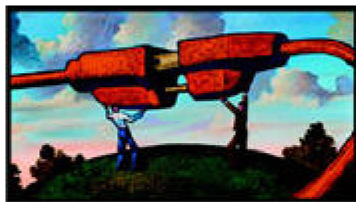

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Overseer's Undercurrent

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Holding Patterns

The California Public Utilities Commission is contemplating substantive changes to its rules governing the relationships between energy utility holding companies and their affiliates. Some of its proposals are certain to elicit howls of indignation from the Big Four IOUs.

Investigations into utility affiliate transaction rules are a cyclical occurrence at the CPUC, as it seems that every major phase of market evolution asserts new challenges to regulatory authority that must be tamed by new rules. In the pre-restructured marketplace of the 1980s and 1990s, the wave of holding-company formations (PG&E Corp., Edison International, and Enova Corporation) and attempted mergers (involving, variously, San Diego Gas & Electric/Tucson Electric Power, Southern California Edison/SDG&E, then the successful Enova/Pacific Enterprises deal that spawned Sempra Corp.) raised major issues of structure and governance.

Utility investments in nonenergy enterprises presented a mixed bag of successes and disastrous failures in real estate and retailing. The creation of nonutility generation affiliates and energy-trading operations raised another set of competitive issues, as did the formation of "energy solutions" companies of many types that were expected to thrive in the new retail marketplace. Then the Western energy crisis and post-Enron shock waves deflated nearly all those grand schemes.

The CPUC's current motivation for looking anew at its affiliate rules stems from the essential elimination of the federal Public Utility Holding Company Act of 1935. "With the loss of PUHCA, this commission has lost one of the protections underpinning its approval of the formation of the holding companies," said the agency [D06-06-062 in R05-10-030].

Merger activity is on the rise, and California's utilities might either acquire or be acquired.

Also, the commission is concerned that potential conflicts of interest are "becoming more widespread" and pose a threat to the state's ability to oversee wholesale competitive markets, environmental protections, or the "first priority" condition of ensuring the financial health and security of the regulated utilities.

Among new rules under consideration are those that might require "ring-fencing" to insulate the utilities from financial risks posed by affiliates. The commission will certainly boost reporting requirements, and it may redefine and further limit the kinds of "shared activities" that are allowed for corporate support, including lawyers and lobbyists. The idea also has been raised of extending current prohibitions against "joint employees" to include contractors and consultants.

No doubt, there will be some proposals to rein in executive compensation and to look at whether affiliate salaries are "so high as to attract utility personnel or induce them to assist the affiliates in order to gain support for a transfer."

But most critical of all, in the commission's consideration, is to make certain that the affiliate rules apply to the holding companies as well as to subsidiaries. I wasn't aware that this was a problem, but according to the commission, the utilities interpret the existing rules as "inapplicable" to their corporate parents. This means that the rules "can be totally circumvented at the top of the corporation, where the significant decisions are made."

Over the next several months, we can expect a paper war of sorts, as parties argue pro and con about these proposed changes to the affiliate rules, culminating in a scheduled October 18 oral argument and a final decision by the end of the calendar year. Interestingly, the CPUC says it does not need to take further evidence in this proceeding but instead will rely on workshops and written comments. Look for a draft set of rules by August 25, then watch the sparks fly.

In the meantime, I thought it might be helpful to take a look at the current structures of the three corporations and their various holdings. Much has changed in the past five years.

Of the three California energy holding companies targeted by this case, PG&E Corporation (PCG) is the easiest to describe. Virtually all that's left after the twin Chapter 11 proceedings is the PG&E utility. Gone are the National Generating Company and the interstate gas pipelines. Left in the dust of bankruptcy were several company shells that would have transferred PG&E's business operations out of state jurisdiction and into exclusively federal oversight. The company's foray into retail energy services - what was it called? - anyway, it has long since been sold off.

There remain some real estate holdings, but the crown jewels of the company, the properties associated with PG&E's hydroelectric portfolio, are now in the hands of a trust - also an outcome of the bankruptcy settlement.

Still, according to the CPUC, PG&E Corp. is "examining new business opportunities in the unregulated sector," and the utility may have new affiliates in the near future.

Edison International (EIX) is a misnomer. The global enterprise that once was the Mission Energy Holding Company was mostly sold off or shuttered by late 2004, with its domestic assets restructured into Edison Mission Energy (EME). As far as I can tell, the sun still sets on the Mission empire at an Istanbul power plant and a Singapore office.

The majority of EME projects are right here in California, including the controversial acquisition of the Mountainview power plant in 2005. After a huge $666 million loss in 2004, Mission Energy contributed more than $322 million in profits last year.

Otherwise, the latest additions to the EIX portfolio are about 30 small wind partnerships (1.25 MW to 2 MW each) and related transmission facilities in Minnesota, plus a planned 120 MW wind farm in New Mexico. And something in Iowa, though I cannot figure out exactly what EMOM Services is or does.

At one time there was a diversified Edison Enterprises venture, offering everything from home security systems to electric battery recharging for forklifts. There were high hopes for retail sales, O&M services, high technology, and even refrigeration subsidiaries. All are gone. Arguably, the most successful of the corporation's enterprises has to be Mission Capital, which has made steady profits ($91 million in 2005) from providing loans and affordable housing.

Of all the utility holding companies, only Sempra can claim unqualified success in its lesser-regulated ventures. Even so, Sempra has reorganized its holdings multiple times in the past five years, trying to achieve a more simplified construct.

Besides the SDG&E and SoCal Gas utilities (which, mark my words, will eventually be reorganized into a single gas distribution utility and a separate local electric utility), there are five major

affiliates bearing the Sempra brand: Commodities, Generation, Pipelines & Storage, Financial, and LNG. Each, except for Sempra LNG, has been profitable for at least the past three years. LNG is still losing money, but the company believes it will be a major revenue generator within five years.

The Sempra corporate parent also records a loss each year, but that's because it incurs only costs, taxes, and litigation. Big plans are in the works; Sempra projects as much as $10 billion in capital expenditures over the coming decade, $6 billion for the utilities and more than $4 billion for LNG, pipelines, and power plants. The corporation has become the global enterprise that Edison wanted to be.

Sempra Commodities, the energy trading arm, is of particular interest, having earned more than $460 million last year - nearly as much as the two utilities combined. While Sempra occasionally makes noises about selling off the trading operations (regulatory life might be simpler if it did), the unit is a major cash cow, with "unrealized revenues" for trading activities of nearly $1.5 billion on its books. A couple of years ago, then-CEO Steve Baum said that 90 percent of those unrealized revenues turn into cash within two years.

That's the current state of the holding companies. They certainly are not "your father's utilities," nor are they the companies their executives set out to create a decade ago. They are evolved survivors of a unique and challenging period in the history of the energy industry.

Maybe the CPUC is correct; perhaps new circumstances warrant revisiting and revising the regulations. But it ought to be apparent that each company is different in ways that standardized strictures might not fit. And there's always the likelihood that by the time new regulations take effect, a whole new reality will be upon us.

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