Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System[1]

INTRODUCTION AND BACKGROUND

On March 27, 2003, in Reno, Nevada, the Subcommittee on Accounting and Finance (Subcommittee) initiated a project to study "ring fencing" mechanisms and how such mechanisms can affect utility regulation. This paper represents an analysis of our findings.

Ring fencing has been defined in different ways but generally involves techniques used to insulate the credit risk of an issuer from the risks of affiliate issuers within a corporate structure.[2] Our interests in this project are directed toward identifying and analyzing the various ring fencing mechanisms that can be employed to insulate the regulated utility from the business practices and credit risks of sometimes highly speculative, non-regulated affiliates.

The Subcommittee has addressed the interrelationship of regulated utilities and non-regulated affiliates before. First, in 1999, the Subcommittee developed "Guidelines for Cost Allocations and Affiliate Transactions" (Guidelines) for energy utilities, which were adopted by NARUC at its Summer Meetings, San Francisco, California July 22, 1999. The adopted Guidelines are intended to "provide guidance to jurisdictional regulatory authorities in the

[1] Prepared by Timothy Devlin, Florida Public Service Commission, Rebecca Phillips, Kentucky Public Service Commission, and Thomas Ferris, Wisconsin Public Service Commission with the assistance of Chancy Bittner of the Iowa Utilities Board, David Hodgden and Joseph Buckley of the Ohio Public Utilities Commission, Charles Christiansen, California Public Utilities Commission, and Terri Carlock, Idaho Public Utilities Commission. This paper was prepared on behalf of the NARUC Staff Subcommittee on Accounting and Finance. Any views or opinion expressed by the authors are not necessarily those of NARUC, the Florida, Kentucky, and Wisconsin Public Service Commissions, or any other particular state utility regulatory commission.

[2] Bonelli, Sharon, Yee, Mona, CFA, and Lapson, Ellen, CFA (2003). Corporate Finance, Rating Linkage Within U.S. Utility Groups, Utilities, Holding Companies and Affiliates. Fitch Ratings: Global Power/North America Special Report, April 9.

development of procedures and the recording of transactions for services and products between a regulated entity and affiliates."[3] Essentially, these Guidelines address cross subsidization issues between affiliated companies.

Additionally, in 2000, the Subcommittee prepared a white paper, "Codes of Conduct Governing Competitive Market Developments in the Energy Industry: An Analysis of Regulatory Actions." The purpose of the White Paper was to study the various codes of conducts in place around the country and to analyze the application and effectiveness of the various components of such codes.

CURRENT FINANCIAL ENVIRONMENT

Due to recent events in the energy industry, including the implosion of Enron in late 2001, investigations into the trading activities of numerous marketers and the general glut of electricity in the marketplace, there has been a general trend towards electric utility bond downgrades. These downgrades have been most notable for electric utility companies operating within larger corporate structures and for those operating in states that have, or are in the midst of, restructuring. Although utilities that remain fully bundled may not appear in and of themselves to be riskier, bond rating agencies are more inclined to rate utility bonds at a rating similar to that of its parent company.

Because of the recent trend of rating agencies to consolidate utilities and non-regulated affiliated companies when evaluating risks, there has been increasing concern over the impact of non-regulated ventures upon the utility’s access to debt and equity capital and the corresponding cost of such capital as well as the prospect of the utility being pulled into bankruptcy by its parent’s insolvency. As a consequence, ring fencing techniques are gaining the regulator’s attention.

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[3] NARUC Resolution Regarding Cost Allocation Guidelines for the Energy Industry, dated July 22, 1999.

RING FENCING MECHANISM

There are several techniques that can be employed separately, or together, to insulate a utility from the risks of affiliate issuers within a holding company system. These include pro-active regulatory oversight, financial restrictions, structural separations, and operational controls.[4]

In ring-fencing, a shell is built around the utility by employing techniques to create a "package of enhancements." According to Standard and Poor's (S&P), a properly structured package of enhancements consists of three elements:[5]

1. A special "Structure," often including a "special purpose entity," structured in a way that reduces the risk of a subsidiary being pulled into bankruptcy along with its parent.
2. A tightly drafted set of covenants, including dividend tests, negative pledges, non-petition covenants, prohibitions from creating new entities, restrictions on asset transfers and inter-company advances, that preserve the financial well-being and autonomy of the ring-fenced subsidiary.
3. The third element is collateral. If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary.

According to Fitch,[6] "Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will. Nevertheless, corporate policies are helpful indicators of management intent. While there are cases in which a

[4] Bonelli, Yee, & Lapson, page 4.
[5] Venkataraman, Swami, Standard and Poor's (2003). Holding Company Diversification and Its Impact on Regulated Operations. Speech before the NARUC Staff Subcommittee on Accounting and Finance, Reno, Nevada, March 26.
[6] Bonelli, Yee, & Lapson, page 2.

financially stressed parent has extracted dividends, inter-company loans or assets from its regulated utility subsidiaries, there are numerous cases illustrating voluntary restraint by a financially stressed parent holding company. Xcel and Allegheny Energy are two recent examples of holding companies that have refrained from transactions that impair the financial condition of their utility subsidiaries."

Structural separations are another way to insulate the utility from the risks of non-regulated affiliates. One such structural separation is multiple ownership. When a utility is controlled by at least two parents or is the subject of a joint venture, the financial problems of any one of the parents is less likely to have consequences for the credit quality of the utility. Generally, the utility will be better insulated if credible owners are on equal footing and are able to prevent each other from harming the credit quality of the utility.[7]

Holding Companies are generally structured in one of two ways. The first, more common structure, involves a nonregulated shell holding company, which owns the equity of both the regulated and nonregulated subsidiaries. In the second structure, the regulated utility operates as the parent holding company owning stock in various subsidiary companies.[8] It may prove to be easier to insulate a utility if it is held as a subsidiary in a holding company structure instead of a structure in which the utility holds the equity (and therefore the equity risk) of various subsidiaries.

[7] Venkataraman.
[8] Bonelli, Yee, & Lapson, page 3.

In some instances, the utility is held as a division of a parent company, without a separate capital structure. In these instances, the regulator might want to consider requiring utility operations be held as a separate subsidiary instead of being operated as a division so that a clearly separate capital structure can be defined. As Fitch notes, the holding company structure aids in the construction of a strong ring fence. A regulated utility operating as a division of the parent company results in a higher risk profile for the utility than if held as a separate subsidiary. [9]

The final way to achieve insulation is the imposition of restrictions from the outside --from regulation, or even legislation, particularly at the state level. The strongest form of regulatory insulation exist where there are tight, statute-based restrictions on cash and asset transfers coupled with active and pre-emptive oversight by the regulatory body. [10]

State Commissions generally have broad powers to protect utilities from any adverse actions of affiliated companies. Some of these powers are explicitly provided for by statute, including prohibitions on the use of debt for non-utility purposes and encumbering utility assets for non-utility purposes. The regulator might also be proactive in encouraging a properly structured package of ring-fencing enhancements as discussed above. That is to say, the regulatory entity might require the insertion of a special purpose entity between the utility and the holding company, structured in a way that reduces the risk of the utility being pulled into bankruptcy along with its parent or other affiliated company. This could also require a tightly drafted set of covenants subject to commission review.

[9] Bonelli, Yee, & Lapson, page 3..
[10] Venkataraman.

Additionally, many Commissions have codified Codes of Conduct and Cost Allocation Rules as the energy market has evolved toward a more competitive market. Other tools employed by Commissions to safeguard utility assets have been established through Orders under the Commissions' broad power of ensuring that utilities provide safe, adequate, and reliable services at just and reasonable rates (or prices).

S&P states that "insulation brought about by legislative statutes is a great deal more certain than state utility commission rulemaking and will provide for greater ratings separation." S&P also states that, "Notably, most state regulators maintain their state or commission has explicit laws or regulations in place that provide sufficient authority to prevent the financial condition of the utility from being adversely affected by the activities of nonregulated affiliates. However, from a credit perspective, Standard & Poor's believes most of these laws and regulations to be reactive measures; they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred."[11]

In a recent presentation to the Subcommittee, S&P named three states that they believe have adequate regulatory insulation mechanisms. Interestingly, one example involves a Commission Order, not a definitive statute. These states and mechanisms are:[12]

1. The Wisconsin Commission has explicit statutes governing the energy utility/affiliate relationship. Statute 196.795(5)(g) requires that "no holding company system may be operated in any way which materially impairs the credit...of any public utility affiliate." Statute 196.795(5)(c) and (d) prohibit a utility from lending money to or guaranteeing any obligations of its parent holding company or any nonutility affiliates. Statute 196.795(6m)-Asset Cap, limits nonutility investments to 25 percent of public utility assets with certain

[11] Ferara, William (2002). Research: Is State Utility Regulation Coming Back Into Vogue?. Standard & Poor's Ratings Direct, October 4.
[12] Venkataraman.

exceptions. Statute 196.795(5) also includes provisions limiting subsidies between the utility and nonutility affiliates. Statute 196.52 relates to relations with affiliated interests and Commission control of affiliate contracts. Statute 196.80 requires Commission approval for an energy utility to merge, consolidate, acquire the stock of any other public utility, or sell, acquire, lease, or rent any public utility plant or property constituting an operating unit or system. Statute 196.795(3) regarding "takeovers" requires commission review and approval before allowing anyone to own more than 10 percent of the outstanding voting securities of the holding company. Statute 201.03 requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Finally, Statute 196.795(4), for utilities in an energy holding company system, and 201.11 authorize the Commission to order a utility to cease paying dividends on its common stock when there is a finding of capital impairment.

2. The Oregon Commission placed certain conditions in its Order approving the Portland General Electric Company (PGE)/Enron merger. Most notable, "PGE must maintain the common equity portion of its capital structure at 48% or higher unless the Commission approves a different level, and must notify the Commission of certain dividends and distributions to Enron." The 8-notches bond rating differential between PGE and Enron would seem to indicate successful ring fencing.

3. The Virginia Commission also has explicit statutes regarding utility/affiliate relationships. Chapter 3 (§56-58) of Title 56 of the Code of Virginia requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Additionally, Chapter 3 (§56-59) and Chapter 4 (§56-82) require that utilities, prior to assuming obligations as a guarantor, seek Commission approval for such guarantees. Chapter 4 (§56-82) requires utilities to gain Commission approval for affiliate loans. Chapter 4 (§56-83) authorizes the Commission, under certain circumstances, to prohibit a utility from paying dividends to an affiliate. Chapter 5 requires that prior to the change in ownership or control of : (1) a utility operating in Virginia, (2) any utility asset located in Virginia, or (3) utility securities occurs, Commission approval must be obtained. Under SEC Rule 53(c) of the Public Utility Holding Company Act, the Virginia Commission has been able to get utilities to agree that measures will be taken if bond ratings fall to certain levels. These conditions were based on the above mentioned statutes.

In summary, of the three states that S&P mentioned, two rely upon state statutes for their regulatory insulation. The third relied on conditions in a merger that indirectly is dependent upon state authority over mergers.

FEDERAL ROLE

As noted by Fitch, the Public Utilities Holding Company Act of 1935 (PUHCA) has some positive effect on the credit quality of subject utilities by regulating holding companies on matters including company structure, intercompany loans, reporting, acquisitions, and issuance and sale of securities.[13] Furthermore, according to the American Public Power Association (APPA), the financial problems of many electric utilities and utility holding companies today can be traced directly to the partial repeal and weakened safeguards of PUHCA via the enactment of the 1992 Energy Policy Act.[14] If PUHCA is totally repealed despite concerns (as is being seriously considered), it becomes increasingly important for the states to augment their own ability to monitor and regulate holding companies.[15] There is some concern that the Commerce Clause could severely constrain the ability of a state to regulate a multi-state holding company.[16] In any case, the importance of oversight will only increase if the repeal sets off, as some expect, another major merger wave.

[13] Bonelli, Yee, & Lapson, page 2.

[14] APPA, "The Public Utility Holding Company Act—Its Protections Are Needed Today More Than Ever," February 2003, p. 4.

[15] In this regard, also see the January 30, 2002, letter of John D. Dingell and Edward J Markey to Harvey L. Pitt, then Chairman of the SEC, at http://www.house.gov/commerce_democrats/press/107ltr129.htm.

[16] Anderson, John, "Commentary: Pro & Con," Public Utilities Fortnightly, July 15, 1995, p. 38.

The Federal Energy Regulatory Commission (FERC) has recently undertaken steps to increase its active oversight of utility/holding company relationships for those utilities under its jurisdiction. These steps include an on-going rulemaking initiative into cash management practices[17] and a recent decision to impose new conditions to all future public utility issuances of secured and unsecured debt authorized by the commission. These conditions are:[18]

1. Public utilities seeking authorization to issue secured debt backed by a utility asset must use the proceeds of the debt for utility purposes only.
2. If any utility assets that secure debt issuances are "spun off," the debt must follow the asset and also be "spun off."
3. If any of the proceeds from unsecured debt are used for nonutility purposes, the debt must follow the nonutility assets. If the nonutility assets are "spun off," then a proportionate share of the debt must follow the "spun-off" nonutility asset.
4. If utility assets financed by unsecured debt are "spun off" to another entity, then a proportionate share of the debt must also be "spun off."

There is also an amendment to the national Energy Bill that addresses corporate and financial separation. If passed into law, this would presumably increase FERC's authority and articulate a needed mandate to protect public utilities from the financial distress caused by risky investments made by utility parent companies in nonutility businesses. However, the proposed legislation does not provide states with the additional authority needed to better ensure that consumers are protected from potential abuses by large, unrestricted holding companies. Such additional authority would include the right of the states to form joint oversight bodies to conduct financial and managerial audits of multi-jurisdictional utilities, including those operating within a larger corporate structure. This authority would provide for such audits and other oversight actions as states deem necessary with or without federal agency involvement.

[17] FERC, "Regulation of Cash Management Practices," Docket No. RM02-14-000.

RING FENCING AND BANKRUPTCY

As previously mentioned, ring fencing aids in protecting the utility from the financial problems of non-regulated affiliates. The extreme case would be one of bankruptcy. In California, Edison International and Pacific Gas & Electric Corp. attempted to protect its subsidiaries from insolvency by implementing the following ring fencing measures:[19]

1. Making certain subsidiaries into special purpose entities (SPE) or "limited purpose operating entities" similar to an SPE;
2. Providing a nonconsolidation opinion between subsidiary and parent (upon insolvency of the parent, the assets of the subsidiary would not be consolidated with the parent's);
3. Securing legal comfort that the ring-fencing did not contradict any law, regulation, order, or contract; and
4. Securing other legal comfort that the ring-fencing would not invoke any of the "recharacterization" provisions of the Federal Bankruptcy Code.

Since a parent may have the incentive to file a subsidiary utility into bankruptcy, there are other economic measures that could be undertaken. These include termination provisions in certain contracts (i.e. commodity hedge) in the event of non investment grade rating.

On April 23, 2003, several state commission staff members and analysts at Fitch discussed ring-fencing. Fitch pointed out there is no perfect ring fence that can completely insulate a utility. They question certain techniques such as the "golden share" where an independent director for a utility has certain powers. More importantly, according to Fitch, companies have an inalienable right to file a subsidiary into bankruptcy. A company cannot waive this right according to the General Counsel at Fitch. Regardless, Fitch mentioned several measures that aid in the insulation of the utility and include:

[18] FERC, "Commission Sets New Conditions for Utility Debt Acquisition," Docket No. ES02-51-000, News Release, February 20, 2003.
[19] Rigby, Peter (2001). Ring Fencing Subsidiaries From Parents' Bankruptcies in California. Standard & Poor's Project & Infrastructure Finance, October, 121-123.

(1) minimum debt/cash flow ratio, (2) separate books and records, (3) separate subsidiaries, and (4) limitation on upstream loans.

The filing of a bankruptcy creates an automatic stay that halts all attempts by creditors to collect their claims from debtors. Creditors who willfully violate the automatic stay are subject to sanctions. However, federal, state and local government agencies are not subject to the automatic stay in the exercise of certain police or regulatory powers.[20] Regulatory actions of an economic nature would probably not be exempted from the automatic stay. Most state commission actions are of an economic nature and therefore, are mooted by bankruptcy filing.

POSSIBLE RING FENCING MEASURES

While according to the ratings agencies, state statutory authority is the preferable tool to properly insulate the regulated utility from non-regulated affiliate activities, any action that state regulators take that provides support (whether legal, regulatory, financial, or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive from a credit rating standpoint. Only when sufficient regulatory insulations exist will the corporate credit rating (risk of default) of an operating company be separated from that of the holding company.[21]

To the extent permitted under its state statutes and depending on the specific circumstances, in any rate case proceeding, approval of mergers, approval of affiliated interest contracts, approval of securities, or any other similar proceedings, a state commission may want to consider ways to insulate a utility in a holding company system by restricting the flow of the

[20] Overview of Bankruptcy and the Impact of Bankruptcy on the Regulatory Process, United States Trustee for Region 21, Northern District of Florida, Tallahassee, Florida.

utility's cash to its parent company, such as overhead allocation, loan and dividend restrictions, and stringent equity-maintenance requirements.[22]

The following are suggested areas to be considered ring fencing measures (some are more strenuous forms of others given):

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restriction against using utility assets as collateral or guarantee for any non utility business.

2. Commission authority to restrict dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to, maintenance of a minimum equity ratio balance.

3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between the utility and affiliate companies.

4. Commission authority over the establishment of a holding company structure involving a regulated utility.

5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

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[21] Ferara.
[22] Ferara.