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Jurisdiction of State Regulatory Commissions Over Public Utility Holding Company Diversification

INTRODUCTION

The energy industry and numerous critical observers are currently engaged in a debate over the role of state public service commissions in regulating a recent but widespread phenomenon: diversification of public utility companies. Although historically utilities have not been thought of as diversification candidates, inflationary pressures in recent decades have caused many utilities to expand into unregulated, non-utility areas of business. A common mechanism for implementing such diversifications is the organization of a holding company to act as a parent for the utility, thereby allowing for the creation of non-utility subsidiaries. While holding companies are legal entities which can

1. Any business activity that falls outside ordinary utility functions is considered diversified activity. Traditional utility functions include generation, transmission, and distribution of commodities such as electricity and gas. Ferrar, Business Diversification: An Option Worth Considering, PUB. UTIL. FORT., Jan. 7, 1982, at 17.


3. Holding companies are corporations organized for the purpose of acquiring and holding the stock of other corporations. Corporations that engage in business activities and only incidentally hold majority stock in another corporation are not holding companies. 6A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2821 (1981). In North Am. Co. v. Securities & Exch. Comm'n, 327 U.S. 686 (1945), the Court noted that "the dominant characteristic of a holding company is the ownership of securities by which it is possible to control or substantially to influence the policies and management of one or more operating companies in a particular field of enterprise." Id. at 701. See generally U.S. GOVT PRtg. OFF., LAWS RELATING TO SECURITIES COMMISSION EXCHANGES AND HOLDING COMPANIES (1981).

4. A corporation that has either direct or indirect power to elect a majority of the directors of another corporation is deemed a parent corporation over the corporation it controls. The terms "holding company" and "parent company" are frequently used interchangeably. H. BALLANTINE, CORPORATIONS § 134 (1946).

5. When the majority of a corporation's stock is held by a parent company, the corporation held is termed a "subsidiary." 6A W. FLETCHER, supra note 3, at § 2821. The hold-
serve as useful constructs for implementing diversification, they can also present stumbling blocks to public service commissions charged with the duty of regulating utilities. The primary problem is that public service commissions frequently lack the jurisdiction to review holding and subsidiary company decisions directly affecting the utilities involved.\(^6\)

Furthermore, critics of unregulated utility diversification fear that it will occur at the expense of utility ratepayers if ratepayers are forced to pay for diversification in the form of higher rates or substandard utility service.\(^7\) While shareholders, especially the large institutional investors which dominate the utility stock market,\(^8\) can sell their stock if they see the non-utility endeavors failing, ratepayers cannot usually extricate themselves because they are locked into the utility’s service territory.\(^9\)

This note examines state public service commission jurisdiction over diversification activity by public utility holding companies in Michigan, Illinois, New York, and Connecticut. In all four states, the decline of corporate and industrial activity spurred the development of a diversification strategy as a profit enhancing course. The cases examined are a representative sampling, exemplifying the range of public service commission responses to diversification by public utility holding companies.\(^10\) The Publishing company is regarded as an entity separate from its subsidiary. Accordingly, the business transactions of the subsidiary are not generally attributed to the holding company.\(^{11}\) In appropriate circumstances, however, a subsidiary can maintain an action against its holding company based on a breach of fiduciary relationship. 13 W. FLETCHER, supra note 3, at § 5888 (1980 & Supp. 1983).

6. See infra notes 47-100 and accompanying text.
7. See infra note 41.
9. See infra note 41-42.
Public Utility Diversification

1983

Public Utility Holding Company Act of 1935,\(^\text{11}\) the federal act designed to regulate public utility holding companies with interstate operations is then examined as one potential alternative treatment of public holding company diversification. Finally, the note proposes a state legislative response designed to promote equitable state regulation of public utility holding companies.

**BACKGROUND**

**Public Utility Regulation**

A public utility may be defined as any enterprise subject to long-term governmental regulation for the purpose of consumer protection.\(^\text{12}\) One feature which characterizes a utility is the general public's need for the utility's service. Another is the utility's possession of certain technical characteristics that lead almost inevitably to monopoly.\(^\text{13}\) Utilities have existed from the first time the general public demanded a product or service held by another as a natural monopoly.\(^\text{14}\) The existence of public utilities is now wide-

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\(^{12}\) J. Bonbright, Principles of Public Utility Rates 4 (1961). The purpose of public utility regulation is to protect the public in its collective role as consumer, as opposed to the public as taxpayer or producer. Id. A public utility is also defined as a business or service engaged in the business of supplying consumers with goods or services which are required on a continual basis. U.S. Dept. of Energy, A Consumer's Guide to the Economics of Electric Utility Ratemaking 213 (1980) [hereinafter cited as Consumer's Guide].

Economists categorize utilities into three groups: energy, communications, and transportation. Some types of utilities are considered partially competitive (railroads, waterways, pipelines, cable television), while others are considered primarily monopolies (telephone service, electric power, natural gas, sewage). C. Wilcox & W. Shepherd, Public Policies Toward Business 334 (5th ed. 1975).

\(^{13}\) J. Bonbright, supra note 12, at 4.

\(^{14}\) The term "natural monopoly" describes a business which cannot operate efficiently unless it operates as a monopoly because of the business's inherent technical characteristics. The "natural monopoly" status of public utilities is due primarily to the industry's severely localized market. J. Bonbright, supra note 12, at 11-12. Some economists question whether technology has not rendered "natural" monopolies impotent, arguing, for example, that copy-by-wire is a competitive alternative to the postal monopoly. Stelzer, A Policy Guide for Utility Executives: "Know When to Hold 'em; Know When to Fold 'em," PUB. UTIL. FOR., Oct. 9, 1980, at 62.

Utilities date at least as far back as 2300 B.C., when Hammurabi promulgated his code fixing yearly rates for the hiring of ships. J. A. Priest, Principles of Public Utility Regulation—Theory and Application 5 (1969). Priest notes that the first public utility may have far predated Hammurabi's Code if one includes in the class the serpent whose natural monopoly over the fruit trade was plied to over half of the world's then existing population. Id. Accord Genesis 3:1-7.
spread, supplying the public with everything from telephone service and natural gas to waterways and cable television.\footnote{15}

Public utilities have been subject to regulation since 1670, when Lord Chief Justice Hale of Britain noted the need for monitoring port facilities and ferry boat businesses.\footnote{16} According to Hale, these operations required regulatory review because they were businesses “affected with a publick interest.”\footnote{17} By the 19th century in America, however, only a handful of states had imposed public utility commission oversight of utilities, and those that undertook utility review did so on an advisory basis.\footnote{18}

Then, in 1876, the Supreme Court, in the landmark case of \textit{Munn v. Illinois},\footnote{19} affirmed the rights of states to regulate private businesses affected with a public interest.\footnote{20} As a result, by the 1930’s, most states had created public service commissions.\footnote{21} Many utilities even lobbied for these commissions, preferring state regulation to federal regulation or public ownership.\footnote{22}

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15. C. Wilcox & W. Shepherd, \textit{supra} note 12, at 334. Utility systems generally undergo four states of development. In the first stage, the system is invented. In the second stage, the system experiences further growth and seeks regulation as a means of attaining legitimacy and permanence. The third stage is characterized by the utility’s switch to a defensive posture as the utility encounters objection to high rates and as the utility competes against technological breakthroughs that would render at least some utility services useless. In the fourth stage of utility development, the utility may yield to competitive pressures and revert to conventional competitive processes. \textit{Id.} at 348-49.


17. \textit{Id.} This notion of the public interest in utility regulation has been the focal point of subsequent utility legislation. Munn v. Illinois, 94 U.S. 113 (1876). See also Arnebergh, \textit{Public Utilities Regulation and the Community Interest}, 30 S. Cal. L. Rev. 191 (1957) (arguing that the public interest must be protected by regulation when a necessary good or service is provided to the public by a monopoly).

18. C. Wilcox & W. Shepherd, \textit{supra} note 12, at 353. During this period, advisory bodies depended upon the combined effects of competition and supervision to exert a regulatory effect upon utilities.

19. 94 U.S. 113 (1876).

20. The Supreme Court reasoned:

\begin{quote}
Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created.
\end{quote}

\textit{Id.} at 126.


22. \textit{Id.} Utilities preferred state regulation because until the 1930’s, state public service commissions had little leverage and were considered passive bodies. Modern state public service commissions have their critics as well, who characterize the regulatory bodies as
Utility Diversification

Prior to the mid 1970's, public utilities experienced steady and substantial profits coupled with slowly rising costs. Increases in the rates they charged, however, were rare, and rate hearings were few and far between. With the onset of inflation, cost increases, and sharp decreases in the growth of service demand, however, many public utilities began to see their financial positions deteriorate. In response, some public utilities diversified into unregulated non-utility areas. This strategy enabled the utility to react more proactively to complaints instead of acting affirmatively to ensure quality service. These critics allege that commissions' weaknesses include easy acceptance of utilities' cost analyses, failure to audit utilities' accounting systems, failure to control utility operating expenses, and unwillingness to govern utility earnings by prescribing criteria of equity or efficiency.

23. Id. at 375.
24. Id. at 375. Economists have referred to the period from 1945 to 1965 as the "golden age of regulation."
27. In the wake of the Arab oil embargo, utilities passed on to consumers the substantially elevated cost of fuel. Consumer's Guide, supra note 12, at 160. Demand statistics reflect consumers' response. During the 1960's, gross energy consumption in the residential sector grew an average of 4.6% annually. This contrasts with the 1.9% average annual rates since then. U.S. General Accounting Office, Analysis of Trends in Residential Energy Consumption (1981).
29. An Edison Electric Institute survey identified 286 diversified businesses in the electric utility industry. Sixty percent of the ventures were related (vertically integrated) to power production, while the remaining ventures reportedly were based on utility expertise.
ities to attempt to profit by operating their subsidiary businesses free from local regulation.\textsuperscript{30}

Utility diversification is generally structured in one of three ways.\textsuperscript{31} First, a utility can diversify by creating a new division within its utility structure.\textsuperscript{32} The operations of such a division will usually fall within the jurisdiction of a public service commission because the division is still a part of the regulated utility. Second, a utility can diversify by creating a subsidiary whose non-utility operations may or may not fall within the jurisdiction of a public service commission, depending on state law and the manner in which the subsidiary is structured.\textsuperscript{33} Third, a utility may diversify

\textit{LIMINARY OFFICIAL REPORT, AD HOC COMMITTEE ON UTILITY DIVERSIFICATION 5 (Nov., 1982)} (comment by the Edison Electric Institute) [hereinafter cited as \textit{PUBLIC COMMENT}].

In the natural gas industry, 82\% of the gas companies responding to a recent American Gas Association survey were diversified. Forty-nine of the companies' diversified ventures were functionally related activities, 50 were directly related to the gas utility business, and 39 were ventures unrelated to the gas industry. \textit{Id.} at 27 (comment by the American Gas Association). Gas company non-utility activities include real estate development, computer services, banking, insurance, and chemical production. \textit{Id.}


30. Diversification can improve a utility financially because it can both decrease risk and increase earnings levels and thus enhance the utility's securities. \textit{CABOT CONSULTING GROUP}, supra note 26, at ii. Some critics of diversification argue that individual investors, through discriminating portfolio selection, can reduce risk more efficiently than the utilities through diversification. \textit{See PUBLIC COMMENT, supra} note 29 (comment by G. Sterzinger, of the National Consumer Law Center).

Nonetheless, as a result of diversification, energy businesses have experienced better earnings, sturdier credit ratings, more marketable securities, and higher market-to-book and price-earning ratios. Lewis & Ross, supra note 2, at 17. For example, in the electric utility industry, studies have shown that diversification can boost return on investment by 10 to 20\%. \textit{PUBLIC COMMENT, supra} note 32, at 16 (comment by the Edison Electric Institute).

31. J. MALKO, G. ENHOLM & T. JADITZ, \textit{supra} note 1, at 9. A recent Edison Electric Institute survey found that of 247 non-utility ventures in the electric industry, 143 were organized as subsidiaries. The survey did not distinguish between holding company subsidiaries and utility-owned subsidiaries. \textit{Id.} at 10.

32. \textit{Id.} at 9.

33. For example, when the Southern Connecticut Gas Company decided to enter the business of drilling and exploring for natural gas, it created two subsidiaries to undertake
by organizing a holding company to act as parent over the utility and its subsidiaries.\textsuperscript{34} This often allows the utility to avoid regulation of its subsidiary because if the existence of the subsidiary as a separate company. Some states, however, allow limited jurisdiction over holding companies to the extent that they have transaction with public utility subsidiaries under “affiliated interests” statutes.\textsuperscript{35}

The underlying purpose of utility diversification through the creation of a holding company is usually two-fold: to enhance the utility’s financial opportunities,\textsuperscript{36} and to avoid public service com-

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the venture. The Public Utilities Control Authority, in its decision permitting the creation of holding companies, specified which subsidiaries should remain Southern subsidiaries, rather than holding company subsidiaries.

\textsuperscript{34} J. Malko, G. Enholm & T. Jaditz, \textit{supra} note 1, at 9.

\textsuperscript{35} Affiliated interests statutes extend public service commission jurisdiction by giving commissions authority to monitor transactions between utilities and corporations or persons who have limited authority over the utility. “Authority” is statutorily defined; it generally means control through stock ownership. The Illinois “affiliated interests” statute is typical:

(2) The Commission shall have jurisdiction over affiliated interests having transactions, other than ownership of stock and receipt of dividends thereon, with public utilities under the jurisdiction of the Commission, to the extent of access to all accounts and records of such affiliated interests, relating to such transactions . . . [t]he phrase “affiliated interests” means:

(a) Every corporation and person owning or holding, directly or indirectly, 10% or more of the voting capital stock of such public utility;

(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 voting capital stock is owned by any person or corporation owning 10% or more of the voting capital stock of such public utility, or by any person or corporation in any such chain of successive ownership of 10% or more of voting capital stock;

(g) Every corporation or person which the Commission may determine as a matter of fact after investigation and hearing is actually exercising any substantial influence over the policies and actions of such public utility even though such influence is not based upon stock holding, stockholders, directors or officers to the extent specified in this Section . . .

\textsuperscript{36} See supra note 30.


mission review. Whether the former purpose is met by diversification is uncertain. As to the second purpose of diversification—avoidance of regulatory jurisdiction—few states have reviewed their public utility laws to determine whether amendment is necessary. As a result, some public service commissions have

37. The Illinois statute providing for the creation of a public service commission is typical. Section 1 of the Illinois Public Utilities Act states, "There is created an Illinois Commerce Commission consisting of 5 members nor more than 3 of whom shall be members of the same political party at the time of appointment." Ill. Rev. Stat. 111 2/3, § 1 (1981). The Act grants the Illinois Commerce Commission jurisdiction over utilities' power to issue stocks (§ 20), to pay dividends (§ 27a), to change rates (§ 36), and to abandon or discontinue service (§ 49a).


38. A number of utilities have clearly benefitted by diversifying. For example, one of the most highly diversified utilities, Pacific Power & Light Co., derives nearly half of its net income from its nonutility subsidiaries. Pacific Power & Light, supra note 29, at 56. Pacific's holdings include the largest investor-owned electric power system in the Northwest, the sixth largest independent telecommunications operation in the country, the eighth largest coal mining company in the country, ventures into gold and other rare mineral concerns, cable television properties, and commercial background music businesses. The company holds over thirty subsidiaries. Pacific's consolidated revenue increased nearly 200% from 1975 to 1980. Edison Electric Institute, Economics Division, Case Studies in Elec. Util. Diversification, (Feb., 1982). Some economists, however, question whether utilities have the level of management and the aggressive characteristics suited to compete outside their structural monopolies. One economist stated that the benefits of diversification may be marginal because investors have not generally greeted diversified companies with enthusiasm and because the economic benefits that accrued to those companies which diversified successfully in the past have changed. The economist suggests that regulatory oversight will curtail the downside risks of diversification borne by ratepayers. Diversification and Deregulation: Complements or Substitutes?, Address by Judith H. Greenman, Senior Consultant, National Economic Research Associates, Inc., to The Annual Conference of the Public Utility Research Center (Feb. 3, 1982), reproduced in Public Comment, supra note 29, at 239.

Another economist has suggested that the stock market will fail to respond favorably to diversification unless utilities diversify into complementary operations, taking advantage of utility management's area of expertise and enhancing both operations' overall performance. An example of such a diversification would be an electric utility's use of its experience in stringing wires and connecting them to homes to perform similar services in the cable television field. Another example would be a utility's marketing of its computer models used to forecast regional economies. Conerly, Diversification: An Economic Framework for Analysis, Pub. Util. Fort., Sept. 16, 1982, at 40. See generally Utility Diversification: Not A Fast Track To The Promised Land, Elec. Wk., Feb. 15, 1982, at 9.

been unable to deal with the consequences of diversification.40 This concerns industry critics, who fear that financial improvement through unregulated diversification will come at the expense of utility ratepayers.41 Additionally, although diversification is indirectly subsidized by ratepayers when utility capital is used to

40. In Illinois, the Illinois Commerce Commission concluded that it lacked jurisdiction over a utility holding company's maneuver calculated to avoid the language of the Illinois regulatory statute. See infra notes 72-100 and accompanying text.

In Connecticut, the public service commission set an example for dealing with diversification ex post facto, although the commission was unable to involve itself until the diversification was already accomplished and ratepayers had been forced to absorb the costs. See infra notes 118-48 and accompanying text.

In New York, the public service commission avoided the jurisdictional question by flatly but perhaps short-sightedly refusing to allow diversification through the holding company arrangement. See infra notes 101-17 and accompanying text.

Finally, the inability of the Michigan public service commission to exercise jurisdiction over a utility's pre-divestiture conduct resulted in the displacement of valuable utility assets. See infra notes 48-71 and accompanying text.

41. With the holding company structure, possible dangers include managerial dilution as the more talented managers are transferred to the more competitive non-utility operations, profit skimming from the utility to the holding company, and favored treatment of the non-utility's goods and services by the utility, any of which could result in the erosion of utility service quality. Diversification Fever, supra note 29, at 7 (quoting Peter Anderson of Wis. ENVTL DECADE). Other threats include the possibility that utilities may be wrongfully charged for non-utility costs, and risks and losses might be absorbed by the utility while profits are kept from them. PUBLIC COMMENT, supra note 29, at 3 (comment by G. Sterzinger of the National Consumer Law Center). See generally 1980 REPORT, supra note 1. Utility services could also deteriorate if retained earnings were passed from the utility to the holding company and subsequently diverted to more profitable ventures than service maintenance or upgrading. In future reorganizations, financial and physical assets attributable to the regulated portion of the business may be unequally divided in favor of the nonregulated portion. Interview with Dr. Alvin K. Grandys, Director of the Governor's Office of Consumer Services for the State of Illinois, in Chicago (Aug. 5, 1983).

Two examples of the dangers that public utility diversification may hold recently occurred in Cook County, Illinois. On May 5, 1982, the State's Attorney of Cook County filed suit in the District Court for the Northern District of Illinois, alleging that Peoples Energy Corporation's diversification program and subsequent divestiture defrauded consumers. The State's Attorney charged that defendants diverted over $100,000,000 derived from rate increases and used this revenue to finance non-utility ventures, thereby undercapitalizing the utilities. As a result of the undercapitalization, the State's Attorney charged, the utilities requested (and received) from the Illinois Commerce Commission a rate hike of approximately 50% in 1982. County of Cook v. MidCon Corp., No. 82 C2803 (N.D. Ill. filed May 5, 1982). (This suit was dismissed by the federal district court on November 8, 1983, on the ground that the Circuit Court of Cook County had already decided the issue in defendants' favor. See infra notes 72-100 and accompanying text.)

In its study of gas pipeline safety in Chicago, the Labor Coalition on Public Utilities also charged that Peoples Energy Corp. and Peoples Gas Light & Coke Co. drained their gas utility of ratepayer capital which should have been used to improve gas distribution...
fund the enterprise, ratepayers may pay an even greater price in the form of higher rates while non-utility operations flourish. Further, absent regulatory oversight, it is not clear how ratepayers can be protected from holding company accounting abuses such as unrecorded cross-subsidization among subsidiaries.

State public service commissions are in many instances powerless to take remedial action, because the business activities of the public utility holding companies and their non-utility subsidiaries frequently fall outside the jurisdiction of public service commissions. This is due to the fact that neither the holding company nor the subsidiary is engaged in utility activity. Typically, public service commissions exercise jurisdiction over utilities' requests for rate hikes, stock issues, and a variety of other business transactions. While this range of jurisdiction was formerly sufficient to protect the public interest, diversification in the public utility industry appears to necessitate broadening commissions' traditional role to the extent that the activity of unregulated subsidiaries affects utility rates and services.

system safety. Thirty-four people were seriously injured between 1975 and 1981 as a result of leaking gas in Chicago. Eleven of the accidents involved cast iron mains, seventy-five per cent of which were installed prior to 1930. The estimated useful life of cast iron mains, once thought to be seventy-five years, has been adjusted downward to fifty years.

Further, property damage caused by gas leaks has increased. A comparison with other urban gas system property reports indicates that Chicago has experienced nearly twice as much property damage as the next closest urban area. LABOR COALITION ON PUBLIC UTILITIES, ANALYSIS OF CHICAGO GAS LINE SAFETY 1975-1981, at 9, 18, 33 (Aug. 30, 1982).

David E. Stahr of the Illinois Public Action Council charged that although ratepayer capital was used to fund the MidCon Corp. non-utility ventures, ratepayers were not permitted to share in the benefits: "The real question is to what extent . . . a public utility [can] be used to build a private empire." Diversification Fever, supra note 29, at 7.

The National Association of Regulatory Utility Commissioners has stated that the financing of non-utility ventures by the sale of utility securities represents an indirect subsidization by ratepayers. Under these circumstances, ratepayers should share in the diversified earnings. 1982 REPORT, supra note 1, at 8.

Cross-subsidization, in the context of utility diversification, is the subsidization of a non-utility by a utility or vice-versa. Cross-subsidization is usually accomplished by charging non-utility expenses to the utility, or by paying non-utility personnel from utility funds. Some argue that organizing holding companies over utility and non-utility subsidiaries makes it easier to detect cross-subsidization. CABOT CONSULTING GROUP, supra note 26, at 81-85. Of course, nothing prevents cross-subsidization if the holding company sanctions it.

See infra notes 72-100.

See supra note 37.
STATES' RESPONSES TO UTILITY DIVERSIFICATION

As the potential benefits of diversification have become more attractive to financially-strapped utility companies, the number of utilities choosing to diversify has increased proportionately.\(^4\) Because the activities of these utility companies, at least in their non-diversified forms, historically have fallen within the jurisdiction of the commissions charged with their regulation, these commissions have had to respond, by necessity, to the diversification strategies being attempted by the utility companies they regulate. Whether the commissions examining the activities of the products of these diversification attempts have jurisdiction over them has been the subject of debate in many states. The following case studies represent a broad range of utility commission responses, including a denial of public utility commission jurisdiction, a limited interpretation of public utility laws, a refusal to allow diversification, and an attempt to accommodate a utility's diversification.

**Jurisdiction of Michigan Public Service Commission Over Divestiture of Michigan Consolidated Gas Company**

Michigan recently addressed the issue of public utility diversification in *American Natural Resources Co. v. Michigan Public Service Commission*.\(^4\) In this case, a state circuit court found that the Michigan Public Service Commission ("Commission") lacked jurisdiction to review the American Natural Resource Company's ("American Natural") divestiture of its utility subsidiary,\(^4\) despite charges that American Natural had stripped the utility of valuable assets prior to the divestiture.\(^5\)

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47. See *supra* notes 23-46 and accompanying text.
49. American National was a holding company for various energy-related corporations, one of which was Mich Con, a natural gas distribution utility company which also maintained a profitable interstate storage division ("ISD"). See Complaint For Order of Superintending Control at 1,2, Inquiry On the Commission's Own Motion, Into the Proposed Divestiture of Michigan Consolidated Gas Company by American Natural Resources Company, No. U-6790 (Mich. Pub. Serv. Comm'n Mar. 5, 1981).
In the early months of 1981, the Commission learned that American Natural was studying the feasibility of divesting itself of one of its subsidiaries, the Michigan Consolidated Gas Company ("Mich Con"). The Commission issued an order specifically reserving jurisdiction over the divestiture and directing Mich Con to prepare testimony regarding the impact of the proposed divestiture on rates and services. The Commission also directed Mich Con to prepare testimony regarding certain transfers of Mich Con assets to American Natural’s subsidiaries and to American Natural itself.

The Commission did not object to divestiture per se, but objected to American Natural’s pre-divestiture conduct. While contemplating divestiture, Mich Con had entered into transactions with American Natural and several of its subsidiaries involving the transfer of Mich Con assets. These transfers of assets, the Commission charged, served to remove Mich Con’s lucrative interstate storage division from the Commission’s jurisdiction and deprived Mich Con of the kind of assets necessary for future growth. None of the transactions had been accomplished pursuant to Commission authorization.

Mich Con asserted that its divestiture and reorganization were subject only to federal securities law, not to the Commission’s jurisdiction. In addition, Mich Con maintained that its utility

52. Id. at 4.
53. Id. at 3.
54. Id. at 3, 4.
55. Id. at 3.
56. Staff Comments, supra note 50, at 31.
58. Staff Comments, supra note 50, at 19.
59. Id. at 31.
60. Id. at 24, 32. The parties disagreed as to whether the transactions required public service commission authorization.
61. Mich Con asserted that American Natural’s management was implementing divestiture on behalf of its shareholders so that the only requirements applicable were those set by the Securities Act of 1933, the Securities Exchange Act of 1934, and Internal Revenue Service rulings on the tax consequences of spin-offs and reorganizations. Brief, supra note 57, at 4.
services would not be impaired by reorganization and that the denounced transactions were matters strictly within American Natural's business judgment, and thus did not warrant Commission involvement.

American Natural, Mich Con, and other involved subsidiaries filed suit in circuit court to contest the exercise of Commission jurisdiction. The circuit court found that the Commission lacked statutory jurisdiction over the proposed divestiture. The Commission's subsequent appeal, however, was never adjudicated because all parties entered into a settlement agreement, which the Commission approved. American Natural agreed to divest Mich Con by transferring its common stock to a newly-formed holding company and distributing the holding company's stock to American Natural shareholders. This transaction effectively divested American Natural of the utility. The agreement also provided that American Natural and Mich Con would restructure certain Mich Con pre-divestiture transactions in a manner more favorable to Mich Con.

In its order approving the settlement agreement, the Commission observed that the agreement implicitly recognized Commission jurisdiction over the securities and property issues involved in the case. Accordingly, the Commission specifically found jurisdiction, and ordered all parties to supply continuing documentation regarding the conduct and performance of the divestiture.

Because the circuit court held that the Michigan Public Service...
Commission lacked jurisdiction in this case, the Commission dealt with the Mich Con divestiture only after it was an accomplished fact. Adequate statutory jurisdiction would have helped to prevent the holding company's wrongful transfer of Mich Con assets and might have afforded more effective ratepayer protection.

**Jurisdiction of Illinois Commerce Commission over Reorganization of Peoples Energy Corporation**

*Peoples Energy Corp. v. Illinois Commerce Commission*\(^72\) illustrates the difficulty of attempting to exercise public service commission jurisdiction over utilities solely through the use of "affiliated interest" statutes.\(^73\) In this case, the Illinois Commerce Commission, like the Michigan Public Service Commission, found itself without the power to assert regulatory oversight over a holding company's divestiture of its utility operations.

On January 16, 1981, Peoples Energy Corporation ("PEC") announced its investigation into the advantages that might result from reorganizing its operations.\(^74\) At the time, PEC was an Illinois holding company for eight subsidiaries in the energy industry.\(^75\) Only three of the eight subsidiaries were regulated entities subject to administrative jurisdiction:\(^76\) Natural Gas Pipeline Company of America ("Natural"), a natural gas company under the

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72. No. 81 CH 6768, (Cir. Ct. of Cook County, Ill. Nov. 19, 1982).
73. See supra note 35.
74. Peoples Energy Corp. v. Illinois Commerce Comm'n, No. 81 CH 6768, slip op. at 25 (Cir. Ct. of Cook County, Ill. Nov. 19, 1982).
75. Id. at 6-8, 11-12. The subsidiaries were Peoples Gas Light & Coke Co., North Shore Gas Co., and Natural Gas Pipeline Co. of Am. (regulated); Harper Oil Co., Texoma Production Co., Buckhorn Petroleum Co., Industrial Fuels Corp., and Exerter Co. (unregulated).
76. ILL. REV. STAT. ch. 111-2/3 § 8 (1981). Section 8 of the Public Utilities Act provides for administrative jurisdiction:
   The Commission shall have general supervision of all public utilities, except as otherwise provided in this Act, shall inquire into the management of the business thereof and shall keep itself informed as to the manner and method in which the business is conducted . . . If any public utility is engaged in carrying on any business other than that of a public utility, which other business is not otherwise subject to the jurisdiction of the commission, that public utility in respect of such other business shall be subject to inquiry, examination and inspection by the commission in the same manner as the public utility business in so far as such inquiry, examination and inspection may be necessary to enforce any provision of this Act . . .
jurisdiction of the Federal Energy Regulatory Commission;\textsuperscript{77} Peoples Gas Light & Coke Company ("Peoples Gas"), regulated by the Illinois Commerce Commission under the Illinois Public Utilities Act, and North Shore Gas ("North Shore"); also regulated by the Illinois Commerce Commission.\textsuperscript{78} PEC's plan was to spin-off\textsuperscript{79} two of its utility subsidiaries, Peoples Gas and North Shore, by separating the remaining subsidiaries from PEC and placing them under a new parent, MidCon Corp. ("MidCon").\textsuperscript{80} The proposed reorganization was for the avowed purpose of eliminating the regulatory jurisdiction of the Illinois Commerce Commission over PEC's non-utility operations.\textsuperscript{81}

Upon learning of PEC's divestiture plans, the Illinois Commerce Commission issued an order directing PEC, its present subsidiaries and other affiliated interests to show why the proposed divestiture would not be subject to the jurisdiction of the Commission, and to the extent such a showing could not be made, to demonstrate that divestiture would be in the public interest.\textsuperscript{82} The Commission asserted its jurisdiction under Section 8 of the Illinois Public Utilities Act, which confers upon the Commission general supervision over public utilities\textsuperscript{83} as well as under Section 8a's

\textsuperscript{77} See Federal Natural Gas Act, 15 U.S.C. § 717a-z (1982). Natural is subject to Illinois Commerce Commission jurisdiction only to the extent the Federal Natural Gas Act does not pre-empt state legislation. The supremacy clause of the United States Constitution provides that state laws that are inconsistent with or frustrate the operation of federal law are subject to pre-emption by federal law. U.S. Const. art. VI. "[W]here the United States exercises its power of legislation so as to conflict with a regulation of the state, either specifically or by implication, the state legislation becomes inoperative and the federal legislation exclusive in its application. Cloverleaf Co. v. Patterson, 315 U.S. 148, 156 (1942).

\textsuperscript{78} See supra note 76.

\textsuperscript{79} In this context, a spin-off is a corporation's distribution to its own shareholders stock in another corporation. R. Holzman, Corporate Reorganization 8.21-.24 (1955).

\textsuperscript{80} PEC had earlier created MidCon as a subsidiary holding company over the non-utility ventures. Peoples Energy Corp. v. Illinois Commerce Comm'n, No. 81 CH 6768, slip op. at 18, 21 (Cir. Ct. of Cook County, Ill. Nov. 19, 1982).

\textsuperscript{81} Id. at 23. The Illinois Commerce Commission's jurisdiction over the utilities created a kind of "shadow jurisdiction" over the non-utilities which could not be eliminated without a change in PEC's corporate structure. The separation of the non-utility ventures from the utilities left the non-utilities beyond the reach of Illinois Commerce Commission jurisdiction.

\textsuperscript{82} Peoples Energy Corp., No. 81-0509, slip op. at 4 (Ill. Commerce Comm'n July 22, 1981).

\textsuperscript{83} See supra note 76.
"affiliated interests" provision, which gives the Commission regulatory jurisdiction over persons and corporations affiliated with a public utility.84

PEC responded by filing suit in the Circuit Court of Cook County for declaratory and injunctive relief.85 PEC asked the court to find that the Illinois Public Utilities Act did not give the Commission jurisdiction over PEC or its reorganization,86 because neither PEC, Natural, nor MidCon were public utilities as defined under the Act. PEC claimed that since the utilities involved, Peoples Gas and North Shore, were not named parties to the transaction between the holding companies, MidCon and PEC, the Act's "affiliated interests" jurisdiction was inapplicable.87

PEC's case attracted the interest of numerous industry observers, five of whom intervened in the proceedings.88 The intervenors agreed with the Commission that despite the form of PEC's reorganization the substance was a transaction intended to be within the jurisdiction of the Illinois Commerce Commission.89 The intervenors asserted that under the proposed reorganization PEC would be a public utility under Section 10.3 of the Public Utilities Act90 because of PEC's indirect ownership of Peoples Gas and North Shore.

84. The "affiliated interest" provision, § 8a(2), provides:
   The Commission shall have jurisdiction over affiliated interests having trans-
   actions, other than ownership of stock and receipt of dividends thereon, with
   public utilities under the jurisdiction of the Commission . . . .
85. Peoples Energy Corp. v. Illinois Commerce Comm's, No. 81 CH 6768, slip op. at 5
   (Cir. Ct. of Cook County, Ill. Nov. 19, 1982).
86. Id.
87. Plaintiff's Brief In Support Of Complaint For Injunctive And Declaratory Relief
   at 28, Peoples Energy Corp. v. Illinois Commerce Comm'n, No. 81 CH 6768, (Cir. Ct. Cook
   County, Ill. Nov. 19, 1982).
88. The intervenors were the South Austin Coalition Community Council, Inc., Business
   and Professional People for the Public Interest, People of Cook County ex rel.
   Richard M. Daley, State's Attorney of Cook County, City of Chicago, Governor's Office
   of Consumer Services, People of the State of Illinois.
89. Peoples Energy Corp. v. Illinois Commerce Comm'n, No. 81 CH 6768, slip op. at
   6-9 (Cir. Ct. Cook County, Ill. Nov. 19, 1982).
90. The pertinent provision of the Act defines a public utility as:
   [E]very corporation, company, association, joint stock company or association,
   firm, partnership or individual, their lessees, trustees, or receivers appointed
   by any court whatsoever that owns, controls, operates or manages, within this
   State, directly or indirectly, for public use, any plant, equipment or property
   used or to be used for or in connection with, or owns or controls any franchise,
   license, permit or right to engage in . . . the production, storage, transmission,
Gas and North Shore and thus should remain subject to the Commission's jurisdiction. Additionally, the intervenors argued that the proposed reorganization, if permitted, might result in less reliable service, increased natural gas utility rates, and a possible loss of certain financial and physical assets which Peoples Gas and North Shore allegedly included in their rate bases.

Nonetheless, the Circuit Court held that under these circumstances the Illinois Commerce Commission could not assert jurisdiction over PEC or PEC's reorganization. The court observed that holding companies of Illinois public utilities had never been treated by the Illinois Commerce Commission as public utilities. The court found that although PEC had historically been treated as an "affiliated interest," the corporate reorganization was not a transaction with a public utility. Therefore, the Illinois Commerce Commission lacked jurisdiction under the "affiliated interest" statutory provision. PEC's avowed purpose of avoiding Commission jurisdiction, the court implied, was wholly irrelevant. The PEC divestiture took place on November...

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91. Peoples Energy Corp. v. Illinois Commerce Comm'n, No. 81 CH 6768, slip op. at 6-9, (Cir. Ct. Cook County, Ill. Nov. 19, 1982).
92. Id. The intervenors feared that utility assets might be transferred to non-utility ventures, resulting in a reduction of the utility's rate base and possibly an increase in rates.
93. Id.
94. Id.
95. The court held the fact that a particular company controls a public utility an insufficient basis to establish the Commission's jurisdiction over that company. The court based its reasoning on past ICC interpretation of the Illinois Public Utilities Act: the ICC historically had treated the PEC as an affiliated interest although the ICC was aware of indicia of PEC's control over its utility subsidiaries, including PEC's ownership of the stock of Peoples Gas Light, North Shore, and Natural; when NICOR was established as a holding company over the Northern Illinois Gas Company, the Commission held that NICOR was not a public utility; AT&T was not treated as a public utility by the ICC despite that holding company's stock ownership in Illinois Bell; and over the past 14 years, the ICC consistently declined to treat holding companies of public utilities as public utilities. Id. at 95.
96. Id.
97. Id. at 90.
98. Id.
99. Id. at 91.
30, 1981. The intervenors are presently appealing the circuit court decision.\textsuperscript{100}

This case illustrates the problems with attempting to exercise commission jurisdiction solely through the use of “affiliated interests” statutes. Although the purpose of affiliated interests statutes is to permit public service commissions to regulate key utility transactions, commissions can nonetheless find themselves in the position of lacking the statutory authority to exercise jurisdiction over the most material transaction of all, the divestiture of a utility. Although public utility law in Illinois currently provides for public service commission jurisdiction over certain transactions in which a utility is directly involved, the commission still lacks the statutory flexibility to involve itself in transactions having direct repercussions on utilities even when those transactions fall within the spirit of Illinois public utility law.

\textit{Jurisdiction of New York Public Service Commission Over Proposed Reorganization of Rochester Telephone Corporation}

In \textit{Joint Petition of Rochester Telephone Corp., Rotelcom, Inc. and Rotelcom Subsidiary, Inc.},\textsuperscript{101} the New York Public Service Commission refused to permit a utility to form a holding company for the purpose of diversification.\textsuperscript{102} On April 8, 1976, the Rochester Telephone Corporation (“Rochester Telephone”), Rotelcom, Inc. and Rotelcom Subsidiary, Inc. (“petitioners”) filed a petition with the New York Public Service Commission (“Commission”), seeking authorization for reorganization.\textsuperscript{103} Rotelcom, Inc. was organized for the express purpose of serving as a holding company after reorganization, while Rotelcom Subsidiary, Inc. was organized to

\textsuperscript{100} Id.


\textsuperscript{102} The New York commission was apparently motivated by the desire to avoid the situation experienced in Michigan and Illinois, that is, the inability of public service commissions to exercise jurisdiction over a utility because it is held by a holding company.

\textsuperscript{103} March Opinion, \textit{supra} note 101, at 1. Rochester Telephone was a public utility providing telecommunication services to the Rochester area.
facilitate the proposed reorganization. Petitioners claimed that Rochester Telephone was suffering capital stagnation under the existing corporate structure and that Rochester Telephone's financing capabilities would be enhanced if petitioners were permitted to organize an unregulated, diversified holding company. Under the plan, Rochester Telephone would become a subsidiary of Rotelcom, the holding company.

The Commission denied the petition primarily because the Commission felt that the petitioners could achieve their financial goals without forming a holding company. The Commission feared that an unregulated holding company might use Rochester Telephone's capital in pursuit of diversified interests to the detriment of ratepayers. Approval of the petition, the Commission noted, could well benefit shareholders if successful, but both ratepayers and shareholders would bear the risk of failure. The Commission also predicted that the holding company might become a takeover target. The Commission concluded that the creation of a diversified holding company outside the Commission's jurisdiction would "profoundly impair" the Commission's ability to regulate Rochester Telephone according to the Commission's statutory mandate.

104. Id. at 1 n.1. Technically, the petition was a request for permission to merge the Rotelcom Subsidiary with Rochester Telephone Corporation. After the merger, the Rotelcom Subsidiary would be dissolved, leaving Rochester Telephone a subsidiary of Rotelcom, Inc., the proposed holding company. The reorganization was structured in this manner for tax purposes.

105. Id. at 4. Petitioners did not deny that their operations were financially successful, but argued that they had reached a "zenith" from which they would fall if not permitted to expand. The Commission said it would not respond since petitioners could show neither signs of business stagnation nor indicia of "supposedly imminent financial deterioration." Id. at 6.

106. Id. at 8.

107. Id.

108. Id. at 15.

109. Id. at 4.

110. Id. at 11. The Commission expressed concern that if a holding company were authorized, the respective interests of Rochester and its holding company might differ. The Commission said that Rochester would be obligated to re-evaluate its commitment to reliable service at reliable rates, and that the Commission would be unable to intervene directly because of lack of jurisdiction. Id. at 4.

111. Id. at 3.

112. Id.

113. The Commission reasoned that its ability to regulate Rochester Telephone would be seriously impaired because the holding company's diversification strategy would to some extent influence the cost of capital to the utility. Accordingly, utility rates would become indirectly dependent on managerial discretion. Id. at 10, 11.
that although it would not approve the proposed holding company arrangement, it would not object to another form of utility diversification. The Commission responded that were they to forego the proposed holding company, the Commission would nevertheless lack jurisdiction to allow other methods of diversification. The Commission did not decide that jurisdictional question, but concluded by noting that it would welcome a petition from Rochester Telephone seeking authority to pursue in other ways the goals outlined as the basis for forming the proposed holding company.

The New York Public Service Commission’s response to Rochester Telephone’s application to form a holding company does not represent the best approach to the question because it is too restrictive. With appropriate safeguards, holding companies serve as useful and reasonable corporate structures for conducting a diversified utility business. The Commission’s refusal to allow the arrangement limits corporate growth because utilities and utility ratepayers could be protected from holding company abuses by adequate commission oversight. The mere fact that a utility organizes a holding company does not signal that abuse will inevitably result, but public service commissions should have the statutory authority to exercise jurisdiction when holding companies do disserve ratepayers.

Jurisdiction of Connecticut Public Utilities Control Authority Over Reorganization of Southern Connecticut Gas Company

The State of Connecticut also recently considered the diversification of a public utility holding company in Application of the

114. The Commission stated that it was “clearly” willing to allow Rochester to diversify. The objection was to the proposed holding company, which would result in diversification that might not meet the “public interest” standard called for in administrative proceedings. Id. at 14. In contrast, under Rochester’s present corporate structure, the public service commission had jurisdiction over the scope and direction of the utility’s diversification. Id. at 5 n.1.
115. Id. at 13. Petitioners argued that the provisions of the Public Service Law forbade “telephone corporations” from engaging in activities other than the operation of telephones. Therefore, if the commission would not allow petitioners to form a holding company and diversify under that structure, petitioners would remain a telephone corporation without the legal authority to diversify. Id.
116. Id.
117. Id. at 15.
Southern Connecticut Gas Co. The Connecticut Public Utilities Control Authority's resolution of the public utility holding company issue is perhaps the most equitable of the four cases studied. In this case, the court permitted the utility to form a holding company, but this permission was conditioned on implementation of a number of safeguards.

Unlike Illinois, the Connecticut Commission had statutory jurisdiction to place conditions on the formation of the holding company. It is still uncertain, however, whether the conditions the Commission imposed upon the formation of the holding company in the instant case will apply to future holding companies.

On August 30, 1977, the Southern Connecticut Gas Company ("Southern") filed an application for corporate reorganization with the Connecticut Public Utilities Control Authority ("PUCA"). Southern asked for authorization to change its corporate structure from a gas utility with subsidiaries to a holding company with utility and non-utility subsidiaries. At the time the application was filed, Southern was a gas distribution company with six subsidiaries. Two of the subsidiaries, SCG Gas Quest, Inc. and Resource Production, Inc., were organized for the purpose of drilling and exploring for oil and natural gas. These subsid-

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119. Id. at 29-34.
120. A Connecticut statute provides that a holding company may not be formed over a utility without public service commission approval. The statute provides in relevant part:
   (b) No gas, electric, water, or community antenna television company, or holding company ... shall interfere or attempt to interfere with, or directly or indirectly, exercise or attempt to exercise authority or control over any gas, electric, water or community antenna television company incorporated by this state ... without first obtaining the approval of the department of public utility control ... .
   (c) No corporation ... or similar organization, or person shall take any action that causes it to become a holding company with control over a gas, electric, water or community antenna television company incorporated by this state ... or take any action that would if successful cause it to become or to acquire control over such a holding company, without first obtaining the approval of the department.
   CONN. GEN. STAT. ANN. § 16-47 (West 1982).
121. Connecticut Decision, supra note 118, at 1.
122. Id.
123. Id. at 17.
124. The remaining subsidiaries include ECON, Inc. (general contractor and building
rieries had discovered millions of dollars worth of oil and gas reserves in Ohio and New York.\textsuperscript{25} Southern initially justified these ventures to PUCA by arguing the necessity of maintaining some measure of control over its supply of gas, since its major pipeline suppliers had indicated uncertainty as to their ability to provide Southern with adequate supplies in the future.\textsuperscript{26} At the same time, Southern argued that the pre-reorganization corporate structure of the company exposed ratepayers to possible "detrimental effects" should any of the non-utilities fail.\textsuperscript{127} Organization of a holding company for Southern and its subsidiaries as sisters would purportedly benefit ratepayers by shielding them from the risk of non-utilities' failures.\textsuperscript{128} In addition, the new corporate structure would allow the exploration and production subsidiaries to escape the restrictions of Southern's Certificate of Incorporation,\textsuperscript{129} and would assure gas supplies at reasonable costs.\textsuperscript{130} Moreover, Southern argued that diversification would enable these subsidiaries to enjoy a more favorable reception in the financial community.\textsuperscript{131}

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\textsuperscript{127} Id. at 6.

\textsuperscript{128} Southern reasoned that ratepayers would be better protected under the holding company arrangement because the failure of the non-utility venture would have little or no impact on a separate utility subsidiary. If the non-utility venture was a Southern subsidiary, however, and that venture failed, ratepayers might bear at least part of the loss in the form of higher rates. Id. at 7. Southern apparently assumed that the possible failure of the holding company's non-utilities would have no impact on the utility subsidiary.

\textsuperscript{129} Southern argued that since Southern's bond indenture prohibited its subsidiaries from borrowing from any source other than Southern and because Southern's bond indenture and certificate of incorporation in turn limited Southern's own borrowing, Southern's drilling and exploration subsidiaries were prevented from securing the funds necessary to achieve their purpose of providing Connecticut ratepayers with an adequate and reasonably priced natural gas supply. Id. at 6.

\textsuperscript{130} Id. at 12.

\textsuperscript{131} Southern reasoned that one economic benefit to shareholders would be the distrib-
In the PUCA hearing regarding Southern's application, Connecticut's Office of Consumer Counsel ("Consumer Counsel") intervened to maintain that Southern's application should be granted only if the granting order were subject to the Consumer Counsel's thirty-five conditions.\footnote{Consumer Counsel Brief, supra note 125, at 6.} These conditions were designed to protect ratepayers and to preserve much of PUCA's regulatory jurisdiction.\footnote{Id. at 9-16.} The Consumer Counsel contended that the true purpose of Southern's proposed reorganization was to isolate profits accruing from unregulated oil and gas discoveries and to funnel them to Southern shareholders, who would become shareholders of the parent company under the proposed reorganization.\footnote{Id. at 9.} Southern ratepayers funded the original exploration, the Consumer Counsel said, and therefore should share in the profits.\footnote{Id. at 5.} The Consumer Counsel also argued that the holding company structure would not protect ratepayers from financial risk, since the financial health of a subsidiary is related to the financial health of the parent.\footnote{Id. at 35.} If the non-utility subsidiaries failed, the result could be an increase in utility rates. The Consumer Counsel also observed that while one of Southern's purposes in expanding oil and gas production efforts was to assure Connecticut ratepayers an adequate gas supply, it was not clear whether federal law would permit Southern to bring gas found out of state back to Connecticut,\footnote{Id. at 17.} rendering this goal inapplicable.

The Consumer Counsel maintained that PUCA should address the fact that Southern, prior to applying for permission to form a holding company, had created its subsidiaries without PUCA's authorization.\footnote{Id. at 7.} Southern's subsidiaries should remain subject to shareholders of retained earnings that had been formerly used for subsidiary investment purposes. \textit{Id.} at 9-16.

Aside from the twenty-one conditions PUCA eventually adopted in this case, the Office of the Consumer Counsel proposed 35 conditions, including that no new parent companies, subsidiaries or affiliated corporations be organized in the existing holding company structure without prior PUCA approval; profits from any discoveries made before the incorporation of the holding company be shared equally with Southern's ratepayers; a system be developed for the equitable allocation of common costs; and the holding company at all times own 100% of its subsidiaries. \textit{Id.} at 48-54.
to PUCA jurisdiction, the Consumer Counsel argued, and Southern should not be allowed to organize new subsidiaries without PUCA approval. Finally, the Consumer Counsel proposed that should PUCA authorize the holding company arrangement, PUCA should retain the right to inspect all books and records of the holding company, subsidiaries and any affiliated companies. This would enable PUCA to discover any attempt by Southern to cross-subsidize, construct improper financing, or wrongfully transfer utility assets.

PUCA granted Southern’s application to form a holding company, stipulating that it would analyze Southern’s rate hike applications without considering the financial fortune or misfortune of Southern’s sister subsidiaries. PUCA made its decision subject to a number of conditions. First, Southern was to be given first opportunity to purchase any gas found by a sister subsidiary. Second, non-utility subsidiaries were not to be organized unless functionally related to Southern. Third, the holding company had to be incorporated in the state of Connecticut. Fourth, the books and records of the holding company and its subsidiaries were subject to PUCA inspection. Finally, PUCA conditioned its decision on Southern’s agreement to subject holding company operations to PUCA review. If PUCA decided that the continued operation of the holding company was not in ratepayers’ best interests, PUCA could amend operating conditions or even dissolve the holding company.

PUCA’s treatment of Southern’s diversification is an equitable resolution of the competing parties’ interests. In granting Southern’s application, PUCA apparently believed that any disadvantages in the holding company arrangement were outweighed by

139. Id. at 8.
140. Id. at 48. PUCA’s review of the organization of new subsidiaries would ensure that subsidiaries are not improperly financed and that utility assets are not transferred.
141. Id.
142. Id. at 53.
143. Connecticut Decision, supra note 118, at 32.
144. Id. at 29.
145. Id. at 32.
146. PUCA stipulated that the holding company be incorporated in Connecticut, thus becoming subject to the Connecticut statute CONN. GEN. STAT. ANN. § 16-47 (West 1960 & Supp. 1982), which provides for administrative review of utility holding company activity. Connecticut Decision, supra note 118, at 32.
147. Id. at 31.
148. Id. at 33.
the advantages ratepayers would enjoy, and that continued monitoring would protect the interests of Southern’s ratepayers against possible abuses. PUCA’s assent to the proposal helps to ensure that Southern’s ratepayers can rely on the utility’s ability to secure adequate gas supplies. In addition, implementation of a diversification strategy enables Southern to attempt to build a broader financial base. At the same time, PUCA’s imposition of conditions protects ratepayers. PUCA’s dictate that any non-utility subsidiaries organized must be functionally related ensures that the utility builds on its expertise instead of engaging in unfamiliar and risky endeavors. While the requirement that the holding company be organized in Connecticut operates to protect against evasion of state control, the condition that books and records shall be open to Commission inspection protects against cross-subsidization and improper financing. Finally, PUCA provides for Commission flexibility by reserving the right to amend operating conditions if necessary. The primary inadequacy of PUCA’s response is the uncertainty that the protective conditions ordered by PUCA will apply to future utility diversifications absent public interest group pressure.

FEDERAL JURISDICTION OVER INTERSTATE PUBLIC UTILITY HOLDING COMPANY DIVERSIFICATION

Many public utility holding companies are subject to federal as well as state regulation. Public utility holding companies with interstate operations are subject to Securities and Exchange Commission (“SEC”) jurisdiction under the Public Utility Holding Company Act of 1935 (“PUHCA”).149 States may want to consider the PUHCA approach as an alternative model in evaluating their own commissions’ jurisdictional reaches.

149. The Public Utility Holding Company Act of 1935 (“PUHCA”) defines a holding company as

(A) 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. . . .
(B) any person which the Commission determines, after notice and opportunity for hearing, directly or indirectly to exercise . . . such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations . . . imposed in this chapter. . . .


The Securities & Exchange Commission is charged with the enforcement of PUHCA because the Act is geared towards protecting the interests of investors of holding com-
PUHCA was enacted to counter utility holding company abuses,\(^{150}\) including fraudulent accounting practices, manipulation of the security markets, intercompany financing agreements disadvantageous to utilities, and pyramiding practices.\(^{151}\) The act provides for the elimination of unwieldy and practically ungovernable holding companies by giving the SEC authority to order utility holding companies to simplify their operations by reorganization.\(^{152}\) PUHCA was designed primarily to assure the integrity of public utility holding companies,\(^{153}\) not to sound the companies and ensuring that investors have access to adequate and accurate holding company investment information. 15 U.S.C. § 79a (1982). The Act requires holding companies or entities intending to become holding companies to register under the Act with the Securities & Exchange Commission. 15 U.S.C. § 79e(a)(1) (1982).


151. In pyramid schemes, investors in a business profit by persuading other investors to invest in the business. Each new investor finds that the only way to earn a sizable profit in the pyramid is by persuading still others to join the company. Product sales become secondary. See SECURITIES, EXEMPTED SECURITIES, AND SOME KEY DEFINITIONS, 3 SEC. & FED. CORP. L. REP. (CLARK BOARDMAN) § 2.13(2) (1979).

Pyramiding in the context of holding companies generally involves the insertion of a number of holding companies between the controlling interest and the operating properties. The construction of this type of corporate structure converts a normally sound investment into a highly speculative enterprise. C. WILCOX, *PUBLIC POLICIES TOWARD BUSINESS* 364-65 (3rd ed. 1966). The enterprise becomes speculative because an economic setback to any of the corporations in the pyramid can severely impair the entire pyramid's profitability.

152. 15 U.S.C. § 79k (1982). See Phillips v. Securities & Exch. Comm'n, 185 F.2d 746 (D.C. Cir. 1950) (holding company's management bears primary responsibility for framing and adopting reorganization plans); Protective Comm. v. Securities & Exch. Comm'n, 184 F.2d 646, 648, 649 (2d Cir. 1950) (SEC order dissolving holding company upheld, due to SEC's findings that the operating subsidiaries unduly and unnecessarily complicated corporate structure, and that holding company contributed nothing to benefit operating companies); In re LaClede Gas Light Co., 57 F. Supp. 997, 1003 (E.D. Mo. 1944) (SEC authority to order holding company to divest interest in public utility company upheld because of SEC's belief that utility should be recapitalized for purpose of fairly and equitably distributing voting power among shareholders); In re Community Power & Light Co., 33 F. Supp. 901, 914 (S.D.N.Y. 1940) (corporate structure unnecessarily complicated when corporations involved are prevented from performing their functions; corporation had not declared dividends in previous nine years due to debt obligations and other financial problems).

Under PUHCA, the SEC also exercises jurisdiction over holding company transactions such as stock issuances (§ 79f, g); acquisition of interest in electric and gas companies (§ 79h); acquisition of interests in non-utilities (§ 79i, j); intercompany transactions (§ 79j); and service, sales, and construction contracts (§ 79m).

153. See In re United Corp., 232 F.2d 601, 604 (3d Cir.), (purpose of PUHCA to elimin-
“death knell” for these companies.154

Under the statute, all public utility holding companies must register with the SEC155 unless they fall within PUHCA’s liberal exemption provisions.156 A registered utility holding company wishing to diversify must first meet the “functionally-related” test set out in section 79k(b)(1) of PUHCA.157 Under this test, a
utility holding company may not diversify unless the proposed operation is "reasonably incidental, or economically necessary or appropriate to the operations of such integrated public utility system."\(^{158}\) A review of both SEC and judicial decisions reveals that applications to diversify into other energy-related enterprises will likely be granted,\(^{159}\) while applications to diversify into non-utility operations, like housing,\(^{160}\) land development,\(^{161}\) and other non-utility businesses\(^{162}\) will likely be denied. The Act's bias thus appears to be in favor of maintaining integrated holding company systems as well as providing for broad and flexible SEC authority.\(^{163}\)

**The PUHCA Approach**

Although PUHCA can serve for states as one approach to regulating public utility holding companies, it is not an ideal model.

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158. Id.


163. See Comment, Non-Utility Acquisitions Under The Public Utility Holding Com-
First, although the public interest is the nominal basis for the SEC’s decisions, PUHCA’s emphasis is on securities and the protection of investors.\textsuperscript{164} In contrast, ratepayer protection, not shareholder protection, is the primary problem in public utility holding company diversification. State legislation should reflect this purpose.

Secondly, PUHCA’s strict limitations on diversification ignore the reality that many public utilities have engaged in state-approved diversification and will continue to do so in even greater numbers in the future.\textsuperscript{165} The appropriate legislative response would recognize the place for diversification in the utility business\textsuperscript{166} and provide adequate ratepayer protection through regulatory review.\textsuperscript{167}

\textsuperscript{164} See supra note 149.
\textsuperscript{165} See Diversification Fever, supra note 29, at 6 (citing an Edison Electric Institute study). See generally CABOT CONSULTING GROUP, supra note 26.
\textsuperscript{166} For some utilities, failure to diversify might seriously impair that utility’s financial health. One commentator has pointed out that Texaco’s failure to react quickly and constructively to the 1973 oil crisis almost resulted in disaster for that company. By comparison, six other major oil firms facing the same challenge quickly diversified, and did not suffer Texaco’s setback. Lewis & Ross, supra note 2, at 22.
\textsuperscript{167} The SEC’s interest in regulating holding companies is not great. Of 107 public utility holding companies registered with the SEC, 93 are exempt from SEC registration. The SEC’s enforcement of PUHCA has been criticized. In a 1977 study of the SEC’s enforcement of PUHCA, the Comptroller General of the United States concluded that enforcement of the Act was inadequate because many holding companies are engaged in nonutility ventures the Act was intended to prevent. In addition, the SEC lacks an affirmative program to determine whether holding companies’ management are violating the Act, and very few holding companies are monitored under the Act. The Comptroller General’s report also noted that while in the 1940’s 234 SEC staff members were charged with enforcement of the Act, that number has now dwindled to less than 25.

According to the SEC, the staff reduction is justified because the Commission believes the Act’s goal of eliminating complex utility holding companies has largely been accomplished. Compare Comptroller General of the United States, Report to the Congress, The Force of the Public Utility Holding Company Act Has Been Greatly Reduced by Changes in the Securities and Exchange Commission’s Enforcement Policies (June 20, 1977) [hereinafter cited as Comptroller’s Report], with Comment of the Securities and Exchange Commission on the Comptroller General’s Report of June 20, 1977, to the Congress on the Administration of the Public Utility Holding Company Act of 1935 (June 30, 1977) reprinted in Comptroller’s Report, id. [hereinafter cited as SEC Comment]. The SEC responded that Congress never intended that utilities remain permanent “federal wards” under the Act, and that “rigorous enforcement” of the Act over the years has resulted in the elimination of most holding company abuses. SEC Comment, at 11. In a follow-up report, the Comptroller General expressed doubts as to whether PUHCA’s purpose has indeed been achieved, and recommended that Congress direct the SEC to undertake a fresh study of the gas and electric utility industry. Comptroller General of the United States, Report to the Congress, The Securities and Exchange Commission’s Regulation of
It is especially important that states respond affirmatively rather than allowing events to shape regulatory jurisdiction in an ad hoc fashion since the provision in PUHCA exempting intra-state holding companies from SEC review presumes that states are exercising adequate regulatory jurisdiction.

Furthermore, two bills recently introduced in Congress to amend PUHCA would provide even broader exemptions for public utility holding companies, which would shift an even greater burden onto states to assure ratepayer protection. Nonetheless, some PUHCA provisions, particularly the reporting and accounting provisions, could serve as models for states.

**STATES' JURISDICTIONAL OPTIONS**

States should provide an appropriate statutory response to utility diversification in order to protect the public interest. Legislatures must recognize that public service commission jurisdiction should extend comprehensively over public utility holding companies and their non-utility subsidiaries. If state legislatures limit state administrative jurisdiction to affiliated interests statutes, holding companies' freedom to exercise independent business judgment will be greater, but public service commissions will not have sufficient access to information to ensure that the public interest is not being disserved by the formation of holding companies.

Nevertheless, a comprehensive grant of public service commission jurisdiction extending over the public utility holding company's non-utility operations must consider the limited levels of funding, manpower and expertise available

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According to the SEC, one of the major purposes of the Act was to make possible state jurisdiction over public utility holding companies by eliminating holding company evasion through the Act's registration provision. SEC Comment, *supra* note 167, at 20.

H.R. 5220, 97th Cong., 1st Sess. (1981); S. 1870, 97th Cong., 1st Sess. (1981). These amendments would operate primarily to facilitate the diversification of public utility holding companies subject to PUHCA.

to commissions for this task. To the extent that resources are not available, neither the public nor the private interest would be served by extending jurisdiction.\footnote{171}{1982 Report, supra note 1, at 29. The office of the chief economist of the Wisconsin Public Service Commission has suggested the following range of regulatory responses to creation of public utility holding companies: regulate only the utility as before; monitor utility holding company transactions; monitor all holding company actions; or regulate the holding company as a public utility. J. Malko, G. Enholm & T. Jaditz, supra note 1, at 45.}

The answer may be found in a middle ground approach: public service commissions should be granted limited jurisdiction over all public utility holding company operations to the extent that non-utility operations affect utility operations. Public service commissions must be able to respond effectively to unexpected and possibly detrimental creativity on the part of public utility holding companies, such as that exemplified in \textit{Peoples Energy Corp.}\footnote{172}{See supra notes 72-100 and accompanying text.} This approach considers both the public’s need for safeguards and the utilities’ need for enhanced business opportunity.\footnote{173}{See supra notes 16-17 and 25-27.} Public utility statutes should provide for public service commission jurisdiction over any proposed reorganizations, so that pre-divestiture transfers of utility assets can be avoided or, at least, remedied.\footnote{174}{See supra notes 118-148 and accompanying text.} The proponents of the reorganization should have to both demonstrate that the reorganization will not harm the public interest and explain the impact of reorganization on public utility services.

In establishing jurisdiction of public service commissions, states should allow them access to the books, records, and accounts of public utility holding companies. This access will allow the public service commission to examine the structure and strategies of the utilities and their subsidiaries. This will also help the public service commissions to assure that utilities are not cross-subsidizing sister subsidiaries; that the level of investment in non-utility subsidiaries is not detrimental to the utilities’ ability to provide optimum services at the lowest possible rates; that common costs are being equitably allocated; that utility personnel are not working for non-utility operations; that public utility services are not eroding; and, generally, that the public is being adequately served despite the holding company
If the public is being disserved, public service commissions should have the authority to order any necessary and reasonable remedial measures, including an order for the dissolution of the holding company.

If the Illinois Commerce Commission had possessed this range of jurisdiction over Peoples Energy Corporation, the Commission would have been able to monitor a reorganization that clearly affected utilities and ratepayers. PEC would have had to demonstrate that the divestiture was in the public interest and address charges that public utility services would falter after the diversification. Similarly, in American Natural Resources Co., the Michigan Public Service Commission would have been able to address adequately the divestiture of Michigan Consolidated Gas Company to prevent the detrimental transfer of valuable utility assets prior to reorganization. In the Rochester Telephone case, the New York Public Service Commission's decision protected the public interest in the short run by refusing the utility's request to form a holding company. Nevertheless, it provided no framework to guide future regulation of public utility holding company diversification. Finally, Connecticut's Public Utility

175. The National Association of Regulatory Utility Commissioners (NARUC) undertook a study of utility diversification in 1982. After a detailed study of diversification of electric, gas, telephone and water utilities, NARUC issued recommendations including these and other additional suggestions for regulatory bodies to consider. 1982 REPORT, supra note 1, at 80-83.

On March 10, 1982, the State of New Mexico enacted an act designed to guard against some of the dangers of utility diversification. 1982 N.M. LAWS 109. The act provides that state public service commission can require a public utility holding company to produce books and records as necessary to enable the commission to determine whether the transaction in question might adversely affect the public utility (§ 62-6-17(B)). The statute stipulates that the information obtained can be used only to determine the transaction's impact on the utility (§ 62-6-17(C)). The act makes disclosure of confidential or proprietary information a misdemeanor punishable by fine (§ 62-6-17(E)). § 62-6-19(D) gives the commission the authority to issue orders necessary to assure against cross-subsidization or improper cost allocation.

In 1982, the State of Maine amended its statute to subject public utility diversification to comprehensive public utility commission review. See 1982 Me. ACTS 672. The act's definition of "reorganization" leaves open to determination by the state public utility commission what "public utility actions" constitute reorganization. (§ 104-1(B-1)). The act provides that reorganizations must be approved (§ 104-3(A)) and that commission approval of public utility reorganization is to be conditioned on considerations including: (1) the right of the commission to reasonable access to the books and records of the utility and any of the utility's affiliates (§ 104-3(A)(1)); (2) the authority to approve or disapprove transactions between affiliates (§ 104-3(A)(2)); (3) assurance that public utility service will not be impaired (§ 104-3(A)(4)); (4) assurance that reasonable limitations will be placed on non-utility investments (§ 104-3(A)(7)); and (5) the right of the commission to order divestiture of the utility if necessary (§ 104-3(A)(8)).
Control Authority exercised a measure of protective jurisdiction over Southern Connecticut Gas Company's diversification, but, again, stopped short of a regulatory framework for addressing future utility diversification and pre-diversification activity.

Public service commission jurisdiction that extends over less than all of the elements of public utility diversification is inadequate to the task. On the other hand, public service commission jurisdiction need not interfere with non-utility operations having only an inconsequential effect on the utility and its ratepayers. Given the appropriate jurisdiction, public service commissions can adapt to utility business changes and learn from experience what sort of public utility holding company transactions require administrative review.

CONCLUSION

Utility diversification is in many instances a prudent business decision, and the creation of a holding company to facilitate that diversification is an increasingly favored strategy. Accordingly, state public utility law must change adequately to address the evolving utility business. The problem comes in striking the proper balance between protecting the public interest and permitting utilities to explore other business opportunities. An attempt to create state administrative jurisdiction over all aspects of the non-utility ventures of public utility holding companies would be counter-productive, because public service commissions have neither the expertise nor the need to pass judgment on multifarious non-utility business decisions. Yet, public service commissions must have the authority to ensure that ratepayers are not disserved by the creation of public utility holding companies. The most judicious course considers both sides' interests. Public service commissions should be permitted sufficient jurisdiction to oversee utility reorganizations and to have access to holding company books and records. This may ensure that utilities and their ratepayers are not the pawns of utility reorganizations, but rather, the beneficiaries.

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