gas hold-

¹²¹ See *id.* at 165 (opinion of Commissioner Owens).

¹²² See *id.* (noting that Congress meant to allow for "prophylactic standards" to avoid the "potentiality of abuse").

¹²³ See *id.* ("I agree that a *per se* prohibition for exempt holding companies of all non-utility activities not meeting the *functional tests* of retainability prescribed for registered holding companies is not warranted . . ." (emphasis added)).

¹²⁴ See *id.*

¹²⁵ See *id.* Commissioner Herlong dissented from the portion of Commissioner Owens' opinion that would have permitted a holding company to promote use of the utility's product through the acquisition or retention of low-income housing, since Herlong viewed such activities as neither related nor complementary to the utility business. See *id.* at 166 (opinion of Commissioner Herlong).

¹²⁶ See *id.* at 165-66 (opinion of Commissioner Owens).

¹²⁷ *Id.*

¹²⁸ 45 S.E.C. 167 (1973).

ing company system claiming an intrastate exemption from the PUHCA. National Utilities & Industries Corp. ("NUI") sought diversification for many of the same reasons cited by Pacific Lighting: limited prospects for expansion, a saturated service area, and uncertainty over gas supplies.¹²⁹ NUI retained its exemption because the nonutility acquisitions either satisfied the Casey and Loomis guidelines or were considered immaterial as a percentage of NUI's consolidated assets.¹³⁰ Owens and Herlong argued that continued exemption should be conditioned on divestiture of all nonconforming subsidiaries regardless of how small they were relative to the holding company.¹³¹ However, since the Commission was evenly divided, NUI retained its exempt status.

The lesson taught by these cases is that the SEC recognizes some restrictions on diversification even by holding company systems exempt from the PUHCA. However, the extent of those restrictions is far from clear in light of the changed membership of the SEC, the perception of the PUHCA as an obsolete hindrance to prudent investment decisions,¹³² and the general hostility of the Reagan administration to federal regulation restricting operation of the free market.

The PUHCA is described by some as an "emergency brake" in the event that diversification by an exempt holding company should go terribly wrong.¹³³ Since emergency brakes are by definition reserved for extraordinary situations, even with the existence of the PUHCA it is critical that state PSCs set their own guidelines for diversification and define their authority before the situation deteriorates to a point compelling SEC involvement. Various state responses to this challenge are the subject of the next section of this Comment.

B. *State Regulation of Diversification*

Surprisingly few states have directly confronted the issue of regulating diversification through holding companies.¹³⁴ It may be that the

¹²⁹ See *id.* at 168-69.

¹³⁰ See *id.* at 170-71.

¹³¹ See *id.* at 172.

¹³² See *supra* note 119.

¹³³ See D. HAWES, *supra* note 12, § 3.05[2], at 3-39 (The SEC probably would not challenge nonutility acquisitions if they were within the Casey/Loomis guidelines, "absent a threat to the financial integrity of the utility.").

¹³⁴ The question of federal pre-emption of state regulation conveniently presents itself as the threshold issue in a challenge undertaken against the operation of state regulation. In light of the PUHCA's strong policy in favor of state regulation of public utilities, see *supra* notes 81 & 95 and accompanying text, it would be surprising if the Act were construed to preempt state regulation of utility holding companies. This issue is occasionally litigated, as, for example, in *Baltimore Gas & Elec. Co. v. Heintz*, 760

modest degree and moderate impact of diversification thus far has kept the issue out of the public consciousness and off the legislative agenda. Perhaps states have simply assumed that federal regulation of utility holding companies is adequate. Some PSCs may rely on their broad grants of authority as sufficient to reach unregulated activities. However, in the aftermath of recent attempts to repeal the PUHCA and the apparent acceleration of diversification through holding companies, specific grants of statutory authority are becoming more common,¹³⁵ and

F.2d 1408 (4th Cir.), *cert. denied*, 474 U.S. 647 (1985).

Baltimore Gas & Elec. involved a Maryland statute regulating the acquisition of stock in public service companies. *See id.* at 1413. The utility planned a reorganization whereby the utility would become a wholly-owned subsidiary of a holding company, BGE Corp., in order to facilitate diversification by other nonutility subsidiaries. *See id.* at 1412. The Maryland statute appeared to ban such a reorganization, and the utility claimed the statute was pre-empted by the PUHCA. *See id.* The utility also alleged that the statute violated the commerce, due process, and equal protection clauses; but these attacks proved unsuccessful. *See id.* at 1427. For a discussion of these latter challenges, see *The Fourth Circuit Review*, 43 WASH. & LEE L. REV. 431, 505-10 (1986).

The court made short shrift of the preemption argument, relying on the legislative history of the PUHCA, which it said "contemplate[d] coordinate state and federal regulation." *Baltimore Gas & Elec.*, 760 F.2d at 1415. The court asserted that the "purpose of section 11 [15 U.S.C. § 79k] is simply to provide a mechanism to create conditions under which effective Federal and State regulation will be possible." *Id.* (quoting S. REP. NO. 621, 74th Cong., 1st Sess. 11 (1945)).

The utility was reduced to arguing that Congress could have banned holding companies altogether, but since it chose to regulate rather than eliminate, Maryland was prohibited from enacting a statute that would completely bar public utility holding companies. *See id.* at 1415. The court answered this argument by asserting that "Congress' rejection of a statute that would completely outlaw public utility holding companies does not necessarily establish that public utility holding companies cannot be prohibited by the states." *Id.* The conclusion to be reached is that the PUHCA does not cover the entire field of regulation of public utility holding companies. Therefore, even though a holding company might gain an exemption under section 3 of the federal act, that exemption does not necessarily trump a conflicting state regulatory statute.

¹³⁵ *See, e.g.*, CAL. PUB. UTIL. CODE § 314(b) (West Supp. 1988) (granting commission access to books and records of holding companies and subsidiaries); ME. REV. STAT. ANN. tit. 35-A, § 708 (1988) (requiring PSC approval of reorganization of utility, and setting conditions on approval); N.M. STAT. ANN. §§ 62-6-17 to -19 (1984 Replacement Pamphlet) (access to books, records, accounts, and documents of any public utility affiliate); OHIO REV. CODE ANN. §§ 4905.05, .06 & .46 (Anderson Supp. 1987) (guaranteeing PSC access to holding company books, setting cap on investments in nonutility subsidiaries, and limiting dividends payable by utility); WIS. STAT. ANN. § 196.795 (West Supp. 1987) (reporting requirements for holding company, restrictions on affiliate transactions, cap on diversification). For an extensive discussion of various state statutes as well as the efforts of certain utilities to form holding companies, see D. HAWES, *supra* note 12, § 4.03, at 4-16 to -63.

These statutes can be an effective means of protecting ratepayers from potentially risky diversification. One of the first states to pass protective legislation was New Mexico, granting the PSC the authority to investigate transactions by public utilities involving holding companies. *See* N.M. STAT. ANN. § 62-6-19 (1984 Replacement Pamphlet). Recently, the New Mexico Supreme Court upheld the PSC's authority to deny permission to form a holding company. *Public Serv. Co. of N.M. v. New Mexico Pub. Serv. Comm'n*, 747 P.2d 917 (1987). Pursuant to statutory authority, N.M. STAT.

more states are studying the issue.¹³⁶ But as the following discussion illustrates, many current efforts fall short of their goals.

1. Affiliated Interest Statutes

Several states have enacted "affiliated interest" statutes¹³⁷ that are

ANN. § 62-6-19(E) (1984 Replacement Pamphlet), the PSC had promulgated a rule requiring PSC approval prior to the formation of a holding company. *Public Serv. Co.*, 747 P.2d at 919-20 (citing General Order 39, Section 3.1(A)). The court concluded that the power to require prior approval of holding company formation was consistent with, and authorized by, the statute. *See id.* at 920, 921.

¹³⁶ For example, the Delaware PSC is presently drafting legislation for introduction in the 1988 legislative session. *See* Letter from Michael M. Tischer, Deputy Attorney General, State of Delaware, to Jeffrey Knapp (Nov. 10, 1987) (on file at the *University of Pennsylvania Law Review*). From January, 1985 until March, 1986, the Florida PSC researched the extent and conduct of diversification in the state. *See In re Electric Util. Diversification*, Docket No. 85-0096-EI, Order No. 155885, at 1 (Fla. Pub. Serv. Comm'n March 24, 1986) (Order Closing Docket). Although the PSC ultimately declined to formulate specific policy, and decided to proceed on a case-by-case basis, clearly diversification is a concern of some importance. *See id.* Recently, the Connecticut PSC introduced two diversification-related bills to the Connecticut General Assembly. The first grants the PSC authority to monitor financial transactions between a utility and its holding company. *See* Raised Comm. Bill No. 14, LCO No. 204, Conn. Gen. Assembly, Feb. Sess., 1988. The second gives the PSC authority to prevent cross-subsidization between regulated and unregulated entities. *See id.*

¹³⁷ An affiliated interest statute extends public service commission jurisdiction to entities transacting business with utilities where there is some reason to believe that the dealings might not be at "arms-length." For example, a Kansas statute gives the PSC jurisdiction

over affiliated interests having transactions, other than ownership of stock and receipt of dividends thereon, with utility corporations . . . to the extent of access to all accounts and records of such affiliated interests relating to such transactions "[A]ffiliated interests" include the following:

- (a) Every corporation and person owning . . . directly or indirectly [10%] or more of the voting capital stock of [the] utility corporation.
- (b) Every corporation and person in any chain of successive ownership of [10%] or more of voting capital stock.
- (c) Every corporation [10%] or more of whose . . . stock is owned by any person or corporation owning [10%] or more of the . . . stock of [the] utility corporation or by any person or corporation in [a] chain of successive ownership. . . .
- (d) Every . . . officer or director of [the] utility
- (e) Every corporation which has one or more officers or . . . directors in common with [the] utility
- (f) Every corporation . . . actually exercising any substantial influence over the policies and actions of [the] utility.

KAN. STAT. ANN. §§ 66-1401(2)(a)-(f) (1985). The statute also requires "foreign" holding companies to agree to keep the PSC "fully informed as to the transactions between the . . . local . . . unit and the holding company." *Id.* at § 66-1401(2)(g).

Other states with statutes of this type include Illinois (ILL. ANN. STAT. ch. 111-²/₃, ¶ 7-101 (Smith-Hurd Supp. 1987)), Maine (ME. REV. STAT. ANN. tit. 35-A, § 707 (1988)), New York (N.Y. PUB. SERV. LAW § 110 (McKinney 1955 & Supp. 1988)), Pennsylvania (66 PA. CONS. STAT. ANN. §§ 2101-2107 (Purdon 1979 & Supp. 1987)), and Texas (TEX. REV. CIV. STAT. ANN. art. 1446c §§ 3i & 67 (Vernon 1980

used to monitor transactions between a utility and its unregulated affiliates. Affiliated interest statutes can be potent tools for PSCs, but their scope is limited unless they also guarantee PSC access to holding company books.¹³⁸ Another problem with relying solely on affiliated interest statutes is that the PSC "cannot make a definitive determination of costs without full examination of [all] diversified subsidiaries [including those] which do not do business with the utility and hence are not subject to the affiliated interest statute."¹³⁹

The Illinois Commerce Commission discovered the limits of its affiliated interest statute in its five years of litigation over the reorganization of Peoples Energy Corporation.¹⁴⁰ Peoples, a holding company with two public utility subsidiaries and various energy related nonpublic utility subsidiaries,¹⁴¹ wanted to reorganize so that an intermediate holding company, MidCon, would own all the non-utility subsidiaries and Peoples would own the two utility subsidiaries as well as MidCon.¹⁴² The Commission ordered Peoples to show that the reorganization either "was not subject to Commission jurisdiction, or, if it was, why [it] would be in the public interest."¹⁴³ After protracted procedural tangling, the trial court granted Peoples' motion for a permanent injunction, declaring that the Commission lacked jurisdiction over the reorganization.¹⁴⁴

On appeal, the appellate court determined that the Commission's jurisdiction hinged on whether Peoples was a "public utility" within the meaning of the Illinois statute granting powers to the Commission.¹⁴⁵ The Commission argued that Peoples was subject to its juris-

& Supp. 1988)). This list is representative, but not exhaustive.

¹³⁸ See 1982 NARUC REPORT, *supra* note 16, at 15 ("Current regulatory authority over utility diversification stems from existing statutory powers such as affiliated interest statutes. However, regulators should assess their need for additional authority . . . [such as] sufficient access to the books, records, and officers of non-utility operations.").

¹³⁹ WISCONSIN REPORT, *supra* note 35. Regulators recognize the potential shortcomings of affiliated interest statutes and frequently try to convince the utility to agree to more stringent conditions than those expressly authorized by statute. See *infra* note 152 and accompanying text.

¹⁴⁰ See *Peoples Energy Corp. v. Illinois Commerce Comm'n*, 142 Ill. App. 3d 917, 492 N.E.2d 551 (Ill. App. Ct. 1986). For an analysis of an earlier incarnation of this case, see Note, *Jurisdiction of State Regulatory Commissions Over Public Utility Diversification*, 15 LOY. U. CHI. L.J. 87, 100-04 (1983).

¹⁴¹ See *Peoples Energy*, 142 Ill. App. 3d at 921, 492 N.E.2d at 555.

¹⁴² See *id.* at 921, 492 N.E.2d at 556. While the motivation for this reorganization is not clear from the case, there are indications that utility ratepayers had little to gain from Peoples' action. See *id.* at 934-35, 935 n.2, 492 N.E.2d at 565 & n.2.

¹⁴³ *Id.* at 921, 492 N.E.2d at 556.

¹⁴⁴ See *id.* at 923, 492 N.E.2d at 557.

¹⁴⁵ See *id.* The statute in question was repealed and re-enacted between the beginning of the litigation and the disposition of this case. The text of the sections perti-

diction because it was "indirectly" operating a utility.¹⁴⁶ The court, however, concluded that Peoples could not be considered a "public utility" because Peoples *itself* did not operate and manage the utility.¹⁴⁷ The fact that the holding company owned 100% of the utilities' common stock and "exercised substantial business control over the operating utilities" did not destroy this separate corporate identity so as to make the holding company a de facto public utility.¹⁴⁸ The court reached this conclusion by crediting the testimony of managers of the utilities who testified as to their independence from the holding company in day-to-day operations.¹⁴⁹ It is not clear, however, that the court asked the right question. Autonomy in routine operations is to be expected; the abuses frequently arise when the *policy* that will guide day-to-day operations is being set. That policy must be approved, even if only tacitly, at the holding company level.¹⁵⁰

Having lost that argument, the Commission turned to the affiliated interest statute.¹⁵¹ The court turned this provision against the Commission, however, by pointing out that the Commission had historically treated Peoples as an affiliated interest of the utilities and consequently acknowledged a lack of jurisdiction over Peoples, and, further, that Peoples was not a public utility.¹⁵² Since it was undisputed that the newly organized subsidiary was not a public utility, and Peoples was not a public utility, the affiliated interest statute, which governed transactions between a *utility* and its affiliate could not apply.¹⁵³ In this

ment to this case did not change, but the numbering did. The court used the old numbering system. *See id.* at 923 n.1, 492 N.E.2d at 557 n.1.

¹⁴⁶ *See id.* at 924, 492 N.E.2d at 557. The statute defined a public utility as "every corporation . . . that owns, controls, operates or manages . . . directly or indirectly, for public use, any plant . . . used . . . for . . . (c) the production . . . or furnishing of . . . electricity . . . [or] (e) the conveyance of oil or gas by pipeline." ILL. REV. STAT. ch. 111- $\frac{3}{4}$, ¶ 10.3 (1981) (current version at ILL. ANN. STAT. ch. 111- $\frac{3}{4}$, ¶ 3-105 (Smith-Hurd Supp. 1987)).

¹⁴⁷ *See id.* at 926, 492 N.E.2d at 559.

¹⁴⁸ *See id.* at 925, 492 N.E.2d at 558.

¹⁴⁹ *See id.* at 925-26, 492 N.E.2d at 558-59.

¹⁵⁰ For example, the president of the utilities (prior to the reorganization) testified that "he made the ultimate decision as to the terms of any contract, and the contracts negotiated by the management of the operating utilities did not require [the holding company's] approval." *Id.* at 926, 492 N.E.2d at 559. It strains credibility to think that utility contracts affecting the holding company were not reviewed by holding company management, and it is hard to believe that anything like arms-length bargaining between independent firms was occurring. However, by focusing on *operating* (rather than strategic) decisions, the court was able to avoid saying that the holding company was "operating" a public utility within the meaning of the statute.

¹⁵¹ *See* ILL. REV. STAT. ch. 111- $\frac{3}{4}$, ¶ 8a (1981) (current version at ILL. ANN. STAT. ch. 111- $\frac{3}{4}$, ¶ 7-101 (Smith-Hurd Supp. 1987)).

¹⁵² *See Peoples Energy*, 142 Ill. App. 3d at 928, 492 N.E.2d at 560-61.

¹⁵³ *See id.* at 929-30, 492 N.E.2d at 561.

way, a public utility affiliate consummated a major restructuring of its operations, and the citizens of Illinois had no voice in the matter.¹⁵⁴

2. Broad Jurisdictional Grants

Many states simply rely on broad, vague grants of general jurisdiction over utilities to regulate the holding company structure.¹⁵⁵ The difficulty, however, is that facially broad grants of authority to regulate

¹⁵⁴ It appears that the Illinois legislature was not satisfied with the path this case took through the court system. The legislature passed a statute that, effective January 1, 1986, gave the Commerce Commission jurisdiction over all reorganizations, including "any transaction which, regardless of the means by which it is accomplished, will have the effect of terminating the affiliated interest status of any entity [defined in the affiliated interest statute]." ILL. ANN. STAT. ch. 111- 3/4, ¶ 7-204 (Smith-Hurd Supp. 1987).

¹⁵⁵ See, e.g., *In re Elec. Util. Diversification*, No. 850096-EI, Order No. 15885, at 2 (Fla. Pub. Serv. Comm'n) (Order Closing Docket) ("While we have no specific statutory authority addressing diversification, we have the ability to review transactions between affiliated companies . . . [to exclude from] rates those expenses we deem unreasonable . . . [and] establish reasonable rates of return [W]e presently have sufficient authority . . . to address the issue of diversification."); Letter from Robert Reiger, General Counsel, Louisiana PSC, to Jeffrey Knapp (Nov. 18, 1987) (copy on file at the *University of Pennsylvania Law Review*) ("At the present time there doesn't appear to be a need for specific legislation in this area. In Louisiana the LPSC is a constitutional agency and has historically exercised its broad grant of authority through the issuance of orders and rules.").

Other state PSCs view their grant of statutory authority more narrowly, or worse, are limited by narrow judicial interpretations. For example, the Maryland PSC has understood from its inception that it has no authority to prohibit utility diversification, unless the PSC finds that the diversified undertakings are likely to impair the utility's ability to render service. See Letter from Shirley Bigley, Director, Consumer Assistance and Public Affairs, Maryland PSC, to Jeffrey Knapp (Nov. 17, 1987) (copy on file at the *University of Pennsylvania Law Review*). Of course, the Maryland PSC may be less concerned than other states about the perils of diversification because of its strong statutory prohibition against the formation of utility holding companies. See *Baltimore Gas & Elec. v. Heintz*, 760 F.2d 1408 (4th Cir.), cert. denied, 474 U.S. 847 (1985).

Disputes over PSC authority, at least in this context, are litigated infrequently. In most cases, it appears that the parties are able to reach an accommodation that normally entails a granting of permission to diversify so long as the diversifying utility agrees to certain conditions. See, e.g., CAL. PUB. UTIL. COMM'N, REPORT ON SOUTHERN CALIFORNIA EDISON COMPANY'S REQUEST FOR COMMISSION AUTHORIZATION TO IMPLEMENT ITS PLAN OF REORGANIZATION 2-1 to 2-10 (Aug. 25, 1987) (nonstatutory conditions on formation of holding company); Application of Honolulu Gas Co., No. 1861, Order No. 2762 (Haw. Pub. Util. Comm'n, May 27, 1971) (reprinted in 1982 NARUC REPORT, *supra* note 16, at 83) (same); Application by Sierra Pacific Power Company, No. 83-1226 (Nev. Pub. Serv. Comm'n May 14, 1984) (Comm'r Schmidt, dissenting) (access to records, oversight of affiliate transactions); Investigation of Corporate Reorganization of Virginia Elec. and Power Co., No. PUE 830060, at 9 (Va. State Corp. Comm'n June 30, 1986) (restrictions on composition of boards of directors and oversight of affiliate transactions).

When the sides are very far apart, usually one will reconsider. See, e.g. *San Diego G&E Says It's Reconsidering Plan for Holding Company*, Wall St. J., March 31, 1986, at 3, col. 5 (company balked at conditions), or they might end up in court. See *infra* notes 165-85 and accompanying text.

a *utility* might not extend to a holding company or affiliates. The Iowa State Utilities Board is presently engaged in a dispute over this issue.¹⁶⁶

Iowa Power is a utility that is wholly owned by Iowa Resources.¹⁶⁷ The Iowa Consumer Advocate asked to see the minutes of certain board meetings of Iowa Resources, and Iowa Resources resisted.¹⁶⁸ The critical aspect of this case is that the Consumer Advocate's authority is assumed to be co-extensive with that of the Board.¹⁶⁹ Therefore, if the Consumer Advocate cannot gain access to the books and records of the unregulated affiliate (Iowa Resources), then neither can the Board.¹⁶⁰ It is also significant that the Consumer Advocate is requesting access to affiliate records concerning a transaction that might not even involve the regulated entity.¹⁶¹

Relying on a rather obscure precedent, the Board found that the Consumer Advocate has sufficient authority to access the records.¹⁶² The company appealed the decision to the Polk County District Court, where the matter is pending.¹⁶³ The right to access hardly seems as clear as the Board suggests, given that the language of the statute imposes reporting requirements on *public utilities* engaged directly or indirectly in nonutility activities, *not* on holding companies.¹⁶⁴ This seem-

¹⁶⁶ See *Iowa Power and Light Co.*, No. M-205 (Iowa Dep't of Commerce June 3, 1987) (appeal filed).

¹⁶⁷ See *id.* at 1.

¹⁶⁸ See *id.* "The Consumer Advocate. . . is an essential element in the system established to regulate public utilities in Iowa." *Id.* at 2. The role of a consumer advocate is to offset the lobbying power of the utility before the PSC and to represent the interests of consumers. See K. HOWE & E. RASMUSSEN, *supra* note 26, at 57-59.

¹⁶⁹ See *Iowa Power*, No. M-205, at 2.

¹⁶⁰ The Board may have had a vested interest in deciding this case in favor of disclosure.

¹⁶¹ See *supra* note 138 and accompanying text.

¹⁶² See *Iowa Power*, No. M-205, at 5. The Board's holding relied upon an unpublished Polk County District Court opinion from 1983:

. . . it is not unreasonable for the Commission to require utilities to file information concerning affiliated companies which are a part of the same corporate structure. This is clearly an exercise of authority over a public utility that is within the investigatory powers granted to the Commission. . . . The information required may be used by the Commission in the determination of the rates that may be collected by public utilities. This is all that is required to demonstrate the relevance of the information in question.

Id. (citing *Iowa Power and Light Co. v. Iowa State Commerce Comm.*, No. AA-127 (Polk County Dist. Ct. Feb. 3, 1983)). The court seemed to confuse the issue of relevance with that of authority—even relevant information is off-limits to a PSC without jurisdiction. See *Arizona Pub. Serv. Co. v. Arizona Corp. Comm'n*, 746 P.2d 4, 9-10 (Ariz. Ct. App. 1987) (review granted Dec. 15, 1987).

¹⁶³ See Letter from Susan Allender, General Counsel, Iowa State Utilities Board, to Jeffrey Knapp (Nov. 23, 1987) (copy on file at the *University of Pennsylvania Law Review*).

¹⁶⁴ See IOWA CODE § 476.9 (1986).

ingly insignificant distinction can make a critical difference if a court is not receptive to expansive governmental regulation of private enterprises.

In *Montana Power Co. v. Public Service Commission*,¹⁶⁵ the court's interpretation of the PSC's power was narrower than the PSC's interpretation. In that case, the utility announced its intention to reorganize, and the PSC prohibited implementation of the reorganization pending an investigation as to whether it would have subject matter jurisdiction over the holding company.¹⁶⁶ The PSC claimed implied power to enjoin the reorganization under its legislative grant of "full power of supervision, regulation, and control."¹⁶⁷ The Montana Supreme Court held that the order enjoining the reorganization was judicial in nature, and accordingly was ultra vires as to the PSC.¹⁶⁸ The three dissenting justices each pointed out that if the PSC lacked jurisdiction over the holding company, the only meaningful opportunity to investigate the reorganization would be prior to formation.¹⁶⁹ This case underscores the need for more specific grants of statutory authority to agencies charged with regulating diversifying utilities.¹⁷⁰

¹⁶⁵ 206 Mont. 359, 671 P.2d 604 (1983).

¹⁶⁶ *See id.* at 362-63, 671 P.2d at 606-07.

¹⁶⁷ *Id.* at 372, 671 P.2d at 611 (citing MONT. CODE ANN. § 69-3-102 (1987)).

¹⁶⁸ *See id.* at 377-78, 671 P.2d at 614.

¹⁶⁹ *See id.* at 381, 671 P.2d at 616 (Morrison, J., dissenting); *id.* at 386, 671 P.2d at 618 (Keedy, J., dissenting); *id.* at 388-89, 671 P.2d at 619-20 (Shea, J., dissenting). This consideration apparently was a factor in *Public Serv. Co. of N.M. v. New Mexico Pub. Serv. Comm'n*, 747 P.2d 917 (1987), discussed *supra* note 135. Interpreting the statute giving the PSC jurisdiction over public utility holding companies, the court rejected an interpretation that failed to give the PSC the power of prior approval of holding company *formation*. Such an interpretation, said the court, "would strip the [PSC] of its ability to protect ratepayers from the adverse effects of the holding company restructuring until the impact has occurred. This Court must interpret statutes in a way which will not render their application unreasonable nor defeat the intended objective of the legislation." *Id.* at 920 (citation omitted).

¹⁷⁰ Even where the court ostensibly sides with the PSC, there is no guarantee that ratepayers will receive adequate protection. For example, in *Utah Dep't of Admin. Servs. v. Public Serv. Comm'n*, 658 P.2d 601 (Utah 1983), the PSC reached an agreement with a utility permitting the transfer of utility assets to an unregulated subsidiary despite protests from groups appearing on behalf of ratepayers. *See id.* at 604. In that case, a gas utility transferred its oil exploration and production properties to an unregulated subsidiary, prompting claims from the Division of Public Utilities that the utility assets had been financed by the ratepayers and should not now be employed for the sole benefit of the shareholders. *See id.* The PSC approved the transfer retroactively, believing that the properties, once transferred, were beyond its jurisdiction. *See id.* The Utah Supreme Court disagreed, remanding the case to the PSC with the mandate that utility customers share fairly in the transfer of assets. *See Committee of Consumer Serv. v. Public Serv. Comm'n*, 595 P.2d 871, 878 (Utah 1979), *cert. denied*, 444 U.S. 1014 (1980).

On remand, the Division of Public Utilities negotiated a settlement with the utility rather than engaging in a de novo factual inquiry. *See id.* at 878 (specifying criteria by

A dispute over the extent of a PSC's implied powers in the context of a holding company system is also ongoing in Arizona.¹⁷¹ Acting pursuant to what it perceived to be a broad grant of authority to regulate public utilities,¹⁷² the Arizona Corporation Commission imposed certain reporting requirements¹⁷³ on the newly formed holding company over Arizona Public Service, the largest utility in the state.¹⁷⁴ If ever

which the PSC, on remand, "must reassess the transfer and determine whether the properties were utility assets"). The Department of Administrative Services, a major user of the utility's natural gas service, challenged the settlement as violative of the court's remand order and contrary to the interests of ratepayers. *See Utah Dep't of Admin. Servs.*, 658 P.2d at 604, 612-13. The court adopted a deferential standard of review in evaluating whether the settlement was in the ratepayers' interest, stating that it would "set [the PSC's] decision aside only if it is outside 'the tolerable limits of reason' or 'so unreasonable that it must be deemed capricious and arbitrary.'" *Id.* at 612 (citations omitted). The court endorsed the PSC's decision to resolve the dispute without recourse to a judicial forum, and applauded the PSC's "deviation" from the court's mandate. *See id.* at 613-15. The PSC held eight days of hearings to debate the merits of the settlement, and this ventilation of the issues influenced the court's decision to uphold the agreement. *See id.* at 615.

The agreement appeared to protect the immediate economic interests of ratepayers, *see id.* at 616, but the Department of Administrative Services was troubled by "unlawful terms that divest the [PSC] of its jurisdiction over the . . . activities of [the nonutility] affiliates . . ." *Id.* at 617. These terms included a stipulation that none of the parties would "claim that the properties owned by [the unregulated subsidiary] are subject to the public utility regulation of any state." *Id.* The PSC thought it retained its right to intervene if the nonutility operations threatened the provision of utility service, *see id.*, and the court found "no error" in the PSC's reading of the agreement. *See id.* However, the court never reached the issue of PSC jurisdiction over nonutility subsidiaries with fewer direct links to the utility than the subsidiary in this case. *See id.* at 621 n.33 ("[T]he extent to which a wholly owned subsidiary engaged exclusively in exploration and development could lawfully be subject to [PSC] regulatory authority . . . remain[s] for resolution in future proceedings.").

It is important to note that this case did not involve a holding company structure. The nonutility subsidiary involved was a subsidiary of the utility, making the jurisdictional question simpler than it would have been in the holding company context. What seemed to be a strong statement in support of the PSC's authority to intervene to protect ratepayers in *Committee of Consumer Services* ends up looking like an excuse to exclude ratepayers from meaningful participation in the transfer of assets from the utility in *Utah Department of Administrative Services*. Significantly, the opportunity for public comment came *after* the agreement was ironed out by the parties. *See id.* at 615. After investing the effort to reach an agreement, the PSC had a vested interest in seeing that agreement implemented. Under those circumstances, one might wonder how seriously the PSC considered the criticisms of the opposition. The deferential standard of review further weakened the public's voice in evaluating the agreement.

¹⁷¹ *See Arizona Pub. Serv. Co. v. Arizona Corp. Comm'n*, 746 P.2d 4 (Ariz. Ct. App. 1987) (review granted Dec. 15, 1987).

¹⁷² *See id.* at 7.

¹⁷³ *See Corporate Restructuring of the Arizona Pub. Serv. Co.*, No. V-1345-85-126, Decision No. 54504, at 3-9 (Ariz. Corp. Comm'n April 29, 1985). These reporting requirements were primarily intended to permit the Corporation Commission to monitor the type of intracorporate transactions that are highly susceptible to problems of cross-subsidization.

¹⁷⁴ *See Ariz. Pub. Serv.*, 746 P.2d at 6-7.

there were a case for a liberal reading of a grant of authority, this would seem to be it, because the holding company, Pinnacle West Capital Corporation, is undertaking an aggressive diversification program. The most astonishing move to date was the acquisition of Arizona's largest savings bank, MeraBank, for \$440 million.¹⁷⁵ The Commission prevailed in the trial court on a motion for summary judgment.¹⁷⁶ The Arizona Court of Appeals reversed, finding that the Commission lacked jurisdiction over the holding company.¹⁷⁷

The Commission's authority is both constitutional¹⁷⁸ and statutory.¹⁷⁹ The court, unpersuaded by the Commission's argument that the holding company should be treated as a public service corporation by virtue of its control over a public service corporation,¹⁸⁰ relied heavily on the fact that the holding company itself was not a public service corporation.¹⁸¹ The court seemed to think that the commission could obtain the information it needed to protect ratepayers solely through its uncontested jurisdiction over the utility.¹⁸² In reaching this conclusion, the court directly contradicted the reasoning that the *Iowa Power and Light*¹⁸³ board found so persuasive.¹⁸⁴ Specifically, the Arizona Court of Appeals stated that the "perceived need to obtain information from [the holding company], however meritorious, is not a ground for finding jurisdiction . . . under Arizona's constitutional and statutory provisions governing public service corporations. The granting of such jurisdiction over a non-public service holding company is a concern more properly addressed to the state legislature."¹⁸⁵

¹⁷⁵ See D. HAWES, *supra* note 12, § 4.03[1], at 4-18. MeraBank accounts for nearly the same dollar amount of assets of the consolidated entity as the utility itself. See *Arizona Pub. Serv.*, 746 P.2d at 6 n.1.

¹⁷⁶ See *Arizona Pub. Serv.*, 746 P.2d at 5.

¹⁷⁷ See *id.* at 10.

¹⁷⁸ See ARIZ. CONST. art. 15.

¹⁷⁹ See ARIZ. REV. STAT. ANN. §§ 40-201 to -464 (1985).

¹⁸⁰ See *Arizona Pub. Serv.*, 746 P.2d at 8.

¹⁸¹ See *id.* at 7-8 (holding company *itself* "does not provide any public service listed in the [statutory] definition").

¹⁸² See *id.*

¹⁸³ No. M-205 (Dep't of Commerce June 3, 1987).

¹⁸⁴ See *supra* note 162.

¹⁸⁵ *Arizona Pub. Serv.*, 746 P.2d at 8. In addition, the court specifically refused to invoke the corporate law device of piercing the corporate veil because the PSC "offered no evidence of undercapitalization, fraud, misconduct, or impropriety . . ." *Id.* The court, however, failed to address the question of how the PSC could possibly offer this sort of evidence without access to the books of the unregulated affiliates.

III. WHAT IS THE STATE LEGISLATURE TO DO?

A. *Mapping Out the Legislative Goal*

The primary goal of legislation regulating utility diversification should be to protect the ratepayer from the risks attending the foray into unregulated ventures. Federal securities laws ensure that investors can obtain adequate information about a diversifying utility, allowing them to make prudent investment decisions. Furthermore, those investors who are uncomfortable with the prospect of diversification have a ready market for their shares.¹⁸⁶ Investment information alone, however, is unlikely to help ratepayers because it is usually insufficient to enable the PSC to make the difficult judgments necessary to prevent cross-subsidization. Furthermore, ratepayers tend to be the "captives" of the utility that has a monopoly within the service area. The investor, on the other hand, can "get out" of the utility by selling her shares.¹⁸⁷

Effective legislation must be multi-focused. The dynamics of diversification are such that the type of business into which a utility chooses to diversify bears strongly on the probability of the venture's success.¹⁸⁸ Provided the PUHCA survives efforts at repeal, federal regulation may already place adequate restrictions on areas into which registered utilities may diversify.¹⁸⁹ The restrictions on exempt holding company systems, however, are not clearly defined.¹⁹⁰ Given this uncertainty, states will desire the authority to impose similar subject matter restrictions on utilities within their territories.

A second concern is that the holding company structure will shield management from inquiry into improper cross-subsidization.¹⁹¹ In order to address this concern, legislation must empower PSCs with jurisdiction over the holding company/utility system and with access to the records of the diverse enterprises as well as the utility business.¹⁹² The perils of broad, but empty, jurisdictional grants must be avoided,¹⁹³ and

¹⁸⁶ See Sommer, *supra* note 7, at 28. Sommer points to many changes in the securities laws and accounting principles that offer equal or greater protection to investors than the PUHCA. See *id.*

¹⁸⁷ It is conceivable that ratepayers could move to another service area with nondiversifying utilities, or they could convert to an alternative energy source provided by an undiversified utility. In the real world, however, neither of these expensive and disruptive options is likely to be practical for the average ratepayer.

¹⁸⁸ See *supra* notes 27-29 and accompanying text.

¹⁸⁹ See *supra* notes 92-99 and accompanying text (discussing registered holding companies under the PUHCA).

¹⁹⁰ See *supra* notes 106-33 and accompanying text.

¹⁹¹ See *supra* notes 46-71 and accompanying text.

¹⁹² See *infra* notes 204-14 and accompanying text.

¹⁹³ See *supra* notes 155-85 and accompanying text.

the deficiencies of affiliated interest statutes must be repaired.¹⁹⁴ PSCs will also need the incidental power to approve the holding company format before reorganization,¹⁹⁵ and to have information regarding the changing corporate structures.¹⁹⁶ Only with this contextual information will the records be complete.

However, the regulatory effort must not proceed without recognition of the fact that the utility is a profit-making enterprise.¹⁹⁷ Regulations must neither impinge on management's ability to manage effectively on a day-to-day basis, nor their ability to seize attractive business opportunities.¹⁹⁸ The following proposal addresses these concerns in particular detail.

B. Proposal for the Effective Regulation of Diversifying Utilities and the Formation of Holding Companies for the Purpose of Diversification

STATEMENT OF PURPOSE: The purpose of this act is to protect the public interest and to assure the uninterrupted provision of public utility service at reasonable rates to citizens of this state when public utility corporations become affiliated with companies operating in unregulated industries. The public interest is protected when the state public service commission (hereinafter "commission") has sufficient power and authority to assure that companies affiliated with the public utility do not benefit from that affiliation at the expense of higher costs of service to utility ratepayers or of unfair competition to competitors without a utility tie.

By emphasizing that the PSC will continue to regulate the utility, and not the nonutility subsidiaries except as incidental to regulation of the utility, it is possible to meet the philosophical objections expressed

¹⁹⁴ See *supra* notes 137-54 and accompanying text.

¹⁹⁵ See *infra* notes 204-06 and accompanying text.

¹⁹⁶ See *infra* notes 207-13 and accompanying text.

¹⁹⁷ Utilities in the United States are funded almost exclusively by private and institutional investors—not the government. Therefore, "[c]ommissions have tried to assure adequate earnings so that the public utility sector could continue to develop and expand in accordance with consumer demand." C. PHILLIPS, *supra* note 77, at 153. The prevailing view of ratemaking in this country was first stated in *Federal Power v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). A commission's duty is to set "[r]ates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate . . . investors . . ." *Id.* at 605.

¹⁹⁸ See *infra* note 211 and accompanying text.

in *Peoples Energy Corp.* and *Arizona Public Service*.¹⁹⁹

SECTION 1: *Definition of Holding Company*

"Holding company" means:

(a) Any company which, in any chain of successive ownership, directly or indirectly owns, holds, or controls 10% or more of the voting securities of a public utility providing energy service in this state, or

(b) Any person or company which the PSC shall determine, after investigation and a hearing on the record, directly or indirectly, alone or in concert with other persons or companies, exercises such control over the operations, management, or policies of the public utility providing energy service in this state, as to make necessary protection of the ratepayers of the utility or consumers.

This section is modeled on the Wisconsin Act,²⁰⁰ but sets a higher ownership threshold before triggering the provisions. The 10% threshold in the proposed act is in line with the affiliated interest statutes of several states²⁰¹ and the conclusive presumption of ability to control under the federal securities laws.²⁰²

Section 1(b) of the proposed act is essentially a savings clause, encompassing those situations where entities combine to influence the operations of the public utility, but attempts to avoid the strictures of the act by keeping their ownership below the 10% threshold. The specific reference to the need for consumer protection covers those situations where the formation of the holding company may have a minimal impact on ratepayers but significant anti-competitive effects.²⁰³

SECTION 2: *Prior Approval of Commission*

(a) No person or company may form a holding company without prior approval of the state public service com-

¹⁹⁹ See *supra* notes 140-54 & 171-85 and accompanying text. Of course, some may view this as purely a question of semantics. In these cases, courts read the enabling statutes of the PSCs as granting jurisdiction over the public utility and *not* the holding company, even where the holding company owned nearly 100% of the utility. The proposed Act emphasizes that any requirements imposed on the holding company are for the incidental purpose of regulating the *utility*, and not the holding company itself. This statement of purpose avoids the appearance of "attempt[ing] to impress a 'public use' on a business heretofore private . . ." Lilienthal, *The Regulation of Public Utility Holding Companies*, 29 COLUM. L. REV. 404, 434 (1929).

²⁰⁰ See WIS. STAT. ANN. § 196.795(1)(h) (West Supp. 1987) (requiring a 5% ownership threshold).

²⁰¹ See *supra* note 137.

²⁰² See Securities and Exchange Act of 1934, 15 U.S.C. § 78p(a) (1982).

²⁰³ See *supra* notes 67-71 and accompanying text.

mission after a hearing on the record.

(b) The burden shall be on the person or company proposing formation of the holding company to show that the holding company will not be detrimental to the interests of the ratepayers of the utility or consumers.

(c) In determining whether formation of the holding company will be detrimental to the interests of the ratepayers of the utility or consumers, the commission may require the following information from the person or company proposing formation of the holding company:

(1) a comprehensive list of names and corporate relationships of persons and companies that will be in the holding company system;

(2) a description of how the holding company will be formed, including copies of the articles of incorporation of all companies within the proposed holding company system and copies of any document required to be filed for approval of holding company formation under federal securities and other laws;

(3) a statement and description of the method by which shared management, personnel, property, administrative, and any other common expenses will be allocated among the utility and other companies in the holding company system; and

(4) a copy of any agreement or proposed agreement between the public utility and any other company in the proposed holding company system, including but not limited to any agreement to transfer any asset of the public utility to any other company in the proposed holding company system.

Section 2 also borrows heavily from the Wisconsin Act.²⁰⁴ However, the proposed statute explicitly states that the burden is on the person or company proposing formation of the holding company system to justify formation. Section 2(a) is intended to avoid the problem of a PSC discovering too late that it might not have jurisdiction over the holding company system once it is formed by expressly granting the PSC power to deny formation in the first instance.²⁰⁵ Section 2(b) makes clear that the PSC is not to "rubber stamp" the formation of holding company systems. The information requirements of section 2(c)

²⁰⁴ See WIS. STAT. ANN. § 196.795(2)(a) & (b) (West Supp. 1987).

²⁰⁵ Cf. *Montana Power Co. v. Public Serv. Comm'n*, 206 Mont. 359, 379, 671 P.2d 604, 615 (1983) (jurisdiction of PSC to approve or disapprove a proposed reorganization unripe for consideration).

are meant to ensure that the PSC fully understands the corporate structure of the proposed holding company system and will be able, from the outset, to monitor the complex issues of cross-subsidization, including cost allocation and transfer pricing.²⁰⁸

SECTION 3: Powers of Commission with Respect to the Holding Company System

The commission, in fulfilling its statutory mandate to protect consumers and ratepayers of the utility, shall have the power to:

(a) demand access to all books, records, documents, and other information relating to the utility or any of its affiliates within the holding company system, except that the commission may not have access to trade secrets unless it is essential to the protection of the interests of ratepayers or consumers;

(b) detect, identify, review, and approve or disapprove, with the purpose of eliminating any transaction that appears contrary to the financial interest of the utility, all transactions between the utility and any affiliated interest within the holding company system, including but not limited to any loan or capital transfer involving the utility;

(c) impose maximum limits on the total level of investment in nonutility business, except that the commission, having granted permission to form a holding company system pursuant to Section 2, shall not have the power of prior approval or disapproval for any particular acquisition;

(d) order a holding company to terminate its interest in a public utility affiliate on terms adequate to protect the interests of utility investors, ratepayers, and the public, if the commission finds, after investigation and an adjudicatory proceeding, that, based upon clear and convincing evidence, termination of the interest is necessary to protect the interest of investors in a financially healthy utility and consumers in adequate utility service at a just and reasonable price.

Section 3 enumerates those powers that are essential to effective PSC oversight of the holding company system, in comparison to Section 6, which suggests conditions that the PSC may impose on the formation of the holding company system. Access to affiliates' records is a universal feature of statutes regulating formation of holding company sys-

²⁰⁸ See *supra* notes 47-55 and accompanying text.

tems²⁰⁷ and is usually one of the conditions PSCs attempt to impose in the absence of a statute.²⁰⁸

Section 3(b) is modeled on the Maine statute²⁰⁹, but identifies a specific transaction subject to abuse. Some statutes or PSC conditions contain an outright ban on loans from utilities to affiliates,²¹⁰ but the proposed act adopts a more moderate view. There can be valid reasons (for example, cash management) for short-term funds transfers between a utility affiliate and the holding company. The proposed act gives the PSC discretion to disallow these transfers when the PSC determines that there is no valid economic reason for them to take place or if they will result in a direct or indirect subsidy from the utility to the borrowing entity.

Section 3(c) ensures that the utility business will continue to predominate in its holding company system. This restriction minimizes the risk that management's attention will be diverted from the operation of the utility. Subsection (c) also makes clear that the holding company need not secure PSC approval for each individual acquisition, assuring that the holding company will have the flexibility to pursue opportunities as they arise as well as take advantage of frequently narrow financing windows without the delay that accompanies PSC approval for individual acquisitions.²¹¹

Section 3(d) enables the PSC to protect the utility's financial position and ability to access financial markets in the event that an affiliate encounters serious financial difficulty. This subsection is taken directly

²⁰⁷ See, e.g., CAL. PUB. UTIL. CODE § 314(b) (West Supp. 1988) (commission may inspect books of corporations that hold controlling interest in a public utility, or any subsidiary or affiliate of such corporation); ME. REV. STAT. ANN. tit. 35-A, § 708(2)(A)(1) (West 1987) (commission has access to books, records, documents, and other information relating to utilities or their affiliates); WIS. STAT. ANN. § 196.795(5)(b) (West Supp. 1987) (commission has access to any information relating to a holding company system).

²⁰⁸ See, e.g., CAL. PUB. UTIL. COMM'N, *supra* note 155, at 2-4 to -5 (providing commission with access to "all of the holding company and the affiliates' books and records"); Arizona Pub. Serv. Co. v. Arizona Corp. Comm'n, 746 P.2d 4, 10 (Ariz. Ct. App. 1987) (review granted Dec. 15, 1987) (PSC lacks jurisdiction to order parent of utility to comply with reporting requirements).

²⁰⁹ See ME. REV. STAT. ANN. tit. 35-A, § 708(2)(A)(2) (West 1987).

²¹⁰ See, e.g., OHIO REV. CODE ANN. § 4905.46(B)(1) (Anderson Supp. 1987) ("Unless it is authorized to do so by the Commission, no public utility . . . shall . . . lend funds to [or] guarantee the obligations of . . . any company which is not a public utility . . ., and which is affiliated . . . with it in the same holding company system."); WIS. STAT. ANN. § 196.795 (5)(c) (West Supp. 1987) ("No public utility affiliate may lend money to any holding company which is not a public utility or to any nonutility affiliate with which it is in the holding company system.")

²¹¹ See Kahn, *supra* note 18, at 157 (arguing against "ex ante" review of individual proposed investments by asserting that "this is a responsibility for which regulators have no particular competence; they would be foolish to assume it.")

from the Wisconsin act²¹² and is one of the few sections in the proposed act that takes into account the interests of investors. Protection is necessary in this case because the PSC can impose action on the holding company, and the risk of this action is beyond the investor's ability to control.²¹³

SECTION 4: *Obligations of the Holding Company System*

The holding company, and any affiliate within the holding company system as the commission shall require, shall:

(a) furnish the commission with annual reports concerning the financial operations and condition of the holding company or such affiliate;

(b) furnish the commission with copies of all reports filed with the Securities and Exchange Commission;

(c) notify the commission in writing within 15 days following the acquisition of any subsidiary;

(d) provide confidential notice to the commission of the intent to divest, sell, or transfer any subsidiary prior to such divestiture;

(e) notify the commission in writing at least 30 days prior to any transfer of assets between the utility and any other affiliate within the holding company system, and provide the commission with a written statement of the terms of such transfer.

This section²¹⁴ clarifies the obligations of the holding company system, enabling the PSC to enforce the powers granted it in Section 3. Section 4(c) recognizes that the PSC does not have the right of prior approval of holding company acquisitions, but at the same time ensures that the PSC will be kept up to date on these transactions. Section 4(d) is not inconsistent with Section 3(c) (dealing with acquisitions of subsidiaries) because Section 4(d) requires prior notice of *sales* of subsidiaries. The different treatment recognizes a fundamental distinction between acquisition and divestiture—normally speed will only be important in a divestiture if the sale is a distress sale, in which case the commission will want to know why. On the other hand, speed may be important in the event of an acquisition because of financing arrange-

²¹² See WIS. STAT. ANN. § 196.795(7)(c) (West Supp. 1987).

²¹³ There might also be constitutional (takings clause) implications if a PSC ordered divestiture without taking the interests of shareholders into account.

²¹⁴ The section is modeled on the conditions imposed on the proposed reorganization of Southern California Edison Company by the California Public Utilities Commission. See CAL. PUB. UTIL. COMM'N, *supra* note 155, at 2-1 to -4.

ments or competing bidders. Section 4(e) assures that the commission will have enough time and information to review intercompany transfers for possible cross-subsidization problems.

SECTION 5: *Restrictions on Utilities in Holding Company Systems*

No public utility affiliated with a holding company system shall:

(a) guarantee the notes, debentures, debt obligations, or other securities of the holding company or any other company in the holding company system;

(b) make any contract with any company in the holding company system for the purchase and resale by the utility of [electric energy] [gas];

(c) transfer to any other company within the holding company system any proprietary public utility information unless the commission has approved the transfer in writing.

These restrictions are drafted in terms of limiting the public utility in order to avoid the appearance of an unconstitutional regulation of a non-public service corporation.²¹⁵ The prohibition on guarantees is found in both the Wisconsin act and the California conditions.²¹⁶ There is no valid cash management reason to allow a utility to guarantee an affiliate's debt, and guarantee arrangements can significantly boost the liability of a utility in ways that are susceptible to concealment from regulators. Section 5(b) prohibits arrangements where the holding company sets up a subsidiary to sell wholesale energy to the utility, which then resells the energy to its ratepayers.²¹⁷ The purpose of these arrangements is to avoid state regulation of utility rates in favor of the more liberal attitude towards rate increases at the Federal Energy Regulatory Commission.²¹⁸ Regardless of the holding company's motive in

²¹⁵ See *Arizona Pub. Serv. Co. v. Arizona Corp.* Comm'n, 746 P.2d 4, 8 n.3 (Ariz. Ct. App. 1987) (review granted Dec. 15, 1987).

²¹⁶ See WIS. STAT. ANN. § 196.795(5)(d) (West Supp. 1987); CAL. PUB. UTIL. COMM'N, *supra* note 155, at 2-3 (condition 14).

²¹⁷ See, e.g., Friedlein, Finger & DeLaney, *supra* note 46, at 22-23 (VEPCO setting up subsidiary composed of generating plants to sell electricity to holding company at wholesale); Empire State Power Resources, Inc. No. 79-10, (N.Y. Pub. Serv. Comm'n April 12, 1979.) [hereinafter ESPRI] (generating subsidiary).

²¹⁸ See Friedlin, Finger & DeLancy, *supra* note 46, at 23; ESPRI, *supra* note 217, at 10-11. There are numerous problems with relying on the FERC to regulate the transactions of holding companies. See Response of Environmental Action, Western Shoshone National Council and Citizen Start to "Responses to Objections to Its Application and Exemption and Requests for Hearing," and Comments on Amendments at 13-18, Sierra Pacific Resources, Admin. Proc. 70-7408 (S.E.C. filed Aug. 14, 1987) (state PSC review will likely be pre-empted by the FERC inquiry into reasonableness

establishing a generating subsidiary, the function of setting the rates of public utility service properly belongs to the states. Section 5(c) closely follows the wording of the Wisconsin act²¹⁹ and is primarily concerned with the sharing of customer lists—a practice that gives a nonutility subsidiary an unfair competitive advantage over competing firms in unregulated business fields. The PSC would have the discretion to disallow the use of those lists, or at least to assure that ratepayers are compensated for their use.

SECTION 6: *Other Conditions on Approval*

The commission is authorized to attach such other conditions to formation of the holding company system as it shall deem necessary to fulfill the purposes of this act.

This section grants the PSC authority to negotiate the type of additional conditions that some PSCs have been able to extract even in the absence of statutory authority.²²⁰ For example, the PSC may want to impose restrictions on dividends paid by the utility to the holding company.²²¹ Some states incorporate "capital impairment" provisions into their statutes.²²² Other states rely on market forces and covenants in debt agreements to ensure that the utility and the holding company system maintain prudent debt/equity ratios.²²³ A similar requirement is not included in the proposed act because the broad grant of authority to the PSC under Section 3(b) already regulates capital transfers (of which dividend payments are but one kind) between the utility and affiliates in the holding company system. The PSC also might consider a royalty charge payable to the utility by companies in the holding company system in order to compensate for the intangible benefits of association with the utility.²²⁴

SECTION 7: *Future Review of Utility Holding Companies*

The commission shall, by the third anniversary of the

of power supply agreement).

²¹⁹ See WIS. STAT. ANN. § 196.795(5)(h) (West Supp. 1987).

²²⁰ See *supra* note 155.

²²¹ See, e.g., OHIO REV. CODE ANN. § 4905.46(A) (Anderson Supp. 1987) (requiring PSC authorization of all declarations of dividends).

²²² See ILL. ANN. STAT. ch. 111- $\frac{2}{3}$, ¶ 7-103 (Smith-Hurd 1987 Supp.); ME. REV. STAT. ANN. tit. 35-A, § 708(2)(A)(3) (West 1987); WIS. STAT. ANN. § 196.795(4) (West Supp. 1987).

²²³ See, e.g., Virginia Elec. and Power Co., No. PUE 830060 at 5 (Va. State Corp. Comm'n June 30, 1986) (opinion and final order) ("constraints of the marketplace" make additional financial reporting of utilities unnecessary).

²²⁴ See, e.g., Proposed Committee Bill No. 38, Conn. Gen. Assembly, Comm'n on Energy and Public Utilities (introduced Dec. 8, 1987) (every subsidiary must pay 5% of gross revenues to utility as compensation for intangible benefits); CAL. PUB. UTIL. COMM'N, *supra* note 155, at 3-1 to -12 (describing nature of intangible benefits).

formation of the holding company system, and triennially thereafter, investigate the impact of such holding company system on the ratepayers of the utility, on consumers, and on businesses in competition with companies affiliated with the holding company system. The results of each such investigation shall be compiled in a written report to the legislature.

This section is taken from the Wisconsin act.²²⁵ Because the impact of significant diversification is difficult to predict, it makes sense to periodically assess the effectiveness of the legislation in preventing the abuses that caused the backlash against holding companies in the PUHCA.

CONCLUSION

Public utilities are diversifying at an accelerating pace. The abuses that can attend unrestrained diversification led to a major restructuring of the entire industry beginning in the 1930s—a colossal task that has succeeded to a large degree. It is improbable that abuses of that magnitude could accompany the current round of diversification: the state PSCs are stronger, and the federal government could intervene as an emergency brake on troubled diversification ventures. Nevertheless, the SEC seems to be distancing itself from the regulation of routine diversification. In addition, state authorities are discovering that their power to regulate diversification is not as broad as they believed.

State legislatures should act now to clearly define the ground rules of diversification. In the process, they will help the utility industry by removing the uncertainty surrounding the extent and degree of permissible investment in nonutility activity. This Comment has attempted, through a model statute, to set a framework for effective state regulation.

At the very least, it is hoped that the proposed act will stimulate thoughts on how to protect ratepayers from the potential ill effects of diversification.

²²⁵ See WIS. STAT. ANN. § 196.795(7) (West Supp. 1987).

