

Don't Fence Me Out

Hard-and-fast ring-fencing rules are not the best way to maintain order in the partially deregulated utility sector.

BY STEVE FETTER



Steve Fetter

In 1992, my colleagues on the Michigan Public Service Commission (MPSC) and I initiated the first retail wheeling case in the country. Retail wheeling was the old name for competition, back when everyone thought that moving electrons from one place to another was a relatively simple task, one that could not in any way harbor underlying sinister acts or motives. Oh, how 12 years have changed those perceptions.

I left the MPSC within a year to go to Wall Street, joining the utility ratings group at Fitch Ratings. It took another 10 years to formalize retail competition within the state. Clearly, from the MPSC's view, that was a good thing. It allowed California to bear the brunt of the ills that often inflict a first mover on radical innovation. But what followed at Enron put the entire energy sector on edge and led to discussions about means to avoid those pitfalls in the future.

At the state level, policy-makers have started to consider the appropriateness of using ring-fencing to protect a regulated utility's operations from that same company's competitive activities. Ring-fencing is defined as the legal walling off of certain assets or liabilities within a corporation, as in a company forming a new subsidiary to protect (ring-fence) specific assets from creditors. Most of the ring-fencing protections to date

have followed utility stress situations or have been implemented within the context of a utility merger or acquisition. While I, as a former state regulator, can see the apparent appeal of some of the ring-fencing proposals that have been bandied about, as a former Wall Street utility analyst, I also possess the cautionary worry that hard-and-fast statutes and rules are not the best means to maintain order within the partially regulated/partially unregulated utility sector.

That is also why I differ with views expressed by my good friend Dr. Fred Grygiel and his colleague John Garvey, economists at the New Jersey Board of Public Utilities, in the August issue of the *Fortnightly* ("Fencing in the Regulated Utilities," August 2004, p. 32).

For instance, I do not think any commission in the country—certainly not the MPSC—could have imagined moving ahead on competition if strict barriers were to be erected between the regulated and unregulated activities of a company, including prohibition of the long-expected consumer benefits that would flow from legitimate cost-sharing and close interaction among all members of management. Issues such as these do not require a "legal ring-fencing" as much as call for the establishment of fair and well-defined affiliate relations guidelines suited to the characteristics of the utility companies within a particular jurisdiction.

During my tenure as a commis-

sioner, no regulators in any state wanted to have their authority usurped by their own state legislature. Indeed, those same regulators would not have wanted to promulgate their own rules that sought to lock in limits on a regulated utility's activities based upon what policy-makers believed the future would hold.

Unfortunately, the California and Enron debacles have put enormous pressure on policy-makers, both appointed and elected, to do something, anything, to ensure that such episodes do not happen again. Within that atmosphere, I fear that many regulators might think the safest thing to do is severely limit what utility management can do within the regulated and unregulated spheres, accepting that predicting the future is a wholly unavailing proposition.

The one bright sign I do see (though not without the cost of a drag on internal company productivity) is that virtually all regulated utility companies already are subject to federal oversight under the Sarbanes-Oxley Act of 2002. The intent of this new law is to bolster public confidence in U.S. capital markets by imposing new duties and significant penalties for non-compliance on public company executives, directors, auditors, attorneys, and securities analysts. Areas of focus include auditor and audit committee independence, CEO and CFO certification of the truth and accuracy of financial filings, enhanced internal controls and financial disclosure, greater whistleblower protections, and criminal fraud accountability with increased penalties.

Speaking as audit committee chairman of a partially regulated/partially unregulated utility and energy company, I have witnessed firsthand the enormous efforts required of utility management, board members, »

and independent auditors to ensure compliance with that law's requirements. It seems to me that, before state or federal policy-makers hurry to add newer mandates to these, we should allow Sarbanes-Oxley to play out and hopefully provide its intended accountability results.

Indeed, given the events of the last few years, I would expect shareholders, the owners of the enterprise, to play a more active role in monitoring the activities of the management team. I do not believe that we need additional government-mandated checklists to ensure that no regulated utility company, no matter how big or small or where located in the United States, ever becomes the next Enron. Rather, this goal will be better achieved by a return to the mutual respect (albeit with a measure of wariness) that existed between utility regulators and company leadership during the days of, dare I say it, the regulatory compact.

The Regulator's Cardinal Rule

As a state regulator, I lived by one cardinal rule: The best consumer and investor protection is open and frank communication between regulators and utility management. Such a course is far superior to trying to put into place statutory or regulatory policies and limitations aimed at dealing with future unknowns. As a bond rater, I continued to recommend such a path to my former regulatory colleagues, and now, as an energy consultant, I advise my utility clients of the wisdom of such a strategy.

That's not to say there aren't ring-fencing concepts to which I would subscribe today. Separate accounting for regulated revenues and expenses clearly makes sense, as does providing regulators with the access to books and records necessary to carry out their oversight role of the regulated utility, wherever that information happens to

reside (and, nowadays, that locus might very well be outside the United States). The corollary to that rule, however, is that regulators, within their role as consumer protectors, should not be permitted to prospect through the books and records underlying the proprietary activities of the unregulated holding company or other subsidiary.

Corporate structural separation (i.e., through a holding company structure) also is a benign means of segregating risks between regulated utility operations and a company's unregulated activities. Under this path, while regulators can offer input as to appropriate direction, company management has the ultimate say in how best to structure its operations for both productivity and for achieving those public policy aims. This gets back to my cardinal rule about clear communication and mutual respect.

Also, after negative occurrences at a particular jurisdictional utility threaten a regulated utility's financial viability, regulators might wish to mandate a certain percentage level of equity to ensure the financial health of that utility going forward. Of course, regulators should monitor the timing and nature of their involvement in a company's internal affairs. It would make sense for regulators periodically to check on the affected utility's progress toward a return to financial health, as well as changing industry circumstances, with an eye toward alleviating or eliminating such mandated company conduct.

I would warn regulators, however, that expanding that notion to company dividend policy is a risky step. The ability of investors to rely on a utility management's expected dividend policy is at the center of investment strategy within the utility sector. To leave that issue up to quarter-by-quarter review, analysis, and approval by regulators would cut to the core of utility investment strategies and likely would increase investor con-

cerns and thus reduce a utility's value in their eyes. Indeed, the uncertainty that would accompany such interference likely would render the maintenance of a certain equity level a much more difficult task. In addition, such a move could result in the negative consequence of making access to equity financing, one of a utility's key financing vehicles, more costly and perhaps, in times of stressed conditions, totally unavailable. The mere setting of a required equity level should be enough. Let the company manage revenues, expenses, and dividends to meet such stricture.

Finally there should be some relationship between an entity's assets and its involvement with loans, guarantees, and the like. I believe regulators have an appropriate oversight role with regard to the use of regulated assets to stand behind riskier transactions at an unregulated affiliate. Such unregulated activities should not be permitted to jeopardize the financial health of the regulated utility and certainly should never threaten to place that entity into bankruptcy.

To sum up, in times of stress due to financial setbacks or pending merger issues, regulatory ring-fencing or internal company structural separation can serve a beneficial purpose. But beware! Predicting the future is an impossible task: Utility regulators should hesitate before putting policies in place today that limit managerial discretion in the future, based upon the belief that they possess that ability. ■

Steve Fetter has served as chairman of the Michigan Public Service Commission and was former head of the utility ratings practice at Fitch Ratings. He currently runs Regulation UnFettered, a New Jersey-based energy advisory firm, and serves on the board of directors and as audit committee chairman at CH Energy Group. Contact him at RegUnF@comcast.net.