

COMMISSION STAFF
ANALYSIS
OF
RING-FENCING MEASURES
FOR
INVESTOR-OWNED
ELECTRIC AND GAS UTILITIES

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I. INTRODUCTION TO RING-FENCING

“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.”¹ Ring-fencing as a concept includes a number of measures that may be implemented to protect the economic viability of utility companies and their affiliates within a holding company structure. Ring-fencing measures are intended to insulate a regulated utility from the potentially riskier activities of an unregulated affiliate.² Insulating the utility is intended to ensure the financial stability of the utility and the reliability of its service.

As the electric energy industry and markets have been restructured in the U.S. over the last decade a number of issues have arisen with respect to the continued viability of the regulated activities of the utilities. Related to these viability issues is a concern for the continued reliability of electric and gas service to customers. The viability issues arose when vertically integrated generation-transmission-distribution companies changed their corporate structure to conform to new market structure and regulatory requirements. One unintended result is that these alternative corporate structures have created opportunities for affiliates to engage in unregulated activities that may place individual

¹ Fetter, Steve. *Don't Fence Me Out*, Public Utilities Fortnightly, October 2004, pages 20-22, at 20.

² It should be noted that ring-fencing can both fence “in” and fence “out” unwanted financial entanglements within a holding company structure. Thus, although the concept of ring-fencing is usually discussed in terms of measures that can be used to protect a utility company; ring-fencing measures can also be used by a holding company to protect a valued affiliate (such as an energy marketer or trader) from the perceived weaknesses of a utility affiliate. E.g. PG&E and Edison International implemented ring-fencing measures to protect certain energy and marketing affiliates from the regulated utility companies PG&E and Southern California Edison, respectively, during the California energy crisis of 1999-2001.

utility (“wires”) companies at increased financial risk. Consequently, customers may also be placed at risk in terms of continued reliable and reasonably priced (“just and reasonable”) electric or gas service.

The holding companies that own regulated utilities that operate in Maryland are involved directly or through wholly-owned subsidiaries in unregulated activities, i.e. the parent or subsidiaries are not subject to regulations or oversight of the Maryland Public Service Commission (the “Commission”). Also, a regulated utility may itself have subsidiaries or divisions that engage in unregulated activities. These unregulated activities may be riskier than the regulated activities and may result in losses to the affiliates or the utility’s subsidiaries, which should not be borne by the utility’s customers. Unregulated affiliate companies within a holding company can cause financial difficulties to the corporate parent that can lead to bankruptcy. Thus, it may be necessary for state commissions or state legislatures to consider policy measures to protect or ring-fence the utility companies in that state.³

A key difficulty in establishing ring-fencing measures through regulatory or legislative action is the fashioning of a narrowly tailored response that meets all of the goals of the ring-fencing measure, but does not unduly inhibit the operations of the utility and its relationship within a holding company structure. This difficulty is especially important since the goal of the Commission or the legislature is to act timely instead of reacting to events. We conclude that requiring the utilities to file an annual ring-fencing report should provide the Commission with the opportunity to act on a perceived

³ The utility companies and their affiliates have an incentive to establish certain ring-fencing measures on their own.

weakness in a utility's "ring-fence" on a case-by-case basis prior to an event that affects the utility's service or the rates charged to its customers.

II. LAWS AND REGULATIONS

The Public Utility Companies Article of the Annotated Code of Maryland ("PUC Article") confers jurisdiction and general powers (§ 2-112) and supervisory and regulatory power (§ 2-113) over utilities on the Commission. The Commission's regulatory power includes the ability to authorize transactions including: a) those that materially affect a franchise; b) acquisition of the stock of a utility incorporated in Maryland; c) assumption or guarantee of an obligation or liability by a Maryland corporation; and d) financing activities related to capital structure. The Electric Restructuring Act, Sections 7-501 through 7-518, addresses many affiliate issues affecting electric utilities. The Commission's regulations, Code of Maryland Regulations ("COMAR") Title 20, also provide certain ring-fencing protections.⁴

In addition to the current statutory and regulatory provisions, the Commission has drafted, with stakeholder participation, draft COMAR Subtitle 49. Subtitle 49 would prescribe an affiliate code of conduct for electric and gas companies.⁵ These draft regulations address loans, financial guarantees, and asset transaction issues.⁶ The draft

⁴ Relevant sections of the PUC Article and COMAR are set forth in Appendix A.

⁵ In Case No. 8820 the Commission addressed affiliate code of conduct issues as required by the Electric Customer Choice and Competition Act of 1999. However, in *Delmava Power v. PSC*, 370 Md. 1 (2002), the Maryland Court of Appeals vacated Commission Order No. 76292 on the grounds that the Order contained rules of general applicability, which under the Administrative Procedures Act must be adopted through the rulemaking process.

⁶ Relevant sections of the draft regulations are set forth in Appendix B.

regulations appeared in the November 29, 2004 issue of the Maryland Register, Volume 31 • Issue 24.⁷

The requirements of the Public Utilities Holding Company Act of 1935 (“PUHCA”) and the Sarbanes-Oxley Act of 2002 also protect the utility companies’ customers. According to Fitch Ratings, “PUHCA is intended to limit abuses by holdcos [holding companies] and prevent cross-subsidization of nonregulated businesses by regulated entities. Holdcos are regulated on matters including company structure, intercompany loans, reporting, acquisitions and issuance and sale of securities.”⁸ The registered holding companies, whose utilities operate in Maryland, are AGL Resources, Inc., Allegheny Energy Inc., NiSource Inc., PEPCO Holdings Inc. and WGL Holdings, Inc.⁹ The repeal of PUHCA, which has been proposed in recent years, would remove certain requirements and reduce federal oversight of the currently registered holding companies. However, the repeal of PUHCA would not change the conclusions and recommendations of this paper, which are based on the aggregate effect of all of the ring-fencing measures.

Sarbanes-Oxley imposes new duties on public companies including: audit committee independence, chief executive officer and chief financial officer certification of the truth and accuracy of financial filings, assessments on internal controls, enhanced financial disclosure, additional whistleblower protections, criminal fraud accountability,

⁷ Since this paper was presented initially to the Commission, the proposed Subtitle 49 has been withdrawn, but the draft regulations remain in the paper for discussion purposes. Some of the provisions of the draft regulations are still applicable in the context of ring-fencing pursuant to Commission Order No. 74038 in Case No. 8747.

⁸ Bonelli, Sharon, Yee, Mona and Lapson, Ellen. *Rating Linkage Within U.S. Utility Groups: Ring-Fencing Mechanisms*, Fitch Ratings Global Power/North America Special Report, April 8, 2003, at 2.

⁹ There are other holding companies whose utilities operate in Maryland, which are not registered under PUHCA.

and white-collar crime penalty enhancements.”¹⁰ These federal statutes enhance the protections created by ring-fencing measures, by specifically creating a more transparent environment that enables the Commission, shareholders and other governmental entities to monitor the activities of the utilities, the parent holding companies and their unregulated subsidiaries.

III. RING-FENCING MEASURES

In determining which ring-fencing measures to implement, the person contemplating implementation, e.g. a regulator or the company, must determine what benefit is sought through implementation of ring-fencing measures. Principally, ring-fencing measures can serve to protect the financial viability of a utility company, which operates in a franchise service territory in a state, by creating a financial buffer for that utility company. The most often mentioned benefits of ring-fencing are bankruptcy protection and credit ratings separation.

In the literature on ring-fencing numerous measures are discussed as possible solutions for these issues. These include: (1) capital structure requirements, (2) dividend restrictions, (3) unregulated investment restrictions, (4) prohibitions on utility asset sales, (5) collateralization requirements, (6) working capital restrictions, (7) prohibitions on inter-company loans, (8) maintenance of stand-alone bonds, and (9) independence of board members.¹¹ These measures are discussed below.

¹⁰ The Sarbanes-Oxley Act applies to companies that are issuers of securities under the Securities Exchange Act of 1934, which includes the utilities and their parent holding companies.

¹¹ See, “*Ring-Fencing*” *A State-By-State Summary*, Regulatory Focus Special Report, October 15, 2003.

A. Capital Structure Requirements

A common regulatory ring-fencing measure is the establishment of parameters on the capital structure such as the minimum/maximum equity or debt allowed in the utility's capital structure. In the case of Portland General Electric ("PGE"), the Oregon Public Utility Commission ("Oregon PUC") established minimum common equity parameters that PGE needed to maintain in its capital structure. The Oregon PUC, as part of its order approving the merger of PGE with Enron Corporation, required that PGE maintain a minimum 48% equity ratio in its capital structure. While this measure, in connection with other requirements imposed by the Oregon PUC that are discussed below, protected PGE during the Enron bankruptcy, PGE still had some difficulty in acquiring short-term debt such as through commercial paper issues.

It should be noted that there are costs to a utility and its customers of setting a relatively high minimum equity ratio (e.g. 48%).¹² One of these costs is simply the higher cost of equity financing vis-à-vis debt financing, which could be sought from customers at the next rate proceeding. Debt financing of on-going business operations is generally less expensive, within certain leverage limits, than equity financing, because debt usually has a lower cost than equity. Currently, equity costs are typically in the 10%-12% range and interest rates on debt issues typically are in the 5%-7% range. Thus on an on-going basis, financing through debt is normally less expensive.¹³

On the other hand, increasing debt can also bring higher costs. The higher overall costs are due to the fact that the equity and debt markets might view the more heavily

¹² For a detailed example showing the effect of a minimum equity ratio on the cost of capital, see Appendix C.

¹³ See Note 1 in Appendix C.

indebted (“leveraged”) company as a higher risk. Consequently, the debt or equity cost rates may be higher for the more leveraged firm, resulting in higher overall capital costs. One of the reasons for higher debt costs would be that a company with 60% debt in its capital structure might be considered over leveraged by a rating agency, such as Moody’s Investors Service (“Moody’s”), Standard & Poor’s (“S&P”) or Fitch Ratings (“Fitch”), and would consequently receive a lower bond or commercial paper rating. A lower rating would more than likely cause the cost of debt to rise.¹⁴ For example, within the past 15 months, PEPCO Holdings Inc. (“PHI”) had some of its corporate debt and some of its utility subsidiary’s (“PEPCO”) unsecured debt rating lowered due in part to persistently high debt leverage that resulted from the PEPCO-Conectiv merger in 2002. Bond rating agencies clearly saw a greater risk to shareholders from PHI’s having a higher than expected debt level.¹⁵

A second cost when instituting equity ratio limits is the potential for cross-subsidization that may result when a utility company is financed with a higher equity ratio than the unregulated affiliates or corporate parent. The cross-subsidization results because the rating agencies will consider the higher equity ratio of the utility a benefit to its affiliate’s or its corporate parent’s debt ratings. The parent or affiliate may be able to maintain the same debt rating even while it has increased its own debt level. The captive utility customers are paying for the increased level of financial security, including lower debt costs, that the corporate holding company has acquired.

¹⁴ See Note 2 in Appendix C. Also, it is reasonable to assume that the cost rates would not change significantly for a more leveraged firm over a given debt ratio range, if that company had a track record of efficient operations and timely payment of debt costs and dividend payouts. For such a company lower cost rates for debt and equity might still be available at higher debt ratios. See Note 3 in Appendix C.

¹⁵ The bond rating agencies also saw some risk to PHI shareholders from the pending Mirant bankruptcy. Mirant held the supply contract for PEPCO’s SOS supply service through June 30, 2004.

Considering what we now know about the Enron bankruptcy, despite the higher costs to PGE's ratepayers from having a minimum 48% equity ratio, the Oregon PUC made the right decision for PGE's customers, bondholders and the Oregon economy by implementing policies that kept PGE financially viable. While, equity ratios in the 40% to 50% range have been considered reasonable for electric utility companies, "choosing" the right number, as a ring-fencing option, may not be the most important decision parameter.¹⁶ Moreover, the so-called "right number" may be determinable only after the fact and may be based more on the result of a lucky guess than on thorough analysis.

B. Dividend Pay Out Limitations

Other measures such as restricting dividend payments to the parent during times of financial stress by the utility company may be appropriate. However, strict and tightly defined measures may need to be developed. Because equity financing is important to any going concern, it is important that investors not be unduly "scared off" with the imposition of highly restrictive dividend or other corporate policy measures. Moreover, because of the potential controversy for instituting this kind of measure, the implementation may have to be left to special circumstances or enacted through legislation.¹⁷

¹⁶ As noted above, ring-fencing is the cumulative effect of a number of implemented measures and, as a result, focusing on a specific equity ratio may be inappropriate. In addition, a specific equity ratio may not be appropriate for different utility companies. Finally, as discussed previously, the equity ratio will impact ratemaking.

¹⁷ More than a dozen state commissions/boards have some form of dividend restrictions either under statute or through specific commission orders.

C. Non-Utility Asset Investment Limitations

A third ring-fencing measure, which was instituted by statute in Wisconsin, limits non-utility investments to a certain percentage of the public utility company's assets with certain exceptions. This measure has merit, although using a fixed value, such as the 25% limit used in Wisconsin, would have to be determined to be appropriate by the Commission.¹⁸

In a recent Commission Letter Order, addressing the issue of "Premium Services" proposed by The Potomac Edison Company, the Commission allowed the Company to offer these services as non-regulated services. However, the Commission reserved its authority to take action if the Company's non-regulated business activities adversely affected the utility's duties in the provision of regulated utility services. The Commission directed the Company to treat the revenues and costs "below-the-line." The Commission, however, did not institute any other restrictions such as a percentage investment limit as in the BGE case noted in footnote 18. The Commission rejected the Company's proposal to tariff the proposed premium services, noting that "[t]he Commission's jurisdiction over utilities' activities is not plenary power over every aspect of a utility company's operation."¹⁹

¹⁸ In a prior Baltimore Gas and Electric Company ("BGE") proceeding (Case No. 8577), Staff recommended a 20% cut-off for non-utility investments, which was the then existing level of non-utility investment by BGE. The Commission did not adopt this restriction in its Order. *See Re Baltimore Gas and Electric Company* 86 MD PSC 225, (1995).

¹⁹ Footnote one of the Letter Order dated March 30, 2004. *See, Chesapeake & Potomac Telephone Company of Maryland, et al. V. Maryland/Delaware Cable Television Assn., Inc.* 310 Md. 553, 565 (1987).

D. Limitations on Asset Transfers and Cross-Collateralization²⁰

Certain ring-fencing measures can be implemented to limit affiliate transactions, including asset transfers, as well as inter-company loans and guarantees of affiliate transactions, which may financially impair the utility companies. The draft affiliate regulations, discussed in Section II, would provide some ring-fencing protections from these transactions.

Draft COMAR 20.49.02.05C sets forth rules regarding asset transactions. An “asset” is defined in draft COMAR 20.49.01.03B (1) as “tangible property of a type normally included in the rate base of a utility.” Draft COMAR 20.49.01.03B(2) defines asymmetric pricing as the transfer of an asset from a utility to an affiliate at the greater of book cost or market value, and the transfer from an affiliate to the utility at the lesser of these values. Additionally, draft COMAR 20.49.02.05A exempts transactions between utilities or any operating division of the same utility, which is regulated by the Commission or another state’s utility regulatory body. It should also be noted that under federal law, specifically PUHCA, utilities such as Allegheny Power are required to make asset transfers at cost. Therefore, a utility that is not a PUHCA utility, that transfers a tangible asset to an entity that is not a utility or a division of the utility must use the asymmetric pricing rule if it meets the other requirements of draft COMAR 20.49.02.05C.²¹

²⁰ The draft affiliate regulations discussed in this section have been withdrawn. See footnote 7.

²¹ The regulations relating to asset transfers are set forth in Appendix B.

Draft COMAR 20.49.02.06 addresses utility loans to or debt guarantees for an affiliate. The regulation does not apply to cash management or money pools subject to Federal Energy Regulatory Commission (“FERC”) regulation. (Draft COMAR 20.49.02.06A.) Utilities are authorized to make loans or provide a debt guarantee to an affiliate (draft COMAR 20.49.02.06B) subject to the rules in draft COMAR 20.49.02.06C, D, and E. Those draft regulations are set forth in Appendix B.

IV. RATINGS SEPARATION

If the ring-fencing measures are viewed as effective, or are enforceable as through statute or through a Commission order, rating agencies can rate the debt of that utility company several notches higher than the debt of the holding company.²² In the rating process, the rating agencies are acknowledging that the debt issued by the utility company is “safer” or more “bond-able” than the debt issued by the holding company or any of its other unregulated affiliates. This kind of rating action will generally lower the costs to the utility company for acquiring operating funds through issuing debt.

The credit rating agencies, Moody’s, S&P and Fitch, consider implemented ring-fencing measures in determining whether a utility subsidiary will be consolidated with its parent, i.e. have an identical debt rating for the same type and seniority debt, or receive a different debt rating (notched). PGE achieved a debt rating level 8 notches above the debt rating level of its parent, Enron. Admittedly, this was an extreme example, but is still instructive that debt rating levels for a well ring-fenced affiliate have value, even if only 3-4 notches above the lower rated debt of the holding company. The cost differential

²² A ratings notch is defined as a single step change in ratings, such as from A to A+. A ratings grade is three notches, e.g. a rating increase from BBB to A would be a full grade upgrade.

in terms of debt could be about 50 basis points, which for a \$100 million loan would result in annual cost savings of \$500,000 or \$10 million over the term of a standard loan of 20 years.

Each of the credit rating agencies has developed its own procedures to consider the ring-fencing measures employed by the utilities to determine if the credit rating of a utility should be notched above the level of its parent company. S&P has the “general position that the rating of an otherwise financially healthy, wholly-owned subsidiary is constrained by the rating of its weaker parent.”²³ However, S&P does recognize that “a package of enhancements (including structural features, covenants and a pledge of collateral) may be effective to raise the rating of the subsidiary a full rating category over the credit quality of the consolidated entity.”²⁴ Fitch considers regulatory measures, financial constraints, related party transactions, and organizational and operational factors, including organizational structure and separation of books, finances, boards and management.²⁵ Moody’s favors a regulatory ring-fence that includes restrictions on organizational structure, inter-company loans and guarantees, and dividends, as well as obligations to maintain investment grade rating.²⁶

V. BANKRUPTCY RELATED RISKS

In general there are three risks to utility service that are associated with an affiliate’s financial distress.²⁷ The three risks are: (1) the depletion or encumbrance of

²³ Penrose, Esq., James. *Ring-Fencing a Subsidiary*, Standard & Poors Ratings Direct, October 19, 1999, at page 1.

²⁴ Id. at page 3.

²⁵ See, Bonelli.

²⁶ Baltimore Gas & Electric Company presentation on Ring Fencing to Commission Staff dated December 2, 2004.

²⁷ Saunders, Gary A. *Brave new world of big defaults*, The National Law Journal, August 18-25, 2003.

the assets of the utility; (2) that a parent may cause a healthy utility subsidiary to enter bankruptcy; or (3) that a bankruptcy court may consolidate the assets and liabilities of a healthy utility subsidiary with its affiliate in bankruptcy.

A financially distressed parent, or a parent on behalf of another financially distressed subsidiary, “may have the ability and the incentive to deplete the assets of the utility subsidiary or encumber it with liabilities.”²⁸ Since the parent often controls the board of directors of the utility subsidiary, the board may cause the utility subsidiary to declare a dividend, transfer assets, increase its borrowings or guarantee the obligation of an affiliate.

In the extreme case, the affiliate or parent may declare or be forced into bankruptcy, which may have consequences on the ability of the utility to provide uninterrupted service to its customers. The parent may cause the board of directors of its financially healthy utility subsidiary to file for bankruptcy, pursuant to the utility’s charter or bylaws, and join the utility in its affiliate’s bankruptcy proceeding. Also, a “bankruptcy court might find it appropriate to substantively consolidate the assets and liabilities of the financially healthy subsidiary with those of its insolvent parent and treat them as if all assets and liabilities belong to one entity.”²⁹ However, even though a bankruptcy court has the authority to consolidate, there does not appear to be any cases in recent decades where a utility operating in the United States and its holding company parent or affiliate were consolidated in bankruptcy.³⁰

²⁸ *Id.* at 2.

²⁹ *Id.*

³⁰ Bonelli at page 1.

Ring-fencing may be effective to protect a utility subsidiary from the bankruptcy of its affiliate. As discussed above, PGE successfully used ring-fencing measures to avoid the bankruptcy proceeding of Enron.³¹ Although the bankruptcy of Enron did affect PGE's ability to access short-term capital markets, PGE was able to continue operations outside of bankruptcy. The factors that helped insulate PGE from Enron included: PGE owned or leased the assets used in its business, PGE had separate management, and Oregon Law and the Oregon PUC approval of the acquisition of PGE included additional protections, such as limiting dividends and other asset transfers.³² PGE also issued a share of limited voting junior preferred stock to an independent shareholder that limited the ability of PGE to voluntarily file for bankruptcy without the consent of that shareholder.³³

Currently, the utilities in Maryland have established some of the various ring-fencing protections. For example, all of the investor-owned gas and electric utilities that operate in Maryland, except Chesapeake Utilities Corporation, are organized as separate corporate entities that are owned by a holding company that owns other unregulated subsidiaries. This unregulated parent holding company structure is preferable to a structure whereby the utility itself is the holding company that owns the equity of unregulated subsidiaries.³⁴ Some of these utilities have consented to financial covenants through their borrowing facilities that strengthen the financial independence of the utility subsidiary. As an example, PEPCO and DP&L consented to a limitation on their ability

³¹ Grygiel, Fred and Garvey, John. *Fencing in the Regulated Utilities*, Public Utilities Fortnightly, August 2004, pages 32-33, at 32.

³² Saunders at 2.

³³ *Id.*

³⁴ Bonelli at 3.

to sell assets and to create or incur liens, and each company must maintain its leverage ratio within a specified range.³⁵

The PUC Article includes certain safeguards against the risks to a utility from its financially distressed affiliate. Section 5-202 would require Commission approval of a sale of utility assets that materially affects its franchise. Section 5-202 also has been used to assess the merits of mergers of non-Maryland holding companies that control utilities operating in Maryland. Public service companies incorporated in Maryland cannot, without the approval of the Commission: 1) assume or guarantee an obligation with respect to stocks or indebtedness due more than 12 months after the date of issuance (“long-term indebtedness”); or 2) issue stock or long-term indebtedness.³⁶ Also, PUC § 6-103 places certain restrictions on the capitalization of public service companies that are Maryland corporations.³⁷

In addition to Commission Order No. 74038, the draft affiliate code of conduct regulations would also help to protect the Maryland utilities from the financial risks of their affiliates. The affiliate code of conduct would prohibit the utility from engaging in certain practices that may link the services, or the identities, of the utility with its unregulated affiliates.³⁸ Draft COMAR 20.49.02.05 requires the financial recording of utility-affiliate asset transactions on terms that are most favorable to the utility. Also,

³⁵ Five-Year Credit Agreement among PEPCO Holdings, Inc., Potomac Electric Power Company, Delmarva Power & Light Company and Atlantic City Electric Company, as Borrowers, Bank One, NA, as Administrative Agent, Citicorp USA, Inc., as Syndication Agent, and The Bank of Nova Scotia, Keybank National Association and Wachovia Bank, National Association, as Co-Documentation Agents, Citigroup Global Markets Inc. and J.P. Morgan Securities, Inc. as Co-Lead Arrangers and Co-Book Runners dated as of July 26, 2004 .

³⁶ PUC § 5-203.

³⁷ It should be noted that no public utility may sell, lease, or otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission, or any part thereof of a value in excess of \$ 50,000 without authorization from FERC. *16 USCS § 824b* (2004).

³⁸ See draft COMAR 20.49.02.01(B) and (C).

draft COMAR 20.49.02.06 prohibits certain loans and guarantees by a utility to its affiliate and allows the Commission to disapprove of certain other loans or guarantees of which it receives notice. A utility that is subject to and abides by these provisions would be less likely to establish a substantial identity between the entities and thus may diminish the likelihood that it would be consolidated with its affiliate by a bankruptcy judge.³⁹

The current legal and regulatory environment in Maryland, including the draft affiliate code of conduct, contains ring-fencing measures that may limit two of the three risks to utility service that are associated with a parent's or affiliate's financial distress. The risk of a distressed parent depleting the assets of or encumbering the utility subsidiary is limited by the draft COMAR Sections 20.49.02.05 and 20.49.02.06, as well as PUC §5-202. The risk, in the absence of any fraud, of a bankruptcy court judge consolidating a utility with its unregulated affiliate that is in bankruptcy is reduced by, among other things, the holding company structure, financial covenants of the utility to lenders and draft COMAR Section 20.49.02.01.

The risk that a parent holding company in bankruptcy would elect for its financially healthy subsidiary to file for bankruptcy protection still exists. One suggested solution to this risk is for the utility subsidiary to have an "independent" director, or a junior-preferred shareholder,⁴⁰ who may have the fiduciary duty and has the sole authority, under the charter or by-laws of the utility, to prevent the utility from voluntarily filing for bankruptcy.⁴¹ S&P recommends, that the independent director or

³⁹ See, Saunders.

⁴⁰ See Note 9, *infra*.

⁴¹ Penrose at 4; Saunders at 2.

shareholder be required to consider the interests of the creditors of the utility in making its determination.⁴² However, some experts believe there is an inalienable right of the parent to file its subsidiary into bankruptcy that overrides this solution.⁴³ Also, the imposition of an independent director or shareholder may create a legal or financial burden on the ability of the utility to conduct its business that outweighs the benefit of that ring-fencing measure. Thus, the efficacy of imposing an independent director or separate class of shareholder requirement is not clear.

VI. CONCLUSIONS AND RECOMMENDATIONS

This Report examines various ring-fencing measures that may be adopted to protect the assets and financial viability of regulated investor-owned gas and electric companies that operate in Maryland. The Report focuses on capital structure requirements, dividend pay out limitations, non-utility asset investment limitations and limitations on asset transfers and cross-collateralization. In addition, this Report examines the value of credit ratings separation between the regulated utility and its parent company or affiliates. Finally, the Report analyzes bankruptcy-related risks and methods to prevent a regulated utility from being forced into or included in a bankruptcy proceeding. Based upon our examination and analysis, we conclude that adoption of an annual ring-fencing report is an appropriate regulatory tool that can be used to assess the financial viability of, and protect, the State's gas and electric utilities at this time.

⁴² Saunders at 2.

⁴³ *Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System*, Prepared on behalf of the NARUC Staff Subcommittee on Accounting and Finance.

While there are multiple ring-fencing options that may be required by a regulatory body to protect a utility and its customers, it is practically impossible to determine in advance which measures are necessary or appropriate. Additionally, even when an appropriate measure is adopted, there are costs to utility customers, as evidenced by the PGE example, and it is not clear that prospectively such costs will be economic. Furthermore, there are already numerous laws, such as the PUHCA and Sarbanes-Oxley Act of 2002 with which the utilities or their holding companies must comply.

In Maryland, the Commission has broad authority under the PUC Article to act and there are additional regulatory requirements in COMAR as well. (*See Appendix A*). Lastly, we note that the Commission is in the process of addressing the need for an affiliate code of conduct and it is anticipated that COMAR Subtitle 49 will be adopted later this year. (*See Appendix B*). Considering that, currently, many regulatory requirements address ring-fencing issues, and appropriate measures may not be evident in advance, we believe, at this time, that a utility specific annual ring-fencing report is the best method to monitor the utilities and to respond to specific issues as necessary.

Adoption of an annual ring-fencing report has several advantages. First, it allows the Commission to gather information relating to ring-fencing into one report. This will enable both the Commission and the utilities to act more promptly should it become necessary to take measures to protect a utility.⁴⁴ Second, an annual report minimizes regulatory intrusions into utility or holding company activities and management. Third, it enhances confidence that the Commission is exercising appropriate regulatory oversight

⁴⁴ In this regard, after the first report is completed, future reports should be routine. If alterations in reporting requirements are necessary this can be accomplished with minimal disruption.

of the gas and electric utilities. Finally, an annual report will permit the Commission to focus separately on each utility and specific remedy, which will allow the Commission to specifically tailor any regulatory action in the most appropriate manner.

For these reasons, we recommend that the Commission adopt an annual ring-fencing reporting requirement for Maryland's gas and electric utilities. Appendix D includes suggested contents for an annual ring-fencing report to be filed by each utility.

APPENDIX A
RELEVANT SECTIONS OF
PUC ARTICLE AND COMAR

A. PUC Article

The Public Utility Companies Article of the Annotated Code of Maryland (“PUC Article”) confers jurisdiction and general powers (§ 2-112) and supervisory and regulatory power (§ 2-113) over utilities on the Commission. The Commission also has investigative powers (§ 2-115) including the ability to examine books and records. The Commission is authorized to seek injunctive relief, recover forfeitures and compel appearances before the Commission (§ 2-117). The Commission may conduct appropriate proceedings (§ 3-104). The Commission specifically has the authority to set just and reasonable rates of public service companies (§ 4-102). The Commission may determine the fair value of utility property (§ 4-206). The Commission also has certain powers regarding cost allocation manuals of gas and electric companies (§ 4-208).

A utility may not discontinue or abandon a service under a franchise without Commission authorization (§ 5-103). A utility may not assign, lease or transfer a franchise or right thereunder, or enter into any agreement that materially affects a franchise or right without prior Commission authorization (§ 5-202). Section 5-203 and sections 6-101 through 6-104 establish certain restrictions on securities and debt transactions of utilities **incorporated in Maryland**. Subject to Commission authorization, a utility may not acquire the stock of another utility incorporated in Maryland; additionally a utility incorporated in Maryland may not assume or guarantee a

liability payable more than 12 months after the date of issuance without Commission authorization (§ 5-203).⁴⁵ Additional reporting requirements are in § 5-302.

Title 6 of the PUC Article enumerates provisions relating to the business structure of utilities. Subtitle 1 relates to financing and restricts certain financing activities of utilities incorporated in Maryland, subject to Commission approval. Subtitle 2 relates to reporting requirements. Section 6-205 requires utilities to file annual reports, which contain information on the corporate structure, affiliations of its officers and directors, and debt holdings. Section 6-207 requires certain information about stock and indebtedness. Section 6-208 requires information on the basis of control and principal business activities of a public service company and each parent, subsidiary or organization the utility controls and joint ventures in excess of \$1 million. Section 6-209 addresses reporting about officers and directors and their relationships with a utility, parent, or subsidiary, or an affiliation with any entity doing business with the utility.

The Electric Restructuring Act, Sections 7-501 through 7-518, addresses many affiliate issues affecting electric utilities. Section 7-505(b)(3) prohibits discrimination in favor of an affiliate. Section 7-505(b)(10) requires regulations regarding an appropriate code of conduct between the utility and an affiliate providing electricity supply and electricity supply services in Maryland. Appropriate complaint and enforcement procedures are also required. Section 7-505(b)(10)(iii) requires functional, operational, structural or legal separation between an electric company's regulated businesses and non-regulated businesses or affiliates. Section 7-505(b)(13) requires approval of a code

⁴⁵ Section 9-308 does provide that a Maryland railroad company may “acquire, own, hold, pledge, sell, dispose of, endorse, guarantee, or assume the stocks, bonds, and other securities of: (1) a Maryland railroad company; (2) a railroad company of another state; and (3) an inland, coast, or ocean transportation company.”

of conduct to prevent regulated service customers from subsidizing the services of unregulated businesses or affiliates of the electric company. The Commission is required to issue regulations to prevent anti-competitive and abusive practices (§7-507(c)(i)). Section 7-508 authorized the transfer of generation assets from a utility to an affiliate. The Commission may conduct investigations into market power or any other anti-competitive conduct (§ 7-514). Section 7-604 requires the Commission to adopt regulations for gas suppliers to protect consumers from discriminatory, unfair, deceptive and anti-competitive acts in the marketing selling or distribution of natural gas.

Penalties for prohibited acts are enumerated in Title 13 of the PUC Article. Section 13-101 provides for misdemeanor criminal liability for violations of the PUC Article. Subtitle 2 of Title 13 provides for civil liability. Penalties of up to \$10,000 may be levied for violations of the PUC Article or “an effective and outstanding direction, ruling, order, rule, or regulation of the Commission.” (§ 13-201.1). A contract, assignment or transfer that violates the PUC Article is void. (§ 13-207). Finally, the Commission may issue a summary cease and desist order for violations of the PUC Article or Commission orders or regulations. (§ 13-208).

B. Regulations⁴⁶

In addition to affiliate regulations (discussed in Appendix B), the general regulations provide certain ring-fencing protections. COMAR 20.07.04.01 lists certain financial information that is to be provided if a utility is required or called upon to

⁴⁶ In addition to the regulations cited, COMAR 20.45 addresses certain telephone company ring-fencing protections, COMAR 20.73 addresses water and sewage company issues, and COMAR 20.90 addresses certain taxicab issues.

disclose its financial condition. Applications to the Commission to issue stock or other evidence of indebtedness must show the information required in COMAR 20.07.04.02. Additionally, COMAR 20.07.04.04 enumerates the information that must be contained in an application to assign, lease, or transfer a franchise, or a utility's system or a contract affecting any of the above rights. COMAR 20.07.04.05 lists the information required of a corporation that proposes to acquire stock in another corporation.

Subtitle 40 addresses promotional practices. Regulation 20.40.01.02 lists prohibited practices by utilities and affiliates. Utilities may not finance the purchase of land or the construction of buildings that they will not own or possess. Utilities may not acquire property or services for a consideration in excess of its value or furnish property or services for less than its value. They may not extend credit at a lower interest rate or upon more favorable payment terms than sales generally made by non-utility dealers for any appliance or equipment. There are also certain restrictions on payments for advertising. Finally, guaranteeing the maximum cost of electric or gas utility service is prohibited.

Regulation 20.40.01.03 imposes other restrictions on costs of promotional practices and requires that promotional practices first be filed with the Commission before they are offered. Regulation 20.40.01.06 requires utilities to file with the annual report a report on promotional practices by the utility and its affiliates during the period. COMAR 20.50.03.04H requires electric utilities to notify the Commission annually of important planned capital expenses. Monthly operations reports are also required by COMAR 20.50.03.04I.

While Subtitle 51 – Electricity Suppliers – does not apply to an electric company providing Standard Offer Service (“SOS”) or a municipal electric utility (COMAR 20.51.01.01), these provisions may have a broader impact on electric utilities as the State moves away from SOS. COMAR 20.51.02.02 requires applicants for an electricity supplier license to include a statement of financial integrity. If the supplier intends to collect a deposit, a bond or equivalent is required. (COMAR 20.51.02B(8)). Penalties of up to \$10,000 for a violation may be imposed on a supplier who provides misleading or incomplete information, or who fails to update information, and licenses may be suspended or revoked. (COMAR 20.51.02.06.) Under COMAR 20.51.02.08 the Commission, upon review of the statement of financial integrity, may require a bond or other financial guaranty. And COMAR 20.51.03 contains electricity supplier license requirements regarding information, bonding for deposits, cessation of business, and license suspension or revocation.

Subtitle 54 deals with gas suppliers. It has similar provisions to Subtitle 51 including: an application requires a statement of financial integrity (COMAR 20.54.02.02B(4), the need for accurate information and potential Commission sanctions (COMAR 20.54.02.06), bonding requirements based upon a review of the statement of financial integrity (COMAR 20.54.02.08), license updating requirements (COMAR 20.54.03.01), additional bonding details (COMAR 20.54.03.03 and .04), requirements prior to cessation of business (COMAR 20.54.03.05) and grounds for revocations or suspension of a license (COMAR 20.54.03.06). COMAR 20.55.03.02K requires a gas utility to file monthly reports concerning its operations.

APPENDIX B
RELEVANT SECTIONS OF
SUBTITLE 49 DRAFT REGULATIONS

This Appendix lists the provisions contained in the draft of Subtitle 49 that relate to asset transactions and loans and guarantees. This Appendix also contains some miscellaneous provisions.

Asset Transactions – COMAR 20.49.02.05

.05 Asset Transactions Involving an Affiliate

A. This regulation does not apply to transactions between a utility and another utility, or any operating division of the same utility, which is regulated by the Commission or another state's utility regulatory body.

B. Subject to § C of this regulation, a utility may enter into an asset transfer or receipt transaction with its affiliate.

C. If a utility enters into a transaction with an affiliate involving the transfer or receipt of an asset that has a book value of more than \$75,000 per item, or a total book value of \$1,000,000, other than a transaction resulting from an open bidding process, including an auction or a request for proposal with an independent evaluator, a utility shall record the transaction in its financial records based on asymmetric pricing to the extent permitted by federal law or regulation.

Loans and Guarantees – COMAR 20.49.02.06

.06 Utility Loans or Debt Guarantees to an Affiliate.

A. This regulation does not apply to a utility's participation in a cash management or money pool subject to federal regulation.

B. Except as provided under §C of this regulation, a utility may make a loan or provide a debt guarantee to its affiliate

C. Restrictions on Loans or Debt Guarantees.

(1) If a loan or guarantee by a utility to its affiliate creates a reasonable likelihood that the utility's cost of capital, creditworthiness, or ability to provide regulated service will be adversely affected in a material manner, a utility may not:

- (a) Lend money; or
- (b) Guarantee the debt of its affiliate.

(2) New Loan or Debt Guarantee.

(a) If a new loan or debt guarantee by a utility to its affiliate is in excess of \$25,000,000 or 2 percent of the equity capital of the utility, whichever is greater, or the loan causes the utility's proprietary capital ratio to fall below 30 percent, the utility shall inform the Commission that it is making the loan or guarantee at least 90 days before the transaction is closed.

(b) If, within 90 days of receiving the notice under § C(2)(a) of this regulation, the Commission finds that the loan or guarantee creates a reasonable likelihood that the utility's cost of capital, creditworthiness, or ability to provide regulated service will be adversely affected, it may disapprove the loan or guarantee.

(c) If the Commission does not act within 90 days of receiving notice of the loan or guarantee, the utility may undertake the loan or guarantee.

D. A utility loan under this regulation shall include an interest rate equal to the:

- (a) Fair market interest rate at the time of execution of the loan; or

(b) Rate directed or approved by a federal agency having jurisdiction over the loan.

E. Loan or Guarantee – Annual Report.

(1) A utility shall file an annual report of a loan or guarantee to an affiliate for the period ending December 31 of each year by April 30 of the following year.

(2) The report required by § E(1) of this regulation shall contain the following minimum information for each loan or guarantee, as applicable:

- (a) Dollar amount of any loan or guarantee;
- (b) Terms of loan payment;
- (c) Call provision on a loan;
- (d) Name of the corporate record keeper;
- (e) Credit agency analysis;
- (f) Insurance cost; and
- (g) Default terms.

Miscellaneous Provisions

COMAR 20.49.02.07 requires gas and electric utilities to file a Cost Allocation Manual (“CAM”) if they have an affiliate. In particular, the CAM must include a complete description of the types of all costs shared with an affiliate and the methodology and procedure used to allocate costs. (COMAR 20.49.02.07B(4)(c) and (d)). COMAR 20.49.01.01B exempts municipal and small gas and electric companies from Subtitle 49.

It is also important to point out that as an additional protection, COMAR 20.49.02.01C(2) prohibits a utility from operating from the same physical location used by a core service affiliate. A core service affiliate is one that provides core services,

which are defined as “a gas or electric supply service that was provided to the public in Maryland by a utility as a monopoly service, within the utility’s distribution territory, prior to the introduction of customer choice programs.” (COMAR 20.49.01.03B(3)).

APPENDIX C

CAPITALIZATION EXAMPLES

- (1) As discussed in the “Capitalization” section of the Ring-Fencing Report, normally the cost of equity financing is greater than the cost of debt financing. Assuming that a utility’s debt and equity ratings are *not* modified by marginal changes in the debt/equity ratio, then it is possible that a minimum 48% equity requirement would be more costly to a utility’s customers than necessary. For example, assume that absent the minimum equity requirement, a utility’s capital costs could be addressed by using a 55/45 debt equity ratio instead of a 52/48 debt equity ratio. Assume hypothetically that the utility’s total capital is \$500 million, with debt and equity costs of 7% and 11%, respectively. Under these circumstances, the difference in overall capital costs between a 52/48 debt equity ratio and a ratio of 55/45 would be as follows: \$44.6 million = $(0.48 \times \$500 \text{ million} \times 0.11) + (0.52 \times \$500 \text{ million} \times 0.07)$, versus \$44 million = $(0.45 \times \$500 \text{ million} \times 0.11) + (0.55 \times \$500 \text{ million} \times 0.07)$. The additional costs to ratepayers of \$600,000 from having a legal minimum 48% equity ratio instead of a more optimal 45% equity ratio are such a result, all other things being equal.

- (2) A more highly leveraged company may have greater total capital costs. For example, if we took the same hypothetical company (as discussed in Note 1 above) that had a capital structure of debt and equity totaling \$500 million, a 40/60 equity-debt ratio, with assumed equity costs of 12% and assumed debt costs of 7%, its annual capital cost requirements would be \$45 million. If however, a hypothetical company had a 50/50 equity-debt ratio, its annual costs could be \$42.5 million. Under this type of scenario, the calculations are as follows, respectively: \$45 million = $(0.40 \times \$500 \text{ million} \times 0.12 + .60 \times \$500 \text{ million} \times 0.07)$, and \$42.5 million = $(0.50 \times \$500 \text{ million} \times 0.11 + 0.50 \times \$500 \text{ million} \times 0.06)$. Hence, in this example a higher “leverage” (i.e. more debt relative to equity) results in higher overall capital costs.

- (3) A more highly leveraged company may not experience an, or only experience a small, increased cost of debt or equity. Consider the above hypothetical example where the company has a total capital of \$500 million, a debt/equity ratio of 55/45 and costs of 6.5% and 11.5%, respectively. This company would have annual capital costs of \$43.75 million ($0.45 \times 500 \text{ million} \times 0.115 + 0.55 \times 500 \text{ million} \times 0.065$), as compared to the \$44.6 million and \$44.0 million in Note 1 (above).

APPENDIX D

Ring-Fencing – Annual Report

(Suggested Contents)

Report for «"XYZ" Public Service Company» for the financial year 2KX

«"XYZ" Public Service Company»

1. Provide a complete, detailed organizational chart that identifies the regulated company and each affiliate. Please state the business purpose of each business unit of the organization.
2. Provide a complete description of all ring-fencing measures in effect between the regulated company and its affiliates and statement as to how each measure operates.
3. Provide a list of shared corporate officers and other key personnel between the regulated company and any affiliate, along with a description of each person's duties and responsibilities to each entity.
4. Provide a corporate risk assessment profile indicating the financial exposure that each unregulated affiliate poses to the regulated company based on routine and extraordinary business activities.
5. Provide a description of the regulated company's and each affiliated company's capital structure. Describe specific steps or measures taken to maintain an investment quality capital structure by the public service company.
6. What limitations, if any, are placed on non-utility asset investments by the regulated company?
7. Provide a summary of financing secured by the assets of, or guaranteed by, the regulated company on behalf of a non-regulated entity.
8. Identify all assets shared by the regulated company and any of its affiliates.
9. Indicate whether any affiliate of the regulated company has experienced a default of a material obligation or a default that triggers a cross default, or has filed for bankruptcy.

10. Describe any specific protections that exist between the regulated company and non-regulated affiliated companies that mitigate exposure of the regulated company in the event of bankruptcy proceedings by any affiliate.

NOTE: For the purposes of this report, affiliate shall mean “any parent, subsidiary, affiliate, joint venture or other work unit.”