

7. Hierarchical conflict harms customers

Chapter 6 explained how mergers can harm competition. Harming competition harms customers. Mergers can also harm customers in other ways. Three sources of harm are merger cost overcharges, acquisition debt risk and non-utility business risk. Before addressing these three problems, this chapter describes their common source: the inherent conflict between the parent company’s business goals and the subsidiary utility’s service obligations.

7.1 PARENT-UTILITY CONFLICT: BUSINESS DIFFERENCES, HIERARCHICAL CONTROL

Most mergers make the target utility a subsidiary of a multi-business parent. The resulting parent-utility relationship involves multiple conflicts, arising from four sources: differences in objectives, hierarchical control, pressure for “growth,” and market power.¹ A common regulatory response, requiring independent directors, does not remove these problems because regulators misunderstand what independence means.

7.1.1 Holding Company and Utility Subsidiary: Differing Objectives

A utility’s corporate board must fulfill two main legal duties: its fiduciary duty to maximize value for its holding company shareholder, and its utility law duty to provide reliable service to its customers at just and reasonable rates. These two duties present no inherent conflict, because any company’s fiduciary duty to its shareholders is always constrained by other laws: child labor law, hazardous waste law, tax law, minimum wage law—and utility law.

While a utility board has no inherent conflict, its holding company does. Unlike its utility subsidiaries, the holding company has no statutory obligation

¹ See, e.g., Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities and Their Holding Companies and Non-Regulated Affiliates, 2006 Cal. PUC LEXIS 241, at *4–5 (“[C]ircumstances which create conflicts for the utilities between serving their customers or helping their holding companies and other affiliates are becoming more widespread.”); Alliant Energy Co. v. Bie, 330 F.3d 904, 917 (7th Cir. 2003) (“The more products a firm is responsible for, the easier it is for the firm to misreport the allocation of its costs.”).
to utility customers. Nor has it any statutory obligation to provide the utility with equity and debt at reasonable cost. With the 2005 repeal of the Public Utility Holding Company Act of 1935 (PUHCA), 2 the holding company parent—with rare exceptions—is not subject to any utility-type regulation, federal or state. Free of statutory obligations, its goals can conflict with the utility’s obligations. Consider two examples.

1. The utility’s need for equity: As the utility’s sole shareholder, the parent is the utility’s sole source of equity. But while the utility has a legal obligation to serve, the holding company has no legal obligation to invest. Most state statutes give the state commission authority over the utility only, not the holding company; moreover, state and FERC merger approval orders rarely impose on the parent any obligation to support all the utility’s needs financially. 3 So the parent always has a choice: put money in the utility or put it elsewhere. The parent will make the choice that maximizes system-wide profit. The utility’s cost-effectiveness will compete with other holding company goals.

2. The destination of the utility’s profits: By selling service at commission-set rates, a prudent utility earns a reasonable profit. That profit’s destination is determined by the parent, which can order the utility to:

- keep the profit within the utility as retained earnings, ready to finance utility capital expenditures that earn more profit;
- send dividends to the parent, so that parent can invest them in other businesses, use them to retire debt or pay them out to the ultimate shareholders—leaving the utility dependent on the parent for future equity; or
- use the profit to provide financial support to other holding company affiliates—leaving the utility vulnerable to those affiliates’ losses, and dependent on the parent for more equity.

The holding company will choose among these options based on its strategic goals, not on the utility customers’ needs. That is the source of the conflict. 4

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3 A common merger condition requires the utility to maintain a specified equity-debt ratio. Besides applying only to the utility and not also to its holding company or to the consolidated system, this condition has the limited aim of maintaining the utility’s credit rating merely at investment grade. Nor does it guarantee the utility sufficient capital from the holding company to minimize the utility’s total cost or to enable the utility to fund infrastructure cost-effectively.

4 See, e.g., Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities and Their Holding Companies and Non-Regulated Affiliates,
Caution: No utility holding company is indifferent to its utility subsidiary’s health. Letting a utility’s finances weaken and its operational capabilities decline can trigger regulatory penalties. Still, the holding company aims to maximize the value of its portfolio, not the cost-effectiveness of any one member. And capital, like any economic resource, is scarce. So the risk of conflict exists—between the utility’s service obligation to its customers, and the holding company’s portfolio obligation to its shareholders. As the D.C. Commission found: Pepco, after its acquisition by Exelon, “will face competition for shareholder capital from a larger number of regulated affiliates as well as a number of unregulated affiliates who may need resources to stem losses.”

7.1.2 Hierarchical Control: Subordinating Utility Needs to Holding Company Aims

To carry out the obligation to serve, utility management defines its customers’ needs, identifies the capital and operational resources necessary to satisfy those needs, raises the capital and organizes the resources, then directs the activities that satisfy the needs. When making these decisions, utility management is accountable to a utility board. In a pure-play utility corporation, the utility’s management is accountable to a single board. That board is accountable in turn to the thousands of shareholders who own millions of utility shares. But when that utility is acquired by a holding company, its management becomes accountable to a different board. The utility subsidiary will still have its own board, but that board’s members will be chosen by, and be accountable to, the holding company’s board.

When the two boards have different priorities, the holding company’s board necessarily prevails, because 100 percent control is complete control. Exelon limited the Pepco Board’s spending authority in multiple ways, while reserving its power to change that spending authority at any time. Holding

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2006 Cal. PUC LEXIS 241, at *4–5, *7 (finding that with PUHCA 1935’s repeal in 2005, entry of utility holding companies into competitive businesses, and the close ties between competitive and monopoly affiliates, both “call[ing] into question the ability or willingness of the utility holding companies to fulfill their obligations to make the utility’s capital requirements a first priority”).


6 See Nonunanimous Full Settlement Agreement and Stipulation ¶ 103 & tbl.5, attached as Exhibit A to Motion of Joint Applicants to Reopen the Record in Formal Case No. 1119, Exelon-PHI Merger, Formal Case No. 1119 (D.C. Pub. Serv. Comm’n filed Oct. 6, 2015) [hereinafter Exelon-PHI Settlement Agreement]. See also Exelon’s Response to GRID2.0 Data Requests at DR 1-70, Exelon-PHI Merger, Formal Case No. 1119 (D.C. Pub. Serv. Comm’n filed Nov. 3, 2014) [hereinafter Responses to GRID 2.0 Data Requests for Formal Case No. 1119] (“It is therefore Mr. O’Brien’s
company executives like to describe the holding company-utility relationship as one of “review,” “collaboration” and mutual “input.” But control is control. As Exelon made clear, the utility subsidiary’s executives and board have only a voice:

The preparation of budgets for Exelon and its subsidiaries is a collaborative process between Exelon management and management of each subsidiary. The resulting subsidiary budgets are submitted to the subsidiary boards of directors, and the consolidated budget for Exelon is submitted to the Exelon Board of Directors for approval. Under the Delegations of Authority for Exelon and its subsidiaries, the Board of Directors of Exelon Corporation has final approval authority over the consolidated budget for Exelon and its subsidiaries.8

“Preparation” might be “collaborative” but the “final approval” will be hierarchical. And “collaborative” cannot mean “each participant has equal say,” when one of the collaborators has the final say.

A standalone utility faces no hierarchical control. Its own board, advised by management and unconstrained by a holding company’s conflicting objectives, calls the shots.

### 7.1.3 Pressure for “Growth”: Adding to Parent-Utility Conflict

Utility law directs utilities to provide value to their customers. A holding company aims to provide value to its shareholders. One way to add value, holding companies say, is to get “growth.” A utility focuses on its existing customers; the holding company looks for new customers. The reality of scarce resources puts those two objectives in tension.

Exelon’s proposal to acquire PHI made that tension explicit. Content to serve their existing customers, PHI’s three utilities were not looking for more. But Exelon was:

Management continually evaluates growth opportunities aligned with Exelon’s existing businesses in electric and gas distribution, electric transmission, generation,

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7. See, e.g., Direct Testimony of Denis P. O’Brien at 4–12, Exelon-PHI Merger, Formal Case No. 1119 (D.C. Pub. Serv. Comm’n filed June 18, 2014) (describing the parent-utility relationship as one of “review,” “collaboration” and “mutual input”).

customer supply of electric and natural gas products and services, and natural gas exploration and production activities, leveraging Exelon’s expertise in those areas.\textsuperscript{9}

Indeed, financial analysts viewed Exelon’s prior acquisition of Constellation (the holding company for Baltimore Gas & Electric) not as an operational expansion to benefit BGE’s ratepayers, but as a strategic move to benefit Exelon’s shareholders:

With nuclear generation accounting for nearly 140 terawatt hours (TWh) of the company’s 150 TWh total generation in 2010, Exelon is the most exposed of its peers to a decline in natural gas prices, which would drive down its margins. … In our opinion, acquisition of retail power operations is consistent with Exelon’s strategy because these operations offer a natural hedge against natural gas exposure.\textsuperscript{10}

Exelon’s effort to balance a risky portfolio with a monopoly acquisition was, according to one prominent outside analyst, part of a larger plan to add even more risk:

Moody’s believes that the combined entity [i.e., Exelon and Constellation] will still be exposed to earnings and cash flow volatility due to a large unregulated business platform whose financial performance is influenced by market determined commodity pricing levels. … [W]e believe that it will be very challenging for [Exelon] to easily transform the company’s business mix into one that is materially more balanced across regulated operations given the sheer size of the existing unregulated footprint. Moreover, given the competitive position that this merger reinforces, we believe that management, along with the board, will be more inclined in the future to pursue acquisitions of additional unregulated properties as a natural extension of an existing strategy, particularly given the more streamlined and less challenging regulatory approval requirements that tend to accompany unregulated acquisitions.\textsuperscript{11}

As Chapter 7.4 will explain, adding risk increases the opportunity for shareholder returns, but it also increases the possibility of customer harm.

\textsuperscript{9} Exelon Corp., Annual Report (Form 10-K) at 88 (Feb. 14, 2014).
\textsuperscript{10} STANDARD & POOR’S, RESEARCH UPDATE: RATINGS ARE AFFIRMED ON EXELON COMPANIES ON NEWS IT WILL MERGE WITH CONSTELLATION; CONSTELLATION IS ON CW POSITIVE 3–4 (2011), attached as Exhibit KLA-1 to Direct Testimony of Karie L. Anderson, Exelon-Constellation Energy Group Merger, Case No. 9271 (Md. Pub. Serv. Comm’n filed May 25, 2011).
\textsuperscript{11} Id. (emphasis added).
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7.1.4 Substance Conflicts: Generation, Transmission, Renewable Energy, Distributed Energy

Differing objectives, hierarchical control, tension over scarce capital and pressure for growth: they all lead to direct conflicts over substance. Exelon’s acquisition of PHI illustrated three types.

Generation owner vs. generation customer: Rating agencies praised the “strategic benefits of linking a company that is long on generation resources [Exelon] with a company that is long on customer load [PHI’s three utilities].” But those “strategic benefits” become customer risks. The PHI utilities—Pepco, Delmarva Power & Light and Atlantic City Electric—owned no bulk generation, whereas Exelon then controlled 44,563 mW of generation. As a generation investor, Exelon had bet billions on high generation prices. But as buyers of electric power for its non-shopping customers, PHI’s utilities would want low generation prices. Without a merger, and with its three utilities owning no generation, PHI would want to limit its utilities’ power purchase costs—by investing in transmission, storage, demand resources, energy efficiency and distributed generation. But these very actions would dampen demand for generation, thereby lowering prices for Exelon’s generation and lowering profits for its shareholders. With Exelon controlling PHI, that useful tension between buyer and seller, that dampening effect, would diminish. Exelon’s priorities would take control.

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12 Id.
13 Exelon Corp., supra note 9, at 9.
14 As Exelon acknowledged in discovery:
Exelon, as well as other power generators and independent analysts, believe[s] that power prices are in the process of recovering (or moving upward) as natural gas prices move up, demand increases and coal-fired power plants exit the market. However, such factors are not always believed to be reflected adequately in the future price of power. If such events do occur, Exelon Generation would see its profitability increase as it could sell its power at a higher price. In other words, it would realize upside to its currently projected profitability.

Applicants’ Response to D.C. Government Data Requests at DR 1-10, Exelon-PHI Merger, Formal Case No. 1119 (D.C. Pub. Serv. Comm’n filed Nov. 3, 2014) (emphasis added) (referring to analysts’ Apr. 30, 2014 presentation, Slide 11 of which was entitled “Transition Economics are Attractive”).

15 Each of Pepco, Delmarva and Atlantic City Electric served in states—D.C., Maryland, Virginia, Delaware and New Jersey—that had authorized retail competition. Each utility served as the “default” provider for customers who choose not to buy electricity from non-utility competitive companies.

16 See Pepco Holdings, Inc., Annual Report (Form 10-K) at 5 (Feb. 27, 2014) (“PHI’s business objective is to be a top-performing, regulated power delivery company that delivers safe and reliable electric and natural gas service to its customers.”).
Indeed, for the fifteen years before Exelon proposed acquiring PHI, the D.C. Commission wanted its retail utilities to have no profit interest in generation sales. Prior to 1999, Pepco was vertically integrated—it owned the generation that served its customers. But when in 1999 D.C. legislation authorized competition in retail electricity, the Commission welcomed Pepco’s proposal to sell off its generation. With Pepco no longer owning generation, the Commission said, the utility will have

less motivation … to act as an inhibitor to the development of a competitive generation market in the District. … [T]he prospect that District ratepayers will reap the benefits of a competitive [retail] marketplace [is] greatly enhanced.17

But in approving Exelon’s acquisition, the Commission reversed that policy. It allowed Pepco to be controlled by an entity that would have precisely that “motivation … to act as an inhibitor to the development of a competitive generation market.” About this 180-degree turn, the Commission said nothing.

When a generation-owning holding company controls a generation-dependent utility, conflict arises in three more areas: transmission access, renewable energy and distributed energy resources.

Transmission access: A generation-dependent utility wants transmission paths that reach the lowest-cost power sources. Its generation-owning holding company has the opposite interest: keeping generation prices high requires limiting transmission access and raising transmission costs. With FERC Order No. 1000,18 this implicit conflict became explicit. Aiming to lower transmission costs by injecting competition into historically monopolistic transmission markets, FERC removed from incumbent transmission owners’ tariffs their “right of first refusal” (ROFR) to build new regional transmission facilities. The ROFR had allowed incumbent transmission owners to keep those investment opportunities for themselves. In submissions to FERC and to the reviewing court, Exelon’s three utility subsidiaries (along with many other utilities) opposed deleting the ROFRs—an opposition contrary to their customers’ interests in reducing the transmission cost. And when PJM, the regional transmission organization, submitted to FERC the required tariff revi-

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...ations that removed the ROFRs, Exelon’s utility subsidiaries objected again. Exelon’s SEC filings explained why:

FERC’s order could enable third parties to seek to build certain regional transmission projects that had previously been reserved for the PJM Transmission Owners, potentially reducing ComEd’s, PECO’s and BGE’s financial return on new investments in energy transmission facilities.19

Renewable energy and distributed energy resources: The D.C. Commission is seeking to bring more renewable energy and distributed energy into its resource mix.20 But Exelon, as an owner of nuclear and fossil generation, has viewed wind and solar as a threat to its profitability:

The rate of expansion of subsidized low-carbon generation such as wind and solar energy in the markets in which [Exelon] Generation’s output is sold can negatively impact wholesale power prices, and in turn, Generation’s results of operations.

[N]ational regulation or legislation addressing climate change through an RPS [renewable portfolio standard] could also increase the pace of development of wind energy facilities in the Midwest, which could put downward pressure on wholesale market prices for electricity from [Exelon] Generation’s Midwest nuclear assets. … The Registrants are potentially exposed to emerging technologies that may over time affect or transform the energy industry, including technologies related to energy generation, distribution and consumption. … Such technologies could also result in further declines in commodity prices or demand for delivered energy.21

Some of Exelon’s subsidiaries do invest in renewable energy, but those actions don’t remove the conflict. These renewable investments are not acts of charity; they exist either because a state required them, or because Exelon acted to diversify its generation portfolio to minimize its risks. Exelon remains a conventional generation company, heavy on nuclear and fossil generation. Its acquisition of PHI’s utilities, all generation-dependent, increased the chance of conflict.

19 Exelon Corp., supra note 9, at 96 (emphasis added).
20 The D.C. Commission has created a docket, originally called Modernizing the Energy Delivery System for Increased Sustainability (MEDSIS) initiative, to explore and assess non-wires alternatives to traditional distribution investments. The Commission’s initiating Order tasked a working group to compile recommendations on rate design, customer impact, microgrids and pilot projects. See SMART ELECTRICITY ALLIANCE, FINAL REPORT V1.0 OF THE MEDSIS STAKEHOLDER WORKING GROUPS (2019), https://dep.sc.org/psc/dc-md/pdf/medi/Report.pdf.
21 Exelon Corp., supra note 9, at 85, 52 and 44 respectively.
7.1.5 Independent Directors: Not Independent of the Holding Company

Responding to concerns over parent-utility conflict, merger applicants often agree to place independent directors on the utility’s board. This action does not remove parent-utility conflict. A utility board’s independent directors are independent of the utility’s management; they are not independent of the utility’s parent. Indeed, independent directors are independent of management so that their sole allegiance will be to the parent. Independent directors are not independent like a regulatory commission’s members are independent. A commission’s members are independent of the utility so they can serve the public interest. The utility’s directors are independent of the utility’s management so they can serve the holding company’s interests. If the independent director sees a conflict between the holding company’s and the utility customers’ interests, the holding company prevails.

If a utility board member were truly independent of the holding company, she could veto any holding company instruction that conflicted with the utility’s obligation to its customers. Precedent exists in the “golden share” granted to the special purpose entity sometimes positioned between the utility and the holding company. If the holding company enters bankruptcy and orders the utility to join it, the holder of that golden share has the power to veto the holding company’s order. But no holding company has ever proposed, and no commission has ever required, a golden share that empowered a utility board member to veto a holding company order that conflicted with the utility’s obligation to its customers.

Vermont designed a distinct approach. For over fifty years, the state’s transmission system had been owned and controlled by Vermont Electric Power Company (VELCO), a for-profit corporation owned by most of Vermont’s utilities. The proposed merger of Central Vermont Public Service and Green Mountain Power would give the merged company control over 78 percent of VELCO’s transmission system—allowing it to “exercise sole control over

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22 In the Exelon-Constellation merger, for example, the applicants accepted the Maryland Commission’s requirement that at least one-third, and no fewer than two, of the members of BG&E’s Board be independent directors. Exelon-Constellation Energy Group Merger, 2012 Md. PSC LEXIS 12, at *9.

23 “[T]he concern is independence of management.” NYSE LISTED COMPANY MANUAL § 303A.02(a)(ii) cmt. (2013), http://wallstreet.ch.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3%5F3&manual=%2Flcm%5Fsections%2Flcm%5F2sections%2F.

24 Exelon-PHI Settlement Agreement, supra note 6, ¶¶ 72–74 (Exelon committing to create a special purpose entity that holds a golden share empowering its holder to veto voluntary entry into bankruptcy by PHI).
Vermont’s transmission system—an undesirable outcome that would radically alter the existing balance of power in the management and operation of Vermont’s power grid.” The Vermont Public Service Board approved a negotiated governance solution with these main features:

- The merging companies would transfer to VLITE, a new public benefit, nonprofit corporation, an amount of stock sufficient to reduce their VELCO ownership from 78 percent to 40 percent.
- VLITE would be governed by a board of directors drawn from representatives of the energy, utility and public interest sectors.
- VLITE would nominate three independent directors, selected by the Vermont Department of Public Service, to serve on VELCO’s 13-member board of directors. VLITE will have the power to establish criteria for voting on the basis of its VELCO shares.
- The merged company would have no power to unilaterally remove VELCO as the manager of Vermont’s transmission system.
- VLITE would invest the dividends from its VELCO stock in a manner consistent with Vermont energy policy.25

Vermont’s solution, complicated on the surface, was simple at the center. Needing independent directors, Vermont made the directors independent— independent of all economic interests which might conflict with the public interest. No other regulatory commission has done so.

7.2 MERGER OVERCHARGE RISKS

Commissions consider—or should consider—a merger’s benefits and costs at two stages. At the approval stage, the benefit-cost ratio signals whether the transaction uses the merging companies’ resources efficiently. At the rate-setting stage, commissions determine whether, when and how to reflect the merger’s costs and benefits in rates. Having discussed the approval stage in Chapters 4.2, 4.3 and 4.4, we address aspects of the rate-setting stage now.

To make rates just and reasonable, commissions must prevent merger overcharges. This section identifies three types, then evaluates actions regulators can take to prevent them.

7.2.1 Utility Devices for Overcharging

Merging companies have three ways to recover merger costs without appearing to. They can (a) use regulatory lag to keep rates above actual costs; (b) use double-leveraging to charge ratepayers for equity-level returns on equity financed with lower-cost debt; and (b) recover the acquisition premium implicitly.

7.2.1.1 Regulatory lag: a path to excess returns

7.2.1.1.1 Who gets the merger savings—ratepayers or shareholders?

If a merger reduces costs, who gets the savings? Conventional ratemaking sets rates based on reasonable costs.\(^{26}\) For a newly merged company, applying that principle requires re-setting rates based on post-merger costs. All merger savings (net of costs to achieve them) then would go the customers. If rates instead stay at their pre-merger level, the merger savings would go to the shareholders, until the commission sets new rates to reflect the post-merger cost levels. Those are the two poles—all savings to the customers, or all savings to the shareholders for some period of time.

Between those two poles, the commission could allocate the savings between shareholders and customers. But allocating savings with precision is impossible, for at least two reasons. First, distinguishing cost reductions uniquely due to the merger from cost reductions achievable without the merger requires guesswork. Merged or unmerged, all companies change their practices and their costs over time. Second, even for savings uniquely due to the merger, it is hard to synchronize rate reductions with cost reductions. Not all savings occur at identifiable points in time (e.g., while a cost-lowering amendment to a gas purchase contract has a definite start date, a productivity gain from new software doesn’t); moreover, rate changes require complex legal procedures whose schedules don’t mesh with cost changes. Both problems caused the Kanas Commission to reject the merging utilities’ proposal for tracking cost reductions and rate reductions:

The basis of the proposed [tracking] system is the determination of the costs that would have been incurred on a stand-alone basis had KPL and KGE remained stand-alone entities. This would effectively require the Commission to make a finding regarding the cost of service and revenue requirement levels for utility companies that ceased to exist. The Commission would be in a position of taking into account any and all events, technological, economic, natural phenomena or oth-

\(^{26}\) Plus, of course, a fair return on prudent, used-and-useful investment. See Tutorial § 4.1.
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So commissions face a challenge. They must allocate merger savings somehow, because not acting affirmatively cedes the decision to the merged entity, as discussed next.

7.2.1.1.2 Who decides—commission or company?

Once a commission establishes a utility’s rates, the utility must charge only those rates—even if the utility’s costs, sales or cost of equity deviate from the projections underlying the rates. Informed of deviations, the commission can change the rates, but prospectively only. These two legal constraints—the utility may charge only the approved rates, and the commission can change rates only prospectively—come from the filed rate doctrine and its offspring, the prohibition against retroactive ratemaking.28 Given these constraints, if the utility’s costs drop before a commission lowers the rates (a situation known as regulatory lag), the utility keeps the difference.

Turning to post-merger ratemaking: The sooner the merged company introduces cost reductions and the later it applies for new rates, the longer the lag and the more savings it keeps. By exercising control over both decisions, the merged company effectively displaces the commission as the allocator of savings between shareholders and ratepayers. Some commissions even cede their ratemaking power to the merged entity explicitly, by committing not to open a rate case for a specified post-merger period. Information asymmetry makes the actual savings allocation opaque, because the cost-reduction actions and cost data lie within the merging companies. Unless the commission eavesdrops on the actions and audits the data, it will never know how many savings dollars the companies kept. The merged company will know that number—and the merging companies likely based their acquisition price on it.


28 See Scott Hempling, Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction, chs. 9 (filed rate doctrine) and 10 (prohibition against retroactive ratemaking) (American Bar Association 2013). A commission can avoid the prohibition against retroactivity if it gives advance notice that it might change the previously established rate levels, provided the change is retroactive only to the date of the notice.
This last point deserves emphasis. Chapter 5.3.2 explained that the acquirer’s willingness to pay a control premium depends in part on its expectation that the acquired target will earn a return exceeding the commission-authorized return. So if the commission insists on allocating more savings to customers than the merger applicants projected when setting their acquisition price, they will argue that the commission is rattling the bond markets, causing the share price to drop or otherwise threatening a transaction that financial markets expect to occur on the terms negotiated by the applicants. These statements say nothing about the merits of the commission’s allocation; they aim instead to have the acquirer’s projections control the ratemaking outcome. Yet some commissions have adjusted proposed allocations, in favor of customers.

Allocating some merger savings to the merging companies has a valid basis. In competitive markets, if a merged company can reduce its costs while charging market prices for its products, the company keeps the merger savings. Merging utilities deserve a comparable opportunity. And regulatory lag—letting utilities keep, between rate cases, the cost savings they create—is a common means of encouraging and rewarding utility efficiency. The point here is different: allocating merger savings via regulatory lag, where the merging companies control both the cost data and rate case timing, is allocating in the dark.

Regulatory practice outside of mergers offers a solution. When a commission suspects that a utility’s existing rates exceed reasonable cost (including profit), it can declare the rates “interim subject to refund” as of the declaration date. The commission also can direct the merged company to present its

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29 See, e.g., Louisville Gas & Electric-Kentucky Utilities Merger, 1997 Ky. PUC LEXIS 274, at *18 (summarizing applicants’ argument that increasing the customer share of savings based on the company’s current earnings “would require them to terminate the merger because it is a fully priced transaction and any reduction in their earnings would result in an unacceptable loss of shareholder value” (emphasis added)).

30 Id. at *21 (finding that in merger’s non-fuel merger savings in Year 6 would increase significantly; requiring the companies to present a sharing plan in Year 5). See also Central Illinois Public Service-Union Electric Merger, 1997 Ill. PUC LEXIS 546, at *76 (requiring the merged company to submit a new rate case within six months of merger consummation, because “the one-year time frame proposed by CIPS would result in an unreasonable delay in the [retail] ratepayers’ receipt of an appropriate share of merger-related savings”). Reviewing that transaction, FERC found that the proposed “shared savings plan” for wholesale customers would make the merger risk-free to the shareholders because ratepayers would bear all merger costs in the merger’s early years, whereas “many of the merger benefits are more speculative in nature and will not be realized, if at all, until much later.” FERC ultimately approved the merger with different sharing conditions. Union Electric-Central Illinois Public Service Merger, 77 F.E.R.C. ¶ 61,026, at text accompanying n.21 (1996).

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savings plans for approval, then execute them as of specific dates. These two actions enable the commission to gather the facts on merger savings, set rates that reflect those savings, then adjust the rates as new information arrives—all without violating the prohibition against retroactivity. That way, the savings allocation is decided by the commission, not by the merged company.

7.2.1.2 Double-leveraging: another path to excess returns

Chapter 5.3.2.1 explained double-leveraging. The acquirer finances its acquisition with a mix of debt and equity. Debt costs less than equity because the lender has a contractual right to interest on and repayment of principal; equity investors, in contrast, receive no promises from their company. Conventional ratemaking reflects that cost difference by establishing separate costs of capital for debt and equity. Acquirers see the debt-equity difference as an opportunity for gain. If they can use debt to buy the target’s equity, but persuade the commission to authorize an equity-level return on that target’s equity (including the portion purchased with lower-cost debt), the target’s value to the acquirer rises. This extra value comes not from operational improvement but from financing technique. It causes the acquirer to pay a premium, which becomes gain to the target shareholders.

Ratepayers argue that this practice—charging ratepayers an equity-level return on equity purchased with lower-cost debt—violates ratemaking’s central principle: that rates must reflect “lowest feasible cost.” The portion of the target’s equity purchased with debt, they say, should be compensated at the cost of debt, not the cost of equity. Acquirers disagree. Since the holding company holds the debt, they say, the holding company bears the risks associated with that debt. Ratepayers should not get the benefit of debt financing when they avoid the debt’s risk.

But ratepayers do bear risk. By increasing its debt, the holding company decreases its ability to raise equity for the utility. (The holding company, recall, is the utility’s sole source of equity.) And because a debt-burdened holding company will need access to acquired utility’s earnings to help pay off the holding company’s debt, lenders will view the utility as less able to pay off its own debts, and so demand a higher interest rate on prospective utility debt.

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33 See Direct Testimony of Adam Gatewood at 41, Great Plains Energy-Westar Energy Merger I, Docket No. 16-KCPE-593-ACQ (Kan. Corp. Comm’n filed Dec. 16, 2016) (explaining that credit rating agencies recognize that a weakness in either parent or subsidiary will reduce the creditworthiness of the other, especially when the
And debt burdens, whether at the holding company or utility level, can distract management from its core responsibility—providing a utility service reliably and cost-effectively. The real inconsistency, the argument goes, is with the merger applicants: they want to deny ratepayers the benefit of acquisition debt, while telling lenders that ratepayers’ very presence ensures repayment of that debt. As the Kansas Commission explained, double-leveraging causes ratepayers to “subsidiz[e] the acquisition premium;” by doing so, “GPE is using the ratepayers as its bank.”\footnote{Great Plains Energy-Westar Energy Merger I, 2017 Kan. PUC LEXIS 1142, at *39–40 ¶ 44.}

But merger applicants argue back. When a commission applies an equity-level return to a utility’s total book equity, applicants say, it doesn’t care whether individual shareholders bought their stock with debt—so why treat a corporate acquirer any differently? Here’s why: an individual’s ordinary purchase and sale of a utility’s individual shares differs fundamentally from the bulk purchase and sale of all the utility’s shares. The individual stock sales occur in a competitive stock market. Each share is a commodity—indistinguishable from any other share. Because an objective market sets the price, no individual shareholder can extract a price exceeding the market price. But an entire company is not a commodity. It is a differentiable product—indeed, a monopoly product, so its shareholders when acting together have market power. They use that market power to extract the control premium—the excess of purchase price over market value. And as Chapter 1.2.2 explained, the sale is a sale of more than a company; it is a sale of control of a franchise—a government-protected right to provide a monopoly service.

The Kansas Commission didn’t bite. With the premium exceeding the applicants’ savings claims by $600 million, the Commission found the applicants’ commitment not to seek premium recovery not “credible”: “[I]t appears … the Joint Applicants … still plan to recover the acquisition premium indirectly from ratepayers.”\footnote{Id. at *39 ¶ 40.}

### 7.2.2 Regulatory Actions to Prevent Overcharges

To prevent overcharges—rates exceeding reasonable cost and profit—commissions need to allocate cost savings between shareholders and ratepayers so that post-merger rates align with post-merger costs. This subsection describes the traditional techniques, then explains why commissions need to discipline those techniques with clear principles and procedures. We companies have the same directors setting each company’s dividend and capitalization policies).
then address a distinct challenge: allocating costs and benefits not between shareholders and ratepayers, but between the ratepayers of the two merging companies.

7.2.2.1 Aligning rates with costs post-merger: traditional techniques
We have described two sources of merger-related overcharge: controlling regulatory lag, and earning equity-level returns on equity purchased with debt. To prevent or limit these overcharges, regulators have five common techniques. Here is a summary with commentary.

7.2.2.1.1 Freezing pre-merger rates
A rate freeze keeps post-merger rates at pre-merger levels, for some period of time. Its effects depend on the facts. If rates would have increased without the merger, a rate freeze benefits the customers to the extent of the avoided increase. But without a full rate case to establish what the increase would have been, a commission cannot know the benefit’s size. What if rates would not have risen without a merger; and instead, the merger reduces costs below the level underlying pre-merger rates? Then a rate freeze lets the shareholders earn a return exceeding the authorized return. Again without a full rate case, the commission cannot measure the over-earnings.

To eliminate this dual uncertainty, to know whom a rate freeze benefits, a commission can hold a general rate case contemporaneously with the merger proceeding. By establishing the target’s actual costs just prior to the merger, this technique provides an accurate cost base from which to deduct merger savings. The Maryland Commission used this approach in the proposed (later withdrawn) merger between Baltimore Gas & Electric and Potomac Electric Power. The rate case showed that the companies’ pre-merger rates already exceeded reasonable costs. So the Commission both lowered the merging companies’ rates and required a post-merger rate freeze. It also required a rate reduction reflecting a portion of the merger-produced savings. In another freeze variation, the Idaho Commission, like the Maryland Commission, first found that the target utility’s pre-merger rates already exceeded its costs. The Idaho Commission then imposed a cap on the utility’s rate of return, effectively sharing merger savings between shareholders and ratepayers.

36 See, e.g., Puget Sound Power & Light-Washington Natural Gas Merger, 1997 Wash. UTC LEXIS 6, at *30 (finding that given utility’s past history of rate increases, a five-year period of rate stability will benefit consumers).
37 Baltimore Gas & Electric-Pepco Merger, 1997 Md. PSC LEXIS 205.
38 Washington Water Power-Sierra Pacific Power Merger, 1995 Ida. PUC LEXIS 89. The applicants withdraw this transaction.
7.2.2.1.2 Rate credits
Some commissions require rate credits in the merger’s first year. This method guarantees ratepayers some share of merger cost savings. What share, no one knows unless the commission holds a contemporaneous rate case to determine the merged company’s actual cost structure.

In the Exelon-Constellation merger, the Maryland Commission combined direct ratepayer cost savings with public policy expenditures. The merged company had to:

- fund a one-time, $100 per customer credit, amounting to $112 million; and
- invest 50 percent of its projected “synergy savings” ($43.5 million), along with another $70 million, into a Customer Investment Fund. The Commission would spend the fund on energy assistance, energy efficiency and weatherization for low-income customers; zero- and low-interest financing for customer efficiency and conservation projects; and other programs to remove “barriers to adoption of technologies and behaviors related to energy use in homes and small businesses.”

These amounts were only a down payment on merger savings. Exelon also had to track the savings so the Commission could allocate them prospectively in the next rate case.

7.2.2.1.3 Trackers
Without a contemporaneous rate case to establish the target’s pre-merger cost basis, rate freezes and rate credits allocate merger cost savings in the dark. To get more clarity while avoiding a full rate case, some commissions establish trackers. A tracker first screens out savings that would or should have occurred without the merger. Then it identifies merger-induced cost reductions as they occur, allocating those reductions between shareholders and ratepayers via

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41 Cf. Kansas Power & Light-Kansas Gas & Electric Merger, 1991 Mo. PSC LEXIS 44 (finding applicants’ proposed tracking mechanism inadequate because it did not exclude all non-merger savings from the pool of savings to be shared).
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a sharing formula.\textsuperscript{42} Trackers usually operate for only a few years, because
beyond that point it becomes hard to know whether a particular cost reduction
would or should have occurred without the merger.

7.2.2.1.4 Hybrids
Merger negotiations have produced hybrids that mix rate credits and trackers
with later rate cases to verify the outcomes. Consider this Vermont stipulation,
requiring that

- over the first three years, customers receive a credit totaling $15.5 million
against current rates, while the merged company keeps any remaining
savings from operations and maintenance (O&M) costs;
- for years 4–8, shareholders and customers share operations and mainte-
nance cost savings 50-50;
- for year 9 and thereafter, customers receive all operations and maintenance
savings, through rate-setting on a traditional cost-of-service basis; and
- customers receive all non-O&M cost savings.

The parties expected that over 10 years, customers would receive $144 million
(including the $15.5 million in the first three years), out of projected O&M
savings of $226 million.\textsuperscript{43}

7.2.2.1.5 Most-favored-nation clauses
Multistate mergers can produce different outcomes in different states, because
parties bargain differently and because commissions tend to defer to the
bargains reached. This fact has led some state commissions to make merger
applicants match the most favorable terms reached in other states.\textsuperscript{44}

\textsuperscript{42} See, e.g., Green Mountain Power-New England Energy Merger, 2007 Vt. PUC
LEXIS 74, at *29–30 (accepting Green Mountain Power’s proposal to track by FERC
account, for seven years, “actual savings resulting from the proposed merger and
compare them to estimated savings; such savings shall reflect a flat 2.5 percent infla-
 tion rate for ease of tracking”); Southwest Public Service Co., 1997 WL 78696 (requir-
ing tracking mechanism to compare operations and maintenance expense post-merger
to the expense expected without the merger).

\textsuperscript{43} Central Vermont Public Service-Gaz Metro Merger, 2012 Vt. PUC LEXIS 279,
at *90–92 (Findings 194–198).

\textsuperscript{44} See, e.g., Duke Energy-Union Light, Heat & Power Merger, 2005 Ky. PUC
LEXIS 1005, at *23–24 (requiring reconsideration of shareholder-customer sharing
ratio after all the other states complete their proceedings).
7.2.2.2 **Missing: principles and procedures**

We have described five techniques commissions use to allocate merger savings between shareholders and ratepayers: freezes, credits, trackers, hybrids and most favored nation clauses. All five have the same two suboptimalities: the lack of current cost information leaves the actual allocation unknown; and whatever allocation does occur is disconnected from any stated regulatory principle. Parties and commissions might describe the outcome as “fair”; but no one defines fairness or explains why it is fair for a government-protected company to earn returns above the authorized return (the necessary result of allowing the merged company to keep any of the savings). When the commission lacks both cost information and allocation principles, while the merging companies control both the cost information and the decisions on when to produce savings, the resulting allocation—whether implicit or explicit—will likely favor the merging companies. The principle and procedure discussed next provide a more objective, factual basis for the allocation decision.

7.2.2.2.1 **Principle: allocate merger savings based on relative contribution**

Chapter 5.5 recommended allocating the control premium based on shareholders’ and ratepayers’ relative contributions to the value underlying the premium. The same principle works here: shareholders’ and ratepayers’ share of merger savings should reflect their relative contribution to those savings.

Consider economies of scale and best practices—two commonly cited sources of merger savings. Economies of scale, as Chapters 5.3.2.3 and 6.1.2 explained, reflect a product’s inherent cost function. A cost function relates per-unit cost to quantity of sales. For an electric utility, the quantity of sales depends on the size of the population within the government-granted franchise territory, along with the general economic conditions and regulatory policies that affect demand and consumption levels within that territory. Because economies of scale owe nothing to shareholder risk-taking or utility decision-making, the shareholders have no logical claim to those savings. They exist only because government policy makes customers captive. Those facts support allocating all economies of scale savings to customers. As for best practices, unless the merging companies’ practices are patented, they are likely ones conventionally used by prudent utilities—practices integral to a utility’s obligation to serve. Since prudent practices are what ratepayers pay for, again the associated savings should go fully to them.

If the evidence on benefit-entitlement is absent or inconclusive, the commission can apply a default presumption of 50-50—a rebuttable presumption that shareholders and ratepayers contributed to the savings equally.

This principle for allocating merger savings—benefits to the benefit-producers, except where benefit production is part of the obligation to serve—has several advantages. First, it can discipline the control premium: no
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longer will the acquirer base the premium on an expectation of earning excess returns through withholding merger savings from customers. Second, it will cause prospective acquirers to predict savings (and their causes) with more precision, and even to seek advance commission rulings on who will receive which savings—again disciplining the premium by aligning the acquisition price with post-merger rate treatment. Third, and a result of the first two benefits: the competition among acquirers will focus more on performance, because the control premium—which target shareholders seek to maximize—will be recoverable only to the extent of unique benefits not achievable without a merger. Mergers will emerge from a competition where the main criterion is merger savings rather than acquisition price.

7.2.2.2 Procedure: combine merger case with rate case

Cost-based rates should reflect a company’s cost structure. If a merger changes the cost structure, the commission should change the rates. The appropriate rate procedure depends on the facts.

If the pre-merger rates already reflect pre-merger costs: Rates set within the 12-month period preceding the merger will likely reflect actual cost, so they will provide an accurate basis for merger-related adjustments. The merger approval order should require the utility to file new rate tariffs in, say, 90 days. Those new tariffs would adjust the pre-merger rates to reflect merger costs and merger cost reductions in two categories: (1) those the commission approved or ordered in the merger case, based on solid evidence; and (2) those the applicants are now ready to present, having had 90 days to start the merger integration process. The first category of costs and cost reductions would enter rates automatically. The second category would be litigated in this first post-merger rate case. For this second category, the commission would either (a) decide their fate and reflect the results in the new rates; or (b) use a tracker so that rates change as actual costs change.

If the pre-merger rates don’t reflect pre-merger costs: Rates that were set more than 12 months before the merger will not likely reflect actual costs, so will not provide an accurate basis for merger-caused adjustments. The commission then has two main choices.

a. Combine merger case with rate case. Setting rates simultaneously with approving the merger makes clear the financial consequences for all parties upfront. In 1997, it had been several years since the Maryland Commission had reviewed either of Pepco’s or BG&E’s rates. The applicants’ proposed rate freeze would extend this unexamined period for another 2.5 years. The Commission didn’t take the bait. Insisting that “[w]e need to evaluate all rea-
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reasonable methods of providing customers with a fair share of merger savings,” it held a full rate case alongside the merger case.45

b. Combine merger approval with a directive to file a full rate case within 90 days. This rate filing would reflect the commission’s decisions about the acquisition premium, intercompany and interjurisdictional allocations of costs and benefits, treatment of transaction and transition costs, and any required or projected cost reductions. The directive would also make the pre-merger rates “interim subject to refund.” Doing so gives the commission time to set the new rates, then allows it to make the new rates effective back to the date of the merger approval order without violating the prohibition against retroactivity.

Most states have used none of these options. Instead they adopt one of the five non-rate case measures—freeze, credit, tracker, hybrid or most favored nation clause—then wait to open a new rate case until excess earnings appear,46 or until the merged company or intervenors ask.

7.2.2.3 Allocating costs and benefits between the merging companies

Two merging utilities will have two different cost structures: different types and vintages of generating capacity, different load shapes, different fuel contracts, different equity-debt ratios, different costs of equity and debt capital. Different cost structures mean different rate levels.

Merging these two companies poses an immediate problem: if the commission melds their pre-merger rate structures into a single average rate structure, the lower-cost company’s rates will rise. If the two companies serve in different states, that prospect dooms the transaction because no commission will approve a merger that raises rates. Even where the merging companies serve in the same state, their commission will not likely risk the political fallout of raising the lower-cost company’s rates. On the other hand, maintaining separate rate structures conflicts with creating a unified post-merger entity.

The common approach? Let sleeping dogs lie, at least for a while.47 Commissions can also phase in average rates over a time period long

46 See, e.g., NSTAR-Northeast Utilities Merger, 2012 Mass. PUC LEXIS 84, at *8 (holding that “even with approval of the Proposed Merger, if at any time the Department has any reason to believe that the earnings of NSTAR Electric, NSTAR Gas, or WMECo are excessive or if we have concerns about their prices or quality of service, we will investigate the propriety of rates” under existing ratemaking authority); Northeast Utilities-NSTAR Merger, 2012 Conn. PUC LEXIS 47, at *65 (committing to hold a future proceeding that “would involve a determination of the appropriateness of the merger-related costs expended in order to achieve the merger related savings”).
47 See, e.g., Pacific Power & Light-Utah Power & Light Merger, 1988 Mont. PUC LEXIS 20 (holding that lack of clarity over interjurisdictional cost allocations was not sufficient grounds for rejecting the merger, since commission will decide post-merger
Hierarchical conflict harms customers enough to soften opposition. Or they can allocate the merger cost reductions non-proportionally to the higher cost company, as a way to reduce rate differentials over time.

Differing capital structures present a distinct challenge. Because acquisition debt increases the consolidated entity’s debt-equity ratio, the acquired utility will be subject to new financial risks, possibly increasing its future debt and equity costs. Even without acquisition debt, merging two different capital structures changes the debt-equity ratio for the whole. The less debt-leveraged utility becomes part of a more debt-leveraged company; the less equity-heavy utility becomes part of a more equity-heavy company. Whether these changes affect either company’s cost of capital will depend on the size of the change, the amount of any acquisition debt and each utility’s pre-merger financial condition.

### 7.3 ACQUISITION DEBT RISKS

To buy a target with cash, the acquirer needs cash. That cash can come from four sources: the acquirer’s retained earnings, new debt incurred by the acquirer, new equity issued by the acquirer, and proceeds from selling the acquirer’s or target’s assets. Using debt is attractive because it costs less than equity while keeping the acquirer’s retained earnings and assets intact.
And as we will see, using acquisition debt also reduces the acquirer’s need to issue new equity shares, an action that can dilute the value of existing shares. But when acquisition debt enters the merged company’s capital structure, the acquired utility faces new risks. This section describes five. Individually and together, these risks illustrate the conflicts between debt-leveraged consolidations and the public interest in cost-effective utility service.

7.3.1 Acquisition Lenders Want the Acquirer to Control the Target Utility’s Financial Resources

An acquirer plans to pay $1.2 billion in cash for a target whose current stock market value is $1 billion. The acquirer’s shareholders will receive something (a $1 billion company) worth less than they paid ($1.2 billion). Assume the acquirer raises some of the $1.2 billion by issuing new equity shares. Doing so will dilute the value of existing equity shares. To reduce that dilution—and to persuade its existing shareholders to approve the transaction despite the dilution—the acquirer will weight the acquisition financing toward debt and away from new equity. But to make that new debt low-cost, the acquirer must make the debt low-risk. How does a utility’s acquirer persuade its lender that its large acquisition loan will be low-risk? By getting control of the acquired utility’s cash flow—the cash flow from captive customers. That control will help convince lenders that the borrower will repay the debt.

NextEra faced this situation when seeking to pay a premium for the Texas utility Oncor. To reduce dilution of its existing shareholders’ equity, NextEra needed to finance the acquisition in large part with debt. But the large acquisition debt would be costly. It would also reduce NextEra’s bond ratings, making it harder to finance future acquisitions. How might NextEra use Oncor’s captive customers to gain favorable terms from NextEra’s lenders, so as to reduce the equity dilution that might spark opposition from NextEra’s shareholders? The answer was “credit linkage”: consolidating Oncor’s strong financial metrics (strong because it had captive customers) with NextEra’s already debt-heavy metrics. If NextEra could control Oncor’s cash flow, bond rating agencies would view NextEra’s financial condition as enhanced by Oncor’s financial strength.50


50 See Direct Testimony of Staff Witness Randall Vickroy at 27, Oncor Electric Delivery-NextEra Energy Merger, PUC Docket No. 46238 (Tex. Pub. Util. Comm’n filed Jan. 18, 2017) (explaining that NextEra’s credit linkage to Oncor would “offset the increased financial leverage associated with the transaction’s financing plan, allowing NextEra Energy [the acquirer] to maintain its current credit rating level”).

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How then would NextEra get control over the utility’s cash? NextEra proposed to control appointments to Oncor’s Board (except for three “disinterested directors”), and to eliminate the Oncor minority shareholders’ veto rights over Oncor’s dividend and budget decisions. Those two changes would allow NextEra to control Oncor’s cash flow: its spending, investments and dividend payments. All this was confirmed by Standard and Poor’s:

NextEra will be in a position to exercise effective control over Oncor’s resources and cash flows with no additional meaningful insulation imposed elsewhere; this would strengthen its business risk profile to offset the weakened financial profile that results from the proposed [acquisition debt] funding, and leave ratings at the current level.51

The Texas Commission saw things differently. It wanted Oncor’s Board to retain “control over Oncor’s decisions on capital expenditures and operating expenses.” It saw Oncor’s independence from NextEra’s financial needs as “a critical part of the ring fence protecting Oncor.” But NextEra had made clear that Oncor’s independence “would be unacceptable,” so the Commission had no choice: it rejected the transaction.52

By rejecting the NextEra-Oncor transaction, the Texas Commission made the problem go away. But the tensions it addressed will exist whenever an acquirer pays a premium: to avoid equity dilution the acquirer needs to borrow money; but the lenders will want assurance that the acquirer can control the utility’s cash. To please its shareholders the acquirer must have access to the ratepayers. That is one risk from acquisition debt.

7.3.2 Acquisition Debt Creates Financial Risk for the Target Utility

The acquirer’s acquisition debt puts financial pressure on the acquired utility, in at least five ways.

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51 Id. at 28 (quoting NextEra Energy’s Response to Texas Industrial Energy Consumers’ Request for Information 1-4, Attachment 3 at 118, STANDARD & POOR’S RESEARCH UPDATE (Aug. 2, 2016)).

52 Oncor Electric Delivery-NextEra Energy Merger, 2017 Tex. PUC LEXIS 1310, at *19. The Commission soon after approved Oncor’s acquisition by Sempra (the holding company for San Diego Gas & Electric). The Texas Commission’s rejection of NextEra’s acquisition was one of only six merger rejections, out of nearly eighty transactions, in the last thirty-five years. A discussion of those six rejections, explaining why they stand out from the many approvals, appears in Chapter 11.2.
Decrease in utility’s access to equity: When Northeast Utilities proposed acquiring the bankrupt Public Service of New Hampshire, Connecticut regulators found that NU’s high debt and PSNH’s weak earnings would put additional, though indirect, financial stress on [Connecticut Light & Power, an NU subsidiary] and may hinder its access to the financial markets and distort its cost of debt and/or equity. Since CL&P is dependent on NU for infusions of equity, a merger that leaves NU financially weak and saturates the market with NU common equity jeopardizes CL&P’s access to equity.53

And GPE’s high acquisition debt caused the Kansas Commission to label the original GPE-Westar transaction “too risky.” Moody’s had downgraded GPE’s long-term bond ratings, warning that the transaction would “result in consolidated financial metrics [that] reflect levels that are typically associated with a speculative grade financial profile. …” The Commission concluded:

Even if all of GPE’s [financial] projections are accurate, its ability to maintain an investment grade credit rating is tenuous. If its projections are overly optimistic or a negative event such as an increase in interest rates occurs, GPE’s ability to service its debt could be in jeopardy.54

And GPE’s troubles would make it less able to put equity into Westar’s two utilities.

Increase in utility finance costs: The acquirer attracts acquisition lenders by projecting the merged entity’s earnings. If actual earnings lag those projections, future lenders will view the acquirer as riskier—leading to lower bond ratings and higher interest costs on future debt. Then money put by the acquirer into the utility will come at a higher cost, causing the utility to seek higher rates.55 Indeed, an acquisitive holding company’s interest rates can rise

54 Great Plains Energy—Westar Energy Merger I, 2017 Kan. PUC LEXIS 1142, at *26–34 ¶ 30–36. But see Puget Sound Energy—Macquarie Merger, 2008 Wash. UTC LEXIS 1023 (approving Australian company’s acquisition of local utility; though 20 percent of the acquisition cost would be financed with debt, (a) the resulting leverage would be less than prior transactions approved by the Commission, (b) the new acquisition debt would be held at the holding company level rather than at the utility level, (c) commission-imposed conditions would protect ratepayers from bearing the risks attributable to the debt, and (d) in the near future the utility will have to incur new debt anyway). One Commissioner dissented.
55 See, e.g., Southern California Edison—San Diego Gas & Electric Merger, 1991 Cal. PUC LEXIS 253, at *218 (“To some extent … the merged company’s financial condition depends on future Commission willingness to have ratepayers absorb increased costs resulting from the merged company’s capital structure.”); Great Plains
merely because rating agencies expect the company to make debt-leveraged acquisitions. As Fitch stated, in assessing Exelon’s proposed acquisition of PHI: “Even without the completion of this merger, ratings may also be lowered in recognition of [Exelon’s] willingness to pursue a leveraged acquisition.”\textsuperscript{56}

\textbf{Reduced debt access for the utility subsidiaries:} While a 100-percent-owned utility depends on its parent for equity, it can borrow externally in its own name. But the utility’s lenders will worry that a debt-burdened holding company will be unable to provide the utility equity. Less equity means the utility can make fewer infrastructure investments—the investments that produce the earnings that give lenders the confidence to lend.

\textbf{Reduced value for existing bondholders:} The utility’s pre-merger debt carries interest rates reflecting the utility’s pre-merger risks. Post-merger, buyers of the bonds associated with that debt will pay less than they would have pre-merger, because they will be buying an income stream (the existing bonds’ repayment obligation) made less certain by the acquisition.

\textbf{Higher cost of holding company equity:} By taking on acquisition debt, the holding company lowers the probability that its earnings will satisfy prospective equity investors’ expectations. As the Missouri Commission explained: “Although a company’s credit rating applies most directly to its access [to] and cost of debt, companies with a lower credit quality also find fewer equity investors willing to risk their investment dollars on their stock.”\textsuperscript{57} Equity investors will require a higher return—making it more expensive for the holding company to finance the utility.

\subsection*{7.3.3 If the Acquirer Defaults, its Creditors Can Become the Target Utility’s Owners}

Because an acquiring holding company is not a utility company, it does not have the revenue certainty that lenders prefer. Lenders will insist on collateral—like the acquired utility’s stock. If the utility’s stock is collateral for the acquisition loan, then on default the acquirer’s creditors can become the


\textsuperscript{57} Great Plains Energy-Kansas City Power & Light Merger, 2008 Mo. PSC LEXIS 693, at *244.
utility’s owners. The creditors then could remain owners, or they could sell the company to the highest bidder and get out. Neither result—a utility run by creditors lacking experience in utility operations, or run by a company selected based on its ability to pay off the acquisition debt—serves the public interest.

As one commentator described the utility-stock-as-collateral problem:

In keeping with the spirit of speculation that led to the 1929 stock market crash, these kinds of holding companies had frequently pledged as collateral their ownership interests in public utilities (regulated businesses with guaranteed but unspectacular profit margins) for loans that could in turn be invested in more flamboyant ventures possessing greater potential for outsized, speculative gains. When the stock market crash took down the speculative ventures, the holding companies defaulted on these loans and the lenders foreclosed on the underlying collateral, the nation’s supposedly “boring” public utility companies themselves. Thus, an unexpected artifact of the stock market crash was the indirect financial chaos it spawned even in safe sectors of the economy, including industries providing such bedrock services as fresh water and electric power.

Creditor takeover should not happen automatically. Any commission order approving a debt-financed acquisition should make clear that a default-triggered acquisition will require commission approval. Otherwise, the commission’s decision about the original acquirer’s appropriateness would become meaningless should that acquirer be replaced by creditors.

The path just described assumed the parties resolved the default outside of bankruptcy. But default can also lead to bankruptcy. Remember that the acquisition debtor is not a traditional utility—a company whose stable revenue makes bankruptcy rare. The acquisition debtor is a holding company—an investment vehicle that likely holds less stable, non-utility companies like merchant generation companies—a type of company for which bankruptcy is

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59 See Atlantic Tele-Network Co. v. Pub. Serv. Comm’n, 841 F.2d 70, 72–73 (3d Cir. 1988) (upholding Virgin Islands commission’s conditions attached to the acquisition of telephone company stock, where the commission found (in the court’s words) that “since the [utility] stock is pledged as security for the [acquisition] debt, default would result in a chaotic situation for the utility”; and further holding, based on Virgin Islands statute, that “we do not believe the Virgin Islands legislature intended that the PSC would have to wait until disaster struck before taking remedial action”).

not rare.\textsuperscript{61} If the combination of acquisition debt and other failing investments leaves the holding company unable to meet its obligations, it could enter, or its creditors could push it into, bankruptcy.

Then what? The bankruptcy trustee will carry out its legal duty—to maximize the bankruptcy estate’s value so the creditors can recover what they can.\textsuperscript{62} A major value will be the holding company’s stock in the acquired utilities. So the trustee will auction those utilities off to the highest bidder. Recall Oncor: a healthy Texas utility whose private equity, highly leveraged owner went bankrupt; Oncor was sold to the highest bidder.\textsuperscript{63} Nothing in bankruptcy law requires the trustee to select the most cost-effective utility operator. What the trustee must maximize is dollars, not performance.

But an alert commission can make performance the priority, if it acts affirmatively. It can add to its acquisition approval a condition stating that it will approve a post-default or post-bankruptcy owner only if that candidate, among all possible candidates, best meets the commission’s criteria for performance. With that condition in place, the bankruptcy court’s choice of acquirer will need to satisfy the commission’s priorities.

This commission action is available because bankruptcy law does not preempt a commission’s state law authority over ownership transfers.\textsuperscript{64} That was the Texas experience. Oncor was owned 80 percent by Energy Future Holdings Corp (EFHC). Due to its high acquisition debt and its merchant generation troubles, EFHC went bankrupt. The bankruptcy court approved Oncor’s acquisition by NextEra. The Texas Commission then rejected NextEra’s


\textsuperscript{62} See Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 343, 352 (1985) (holding that trustee has “the duty to maximize the value of the estate”).


\textsuperscript{64} The absence of preemption arises from Bankruptcy Code section 362(b)(4), which exempts from bankruptcy law’s automatic stay “the commencement or continuation of an action or proceeding by a governmental unit … to enforce such governmental unit’s or organization’s police and regulatory power.” 11 U.S.C. § 362(b)(4). An explanation of this provision and the applicable case law appears in Appendix A.2.
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acquisition application. No one suggested that the bankruptcy court’s prior approval of NextEra bound the Texas Commission. EFHC’s creditors had to return to bankruptcy court to repeat the process, producing a new winning bidder, Sempra (the holding company for San Diego Gas & Electric). Sempra then had to get the Texas Commission’s permission to acquire Oncor. Again, no one suggested the bankruptcy court’s approval of Sempra prevented the Texas Commission from finding otherwise, or from adding conditions to any the bankruptcy court had imposed.65

While the Texas Commission faced no federal preemption, its method—waiting for and reacting to what emerges from the bankruptcy court—limited its options, because the bankruptcy process emphasizes price over performance. Commissions instead should state in their merger policy that bankruptcy outcomes must satisfy the commission’s specific performance criteria. Seeing this policy upfront, prospective acquisition lenders will know that if default occurs, their wish for the highest payback will take a back seat to the commission’s performance priorities. And if then no lenders want to finance the acquisition, we will know that the transaction’s purpose was not performance.

7.3.4 Acquisition Debt Limits Commissions’ Ability to Extract Performance and Attract New Performers

An acquirer incurs acquisition debt because it expects post-acquisition earnings. If regulators, post-acquisition, act to reduce the expected earnings, they might weaken the holding company. Because a weakened holding company cannot provide capital support to the utility, regulators will hesitate to take such actions. By approving debt-financed acquisitions, then, regulators limit their future options. This problem arises in two main areas: cost discipline and competitive discipline.

Cost discipline: Chapter 5.3 explained that the acquirer pays a premium because it expects post-acquisition returns to exceed both its acquirer’s required returns (its hurdle rate) and the commission’s authorized returns. Suppose the commission approves a debt-financed acquisition. Suppose a year later the commission determines that the acquired utility’s authorized return exceeds its required return. Lowering the authorized return to reflect the required return will push the utility’s earnings below the projections that supported the acquisition debt. The utility, holding company, rating agencies, lenders and stockholders will all pressure the commission to reconsider—to

65 The Texas Commission approved the transaction (and all terms of a settlement among the parties) in Oncor Electric Delivery-Sempra Energy Merger, 2018 Tex. PUC LEXIS 592.
set the authorized return based not on proper capital market theory but on the holding company’s private needs, needs that arose from its acquisition debt rather its utility service obligations. The concern applies not only when a commission adjusts the authorized return; it applies to any form of regulatory discipline, including disallowing imprudent costs and allocating to shareholders the risk of investments that are prudent but turn out to be not used and useful.\textsuperscript{66} The more debt in the utility’s holding company family, the greater the post-acquisition pressure on the commission to refrain from imposing fiscal and operational discipline.

\textit{Competitive discipline:} Chapter 1.2.2.3 explained another reason for acquisition debt: the acquirer expects the utility to increase its earnings by rate-basing future infrastructure projects. What if the regulator decides that the utility must outsource those future projects competitively, thereby reducing the utility’s own rate-basing opportunities? This action, like the cost-disciplining actions just discussed, will lower the utility’s earnings below the acquirer’s expectations. That lowering will put pressure on regulators to scrap competitive bidding and award all capital projects to the utility. Approving debt-financed acquisitions reduces regulators’ flexibility.

\textit{7.3.5 Solutions: Five Regulatory Signals, Sent in Advance}

“\textit{H}igh acquisition premiums … intensify the inherent conflict between shareholders and ratepayers.”\textsuperscript{67} To reduce the conflict, reduce the acquisition debt by limiting what acquirers pay. Commissions can do so by announcing a five-part policy.

1. \textit{Prohibit excessive acquisition prices:} Commissions can establish a standard for the acquisition price. Section 10(b) of PUHCA 1935 prohibited holding company acquisitions of utilities if the acquisition cost was “not reasonable or does not bear a fair relation to the sums invested in or the earning capacity of the utility assets to be acquired or the utility assets underlying the securities to be acquired.”\textsuperscript{68} Commissions can adopt a similar standard, backing it with metrics based on earnings expectations that preserve regulatory flexibility to discipline future performance.

\textsuperscript{66} See, e.g., \textit{New England Power Co.}, 8 F.E.R.C. ¶ 61,054 (1979), aff’d sub nom. NEPCO Mun. Rate Comm. v. FERC, 668 F.2d 1327 (D.C. Cir. 1981) (upholding FERC’s decision to disallow rate-basing of prudent unamortized expenditures on cancelled (i.e., not used-and-useful) plant, while allowing their recovery over five years; treatment was a reasonable balance of policy objectives).


2. **Limit recovery of the acquisition premium:** The limit can be a complete prohibition, or a cap based on the prudence standard; specifically, that the benefit-cost ratio, calculated to include the premium in the cost variable, must equal or exceed the next most beneficial investment of those funds.69

3. **Adjust the target utility’s revenue requirement to reflect the true cost of capital:** Commissions should make clear that if the acquirer buys the target’s equity with debt, the utility’s authorized return on rate base will reflect the cost of that debt; the equity financed with debt will not earn an equity-level return. Commissions also should establish authorized returns on equity reflecting the low risk of a conservatively financed, pure-play utility rather than a utility affiliated with a higher-risk, more leveraged holding company system.70 And commissions should make clear that they will adjust the authorized return on equity to reflect the true cost of equity.

4. **Establish ring-fencing requirements:** As described in Chapters 7.4.8.2 and 7.4.8.3 below, ring-fencing prevents the holding company and its affiliates from extracting excess dividends from the utility, or using the utility’s assets as security to support non-utility debt—two actions that encourage lenders to over-lend and acquirers to over-borrow.

5. **Dampen expectations of automatic future rate-basing opportunities:** Prior to any acquisition, the commission should make clear that an acquisition approval includes no implicit promise that future capital expenditure opportunities will necessarily go to the incumbent utility.

Together, these five measures will discipline prospective acquirers’ earnings expectations and therefore their offer prices, bringing them closer to levels reflecting the discipline of a competitive market. Competition among acquirers will more likely be based on who can create the most customer benefits rather than who can finance the highest price. Bond-rating agencies will evaluate acquisition debt in light of the commission’s limits on future utility earnings, signaling their support or concern accordingly. It is better to have the rating agencies warn acquirers away from debt-heavy transactions than

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69 As explained in Chapter 4.3.3.

70 As the Connecticut regulators stated:

[I]t may no longer be appropriate to use the NU holding company as a proxy for CL&P for the purposes of determining the cost of equity for ratemaking purposes. Not only might the degree of leveraging differ between the two entities, but the market perception of business risk might differ as well. . . . It is not appropriate for CL&P ratepayers to incur capital costs that reflect the additional leveraging and business risk associated with NU’s acquisition of the PSNH system. Northeast Utilities-Public Service of New Hampshire Merger, 1992 Conn. PUC LEXIS 23, at *42.
to allow those transactions to occur and then have the rating agencies warn regulators against imposing appropriate cost discipline.

No commission has announced these policies ahead of a merger, though some variants appear in merger settlements approved by a commission—but only in a form acceptable to merger applicants that designed their transactions without these constraints. FERC in fact has no standards for acquisition financing—not in its 1996 Merger Policy Statement, not in its Order Nos. 642, 667 and 669, and not in its many merger opinions. Indeed, many FERC merger decisions fail even to describe a proposed merger’s financing, let alone assess the financing’s consistency with the public interest.

7.4 NON-UTILITY BUSINESS RISKS

In a laboratory setting, it might be possible to take a utility apart and analyze it so as to insulate ratepayers from all of the potential costs and risks of [investing in non-utility businesses]. Then we could begin to discuss whether the utility can be expected to prudently diversify its activities so as to take advantage of opportunities to minimize its costs. In the real world, ratepayers are unavoidably involved.71

Non-utility businesses bring risks to the utility and its customers. This sub-section first identifies the types of business risks; then describes five adverse effects: contagion, weakened utility finances, quality-of-service slippage, reduced accountability to regulators and loss of regulatory control over future acquisitions. Merger applicants tell regulators these risks are speculative but tell shareholders the risks are material. Given that materiality, the section closes with recommendations for rules that limit the risks and contain their effects.

7.4.1 Types of Business Risk

With PUHCA 1935’s repeal, a utility’s holding company owner can buy, or be bought by, non-utility businesses of any type or size, located anywhere. These businesses involve risks different from and greater than those associated with providing a monopoly utility service. Pure-play utilities, protected from competition and legally assured of just and reasonable rates, have a record of stable earnings and growth. Holding company systems with large non-utility businesses change that model:

In the past, utility managers failed their investors when they bet the company on a technology they did not understand (nuclear power), when they entered businesses

far afield from their experience (diversification), and when they plunged into seemingly related businesses without adjusting their finances to the new risk levels (merchant generation, power marketing, and foreign investment).\footnote{Leonard S. Hyman, Investing in the “Plain Vanilla” Utility, 24 Energy L.J. 1, 10 (2003). See also Markian M.W. Melnyk & William S. Lamb, PUHCA’s Gone: What Is Next for Holding Companies?, 27 Energy L.J. 1, 10 (2006) (finding that utilities’ non-utility investments in the 1980s were “not particularly successful”).}

Non-utility business risks are sufficiently large to trigger the holding company’s disclosure obligations under federal securities law. Consider these four examples, drawn from Exelon’s submission to the Securities and Exchange Commission when it was seeking to acquire the non-generation-owning PHI:

- **Operational risk:** For reasons within and outside the company’s control, older generation could suffer operational failure, requiring new expenditures that could adversely affect operations, financial condition or cash flow.

- **Climate change risk:** Exelon owned over 12,000 MW of fossil generation plants. The “possible physical risks of climate change,” and “mandatory programs to reduce GHG emissions,” could adversely affect operations and finance.

- **Economic risk from low-cost shale:** The development of low-cost shale gas sources could lower the value of Exelon’s embedded generation investment.

- **Nuclear-specific risk:** Exelon’s nuclear generation fleet “is subject to liability, property damage and other risks associated with major incidents at any of its nuclear stations.” Exelon says it “has reduced its financial exposure to these risks through insurance and other industry risk-sharing provisions.” By how much, Exelon didn’t say—except to say that on nuclear waste it is at risk for “losses [that] could have a material adverse effect on Exelon’s and Generation’s [Exelon’s generation affiliate] financial condition and results of operations.”\footnote{Exelon Corp., supra note 9, at 50, 33, 44, 14, respectively.}

Then there is the nuclear waste. Exelon’s nuclear-owning subsidiary is legally responsible for its disposal, but the nation remains undecided on a permanent burial place.\footnote{See Office of Pub. Affairs, U.S. Nuclear Regulatory Comm’n, Backgrounder: Radioactive Waste 2 (2019), https://www.nrc.gov/docs/ML0501/ML050110277.pdf (“At this time there are no facilities for permanent disposal of high-level waste.”); Key Issues: Disposal of High Level Nuclear Waste, U.S. Gov’T} Exelon has bet that someday, somehow, somewhere, someone will take care of its nuclear waste, without unanticipated cost to Exelon.
Foreign holding companies, which now own at least twenty U.S. utilities, represent a distinct set of risks. Foreign laws on taxes, financial disclosure, service quality, and competitive conduct affect those companies’ financial results in ways unfamiliar to U.S. regulators and investors. Also unfamiliar are (a) how foreign corporate executives evaluate new business risks and finance new acquisitions, (b) how foreign utility regulators set standards and compensate for performance, and (c) how foreign political sectors intervene in business and regulatory decision-making. Irritation in the political and trade relationships between the U.S. and foreign governments can also affect the foreign affiliates’ business prospects. Currency differences and changing exchange rates make the inter-affiliate prices hard to determine. Remote records and foreign language add to regulators’ difficulties in finding facts. These distinct foreign risks have not drawn much regulatory attention. Indeed, FERC granted a German acquirer a waiver from having to produce information on foreign energy interests: “We find that it is not necessary for E.ON to provide information at this time about its subsidiaries and affiliates that are not doing business in the United States or are transacting with other subsidiaries and affiliates within the United States.” The waiver was unaccompanied by explanation.

7.4.2 Contagion

Holding companies have corporate boundaries between their utility and non-utility affiliates, but risks seep through. For pure-play utilities, bond rating agencies base ratings on predictable factors like debt-equity ratios, operational performance and regulatory treatment. But for utility members of complex holding companies, the rating agencies’ “presumption is typically that the

75 See Table 3.3.

76 One significant exception: Chapter 11.2 will describe how the Province of Ontario’s interference in the management of its utility holding company, Hydro One, led Washington State’s commission to reject Hydro One’s acquisition of Avista, one of the state’s utilities.

77 E.ON-Powergen Merger, 97 F.E.R.C. ¶ 61,049, at p. 61,285 (2001) (authorizing acquisition, granting waiver of information requirements in Part 33.2(c)(2)).
utility subsidiaries will be affected by the nonutility businesses of a holding company”—unless there are “insulating factors.” Consider these examples:

- **Oncor**: This Texas utility was owned by a debt-heavy, bankrupt parent. Moody’s found that the parent’s debt pressured Oncor’s credit ratings: “Uncertainties surrounding the bankruptcy process include the high level of parent company debt that sits on top of Oncor and constrains Oncor’s rating at this time.” Freeing Oncor from its parent, Moody’s said, would “[resolve] … family contagion risk and [reduce] … parent holding company debt, both credit positives.”

- **Entergy**: In the early 1990s, Entergy (formerly Middle South) was the holding company owner of four utilities, each housed in a separate corporation. Entergy proposed to acquire a fifth utility, Gulf States, then in mid-litigation over the prudence of its River Bend nuclear investment. FERC found that “the potential for an adverse judgment [in the prudence litigation] may affect [acquirer] Entergy Corporation’s risk in capital markets and, thus, its cost of capital. The cost of capital for the parent, in turn, will affect all of the subsidiaries.”

- **Pinnacle West**: In the 1980s, Pinnacle West, the holding company owner of the utility Arizona Public Service, bought Merabank, a savings and loan company. When Merabank failed, Pinnacle West proposed filing for bankruptcy as a way to avoid having to provide the bank with more capital. That impending bankruptcy caused rating agencies to downgrade APS’s bonds to near-junk bond status, raising its borrowing costs.

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78 See Melnyk & Lamb, supra note 72, at 23.

For additional examples of contagion—non-utility business risk affecting the utility—see Exelon–PHI Merger, 2015 D.C. PUC LEXIS 203, at *174 ¶ 142 (finding...
7.4.3 Weakened Utility Finances

A holding company’s non-utility risks affect its decisions on the utility’s finances, in two directions: taking money out and putting money in.

_Taking money out:_ A utility’s captive customers provide predictable cash, monthly. The holding company can use that cash, and the assets that produce it, to help its higher-risk affiliates. It can compel the utility to (a) pay dividends to the holding company in amounts necessary to finance the non-utility affiliates, (b) lend money directly to those affiliates, or (c) pledge the utility’s assets as collateral for third-party loans to the affiliates. The Wisconsin Commission spelled out the problem:

The combination of [the utility holding company] WICOR’s dividend policy and its business objectives, which include acquisition as a major goal, puts pressure on Wisconsin Gas Company to provide an ample flow of cash to WICOR. Thus, the needs of WICOR could inappropriately become the “driver” in determining the amount of the Wisconsin Gas dividend.

Prior dividend payouts had not harmed the utility, the Commission found. But by continuing to extract dividends while ignoring the utility’s needs, the holding company risked “an increase in the long-term overall cost of capital for the utility due to a reduction in its current credit standing.” Extracting dividends “could benefit WICOR’s shareholders, but at the expense of Wisconsin Gas Company ratepayers.”

that Pepco “will be exposed to additional financial risks from the Proposed Merger due to Exelon’s unregulated businesses”); _id._ ¶ 259 (finding that that “ratepayers could be impacted if the cost of capital available to Pepco … is higher because of Exelon’s ownership of non-jurisdictional business operations in general and nuclear operations in particular”); Southern California Edison-San Diego Gas & Electric Merger, 1991 Cal. PUC LEXIS 253 (expressing concern about the proposed merger’s mixing of utility and non-utility businesses); Oncor Electric Delivery-NextEra Energy Merger, 2017 Tex. PUC LEXIS 807, at text accompanying nn.8 & 14 (finding that “the expansive and diversified structure of NextEra Energy and its affiliates would subject Oncor to new and potentially substantial risks,” including, but not limited to, “potential changes in renewable demand resulting from changes in climate or tax policy, commodity risks, retail electric provider risks, as well as power and nuclear generation risks, … [which] in conjunction with the high amount of leverage at NextEra Energy, increase the likelihood that unforeseen events could jeopardize Oncor’s financial stability”).

82 WICOR, Inc., 1987 Wisc. PUC LEXIS 53, at *19–20. See also Ariz. Corp. Comm’n v. State _ex rel._ Woods, 830 P.2d 807, 818 (Ariz. 1992) (en banc) (“The Commission must certainly be given the power to prevent a public utility corporation from engaging in transactions that will so adversely affect its financial position that the ratepayers will have to make good the losses … .”).
Putting money in: The utility business is capital-intensive. A utility continuously adds, repairs, upgrades and modernizes its capital equipment. Large generating plants and transmission lines cost billions and take years to build. Under traditional cost-based ratemaking, rates do not start recovering these construction costs from customers until the assets begin commercial operation. So the utility needs to finance plant construction with equity and long-term debt. A utility’s holding company is the utility’s sole source of new equity. But when the holding company puts scarce dollars into non-utility businesses it has less equity for its utilities.

7.4.4 Quality of Service Slippage

A holding company’s business risks affect not only its finances but also its utilities’ operations, in two ways.

Business complexity distracts management: Whether succeeding or failing, non-utility businesses distract management. Successes cause management to take more risks to produce more success; failures force management to invest time in saving or selling the troubled businesses. El Paso Electric Company had a real estate subsidiary that ran hotels and developed other opportunities. It lost $195 million—in the Texas Commission’s words, a “complete failure.” Utility management’s efforts to finance, save, then sell off these operations consumed “a significant amount of time, energy, and resources,” diverting attention from utility operations.

Non-utility financial pressures cause cost-cutting: If the holding company diverts utility funds to help the non-utility businesses, the utility’s operations and infrastructure can suffer. The Kansas Commission found that to repay its acquisition debt, GPE would take from the to-be-acquired Westar utilities the savings from post-acquisition utility operations. Doing so would cause the utilities to cut “vegetation management activities, and defer maintenance and system improvements”—all actions that would endanger public safety.


7.4.5 Reduced Regulatory Accountability

Some holding companies acquire utilities to diversify regulatory risk.86 Diversifying regulatory risk means, literally, making the holding company’s financial health less dependent on the decisions of any single state’s commission. Exelon’s acquisition of Pepco shrank Pepco’s financial importance to its holding company by a factor of five87—a factor that will grow as Exelon makes more acquisitions.

Diversifying risk sounds sensible, from the shareholders’ perspective. From the customers’ perspective there is a catch. The less the holding company depends on a commission, the less attention it need pay to that commission. A commission’s tools are limited. It cannot force a utility to perform. It cannot create or fix a utility’s culture. It cannot replace the company’s executives or its board.88 A commission can try to change behavior through financial rewards and penalties, but these tools are imprecise: they cause executives to chase after specific dollars (such as for energy efficiency, transmission construction, fuel purchases or generation performance) rather than improve performance as a whole; and when the inducements disappear the desires diminish. Worse, financial penalties can be counterproductive if they weaken the utility’s ability to improve. And as each utility’s earnings shrink in relation to the holding company’s total earnings, so diminishes the influence that any of these measures will have on holding company decisions.

44, at *15 (no showing that merger would “interfere with KPL’s capacity to render safe and adequate service to its Missouri ratepayers”).

86 See, e.g., Exelon Corp., Registration Statement (Form S-4) at 64 (June 27, 2011) (describing diversification of regulatory risks as a benefit from acquiring BG&E).

87 Prior to the Exelon acquisition, Pepco’s contribution to PHI’s revenues was 43 percent; after the transaction, its contribution to Exelon’s revenues would be 8.2 percent. See Exelon Corp., supra note 9, at 74; Pepco Holdings, Inc., supra note 16, at 5 (together showing that Exelon’s 2013 operating revenue was $24.9 billion, PHI’s 2013 operating revenue was $4.67 billion and Pepco’s operating revenue was $2.03 billion). An alternative view: prior to their acquisition by Exelon, PHI’s three utilities earned 95 percent of PHI’s operating revenues. Id. (showing that in 2013, “power delivery” accounted for $4.472 billion while total holding company operating revenue was $4.675 billion; thus “power delivery”—traditional electric service—accounted for 95 percent of PHI’s operating revenue).

7.4.6 Loss of Regulatory Control over Future Acquisitions

The typical utility merger is a merger of holding companies. The post-acquisition entity is not a single combined utility company; it is a corporate family controlled by a holding company. This section (7.4) has explained how a holding company with non-utility businesses subjects its utilities to the risks of contagion, financial weakening, quality-of-service slippage and reduced accountability. When a state commission receives an acquisition application, it can identify these risks, then take action to address them.89

Then what? Once the holding company completes a utility acquisition subject to a state commission’s jurisdiction, it can buy businesses that are not subject to the commission’s jurisdiction. So the commission’s approval has two components, one explicit and one implicit. Explicitly, the commission approves its utility’s affiliation with what the original application described—the business mix controlled by the holding company today. But implicitly, the commission has approved its utility’s affiliation with every business the holding company acquires in the future. The reason: most state commissions have jurisdiction over only the utility, not the holding company; and most states when they approve a holding company’s acquisition of their utility say nothing about the holding company’s future acquisitions of other companies. So even the simplest transaction—a utility’s executives placing a shell holding company above the utility, a transaction easily winning state commission approval because no non-utility risk exists at that time—can transform a pure-play utility into a subsidiary of a conglomerate. That simple shell holding company can then make unlimited acquisitions and investments outside the state commission’s jurisdiction. By a holding company’s own admission, the associated risks are material:

[Exelon’s acquisition] initiatives may involve significant risks and uncertainties, including distraction of management from current operations, inadequate return on capital, and unidentified issues not discovered in the diligence performed prior to launching an initiative or entering a market. As these markets mature, there may be new market entrants or expansion by established competitors that increase competition for customers and resources.90

That holding companies and their non-utility acquisitions fall outside most state commissions’ jurisdiction caused less concern prior to 2005, because PUHCA 1935 imposed prohibitions and limits on holding companies and their

89 We will discuss options for risk-reducing actions shortly, in Chapter 7.4.8.
90 Exelon Corp., supra note 9, at 63.
acquisitions. But with few exceptions, states did not react to the Act’s 2005 repeal by upgrading their own jurisdiction.

Holding company risk-taking can also increase the acquisition premium. The greater the holding company’s non-utility risks, the more it will value the utility target as a hedge, so the higher the premium it will offer. The higher the acquirer’s premium, the more attractive will the acquirer be to the utility target. All else being equal, then, a utility target will prefer an acquirer with high risks over an acquirer with low risks—precisely the opposite of what a commission should approve. And a holding company can have so many high-risk businesses that buying even a multi-billion-dollar utility monopoly fails to lower overall risk sufficiently. That’s how Moody’s assessed Exelon’s proposed purchase of PHI. Despite “the strategic benefits of linking a company that is long on generation resources with a company that is long on customer load,”

the combined entity will still be exposed to earnings and cash flow volatility due to a large unregulated business platform whose financial performance is influenced by market determined commodity pricing levels. … [W]e believe that it will be very challenging for [Exelon] to easily transform the company’s business mix into one that is materially more balanced across regulated operations given the sheer size of the existing unregulated footprint.91

7.4.7 The “Speculation” Defense

Merger applicants, and some commissions, dismiss business-risk concerns as speculative. Though the type, timing and level of harm is uncertain, identifying risks is not speculating—not given these two facts: (1) the post-acquisition company can acquire non-utility businesses of any type at any time, without any commission’s permission or even knowledge, so the risks will emerge only after the fact; and (2) the acquired businesses will likely have objectives that conflict with the local utility’s service obligations. To dismiss those two facts is to assume that when a utility’s sole shareholder is free to engage in unlimited, unrelated business activities, the utility and its customers will never face harm. That is the real speculation.

Only in utility regulation is the term “speculate” considered pejorative. John Snow speculated that London’s 1854 cholera epidemic might be related to

a water pump—and was right. Astronomers speculated about black holes—and then discovered them. Nikola Tesla and Thomas Edison speculated about ways to move electric current over long distances—and found solutions. The likelihood of having a car accident is very small, yet people who wear seatbelts are not accused of speculating. If speculating means guessing without evidentiary or logical basis, regulators should not speculate. But regulators should extrapolate—identify possible outcomes, assign probabilities, and weigh harms and benefits. The harms described in this chapter are the logical, predictable results of this fact: in a monopoly market context, private motivations deviate from the public interest. Combine that fact with uncertainty, and one must extrapolate. Extrapolating is not speculating.

**7.4.8 Regulatory Solutions**

Reducing risk requires constraints—on utilities, their holding companies and their affiliates. Absent statutory constraints, the solution is merger conditions. Those conditions should include ring-fencing, which seeks to protect the utility from non-utility business risks. But instead of requiring protections against risks, it is better to eliminate or reduce those risks, through six other measures. This subsection assesses each of these tools, then closes by discussing enforcement options and their difficulties.

Commissions should establish these requirements well ahead of any merger. That way, merger negotiators will arrive at a purchase price that reflects earnings expectations disciplined by the commission’s policies. Otherwise, the merging parties will negotiate a price based on higher earnings expectations—expectations unconstrained by the commission’s guardrails—then pressure the commission to remove those guardrails or risk killing the transaction.

**7.4.8.1 Merger rules: indirect authority over holding companies**

This chapter has described the utility’s risks: exposure to excess leveraging from debt-sourced equity, holding company extraction of utility funds, bond downgrades, reduced access to equity, holding company control of utility budgets, service quality slippage and the prospect of ownership change if the holding company defaults. Those risks can come from actions at any corporate level—holding company, non-utility subsidiary, utility subsidiary. To protect

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93 For a fine fictional account, see Graham Moore, *The Last Days of Night* (2017).
the utility and its customers, commissions need authority to limit and review corporate actions, and to intervene at trouble points, wherever in the holding company they occur.

But nearly all commissions lack the necessary authority over the holding company and its non-utility affiliates. As previously explained, that authority gap was not a problem before 2005, because PUHCA 1935 required SEC permission for corporate activities at all levels—the top holding company, sub-holding companies and all affiliates, whether utility or non-utility.94 The SEC then was obligated to block any holding company securities issuance that tripped any of these six wires:

• “the security is not reasonably adapted to the security structure of the declarant and other companies in the same holding-company system”;
• “the security is not reasonably adapted to the earning power of the declarant”;
• “financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest”;
• “the fees, commissions, or other remuneration, to whomsoever paid, directly or indirectly, in connection with the issue, sale, or distribution of the security are not reasonable”;
• “in the case of a security that is a guaranty of, or assumption of liability on, a security of another company, the circumstances are such as to constitute the making of such guaranty or the assumption of such liability an improper risk for the declarant”; or
• “the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.”95

Congress mandated these tests because holding companies had been issuing securities based on “fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies.”96

With PUHCA 1935’s repeal, review of holding company financings needs to come from the state commissions and FERC. But neither state utility finance

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94 This authority applied to what practitioners call the “registered” holding companies—mostly multi-state entities. The SEC also had authority to subject non-registered holding companies (known as “exempt” companies—mostly single-state companies) to these reviews if necessary to prevent detriment to the public interest.

95 PUHCA of 1935 § 7(d), 15 U.S.C. § 79g(d) (repealed 2005).

96 Id. § 1(b)(1).
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statutes, nor the Federal Power Act, authorize regulators to check and reject financings by utility holding companies or their non-utility subsidiaries.97 The result? Once a holding company has acquired a utility, no state or federal law allows a regulator to block the holding company from issuing securities that create risks to its utilities.

Regulators do have authority over securities issuances by utilities. FERC’s authority comes from Federal Power Act section 204.98 For utilities seeking to issue securities to finance non-utility businesses, FERC has established four requirements:

• If the utility’s to-be-issued debt is secured by utility assets, the debt’s proceeds must go to utility purposes only.
• If the utility secures its debt with its assets, then divests those assets to a third party or spins them off to shareholders, the debt must depart along with the assets. The utility may not dump the assets but keep the debt.

97 The prominent exception is Wisconsin’s statute, providing that “[n]o holding company system may be operated in any way which materially impairs the credit, ability to acquire capital on reasonable terms or ability to provide safe, reasonable, reliable and adequate utility service of any public utility affiliate in the holding company system.” Wis. Stat. § 196.795(5)(g). Upholding this statute, the U.S. Court of Appeals for the Seventh Circuit held that states may regulate actions at the holding company level without violating the U.S. Constitution’s Commerce Clause, provided the regulation treats interstate and intrastate actions comparably and does not pose an excessive burden on interstate commerce relative to the putative in-state benefits. Alliant Energy Corp. v. Bie, 330 F.3d 904, 916-17 (7th Cir. 2003). The author was an expert witness for the State of Wisconsin in the U.S. District proceeding reviewed by the Seventh Circuit. The Alliant decision cited, among other cases, Baltimore Gas & Elec. Co v. Heintz, 760 F.2d 1408, 1424–25 (4th Cir. 1985), which upheld against Commerce Clause attack a Maryland statute prohibiting non-utilities from acquiring more than 10 percent of a Maryland utility. The Heintz Court reasoned that “a necessary adjunct to ensuring the protection of consumers is the authority to regulate the corporate structure of public utilities,” given the possibility that holding companies will engage in “deceptive financing practices, non-disclosure of important corporate accounts and the manipulation of various ‘service charges’”—all to the consumers’ detriment.

98 Section 204 requires FERC approval whenever a public utility proposes to “issue any security, or assume any obligation or liability as guarantor, endorser, surety, or otherwise in respect of any security of another person.” The issuance must be or some lawful object, within the corporate purposes of the applicant and compatible with the public interest, which is necessary or appropriate for or consistent with the proper performance by the applicant of service as a public utility and which will not impair its ability to perform that service, and … is reasonably necessary or appropriate for such purposes. Federal Power Act § 204(a), 16 U.S.C. § 824c(a). These provisions “ensure the financial viability of public utilities obligated to serve consumers of electricity.” FirstLight MA Hydro LLC, 167 F.E.R.C. ¶ 61,008 at P 10 (2019).
Hierarchical conflict harms customers

• If the utility divests or spins off assets financed with unsecured debt, the associated unsecured debt must follow the assets.99
• If the utility has used the proceeds from unsecured debt for non-utility purposes, then divests or spins off the non-utility business, the debt must follow the non-utility business.100

But these requirements don’t apply when the issuer is the holding company. And they don’t apply to most utilities, because under Federal Power Act section 204 FERC’s authority over utility security issuances exists only when a state lacks that authority.101

Like the Federal Power Act, state statutes address financings—but only by utilities. These statutes do have useful features. Typically, they:

• identify the types of securities issuances triggering review;102
• specify permissible uses of the proceeds;103
• establish criteria for commission approval;104

99 Westar Energy, Inc., 102 F.E.R.C. ¶ 61,186 at PP 20–22 (2003); Westar Energy, Inc., 104 F.E.R.C. ¶ 61,018 at PP 5–6 (2003). In this proceeding, the author represented the Kansas Corporation Commission. In a separate FERC proceeding, the Kansas Commission (represented by the author) had argued that FERC misinterpreted Federal Power Act section 204, which requires utility issuances to be “necessary or appropriate for or consistent with the proper performance by the applicant of service as a public utility,” because raising funds for an unrelated nonutility business is not “necessary” for the proper performance of public utility service. FERC disagreed.

100 UtiliCorp United Inc., 99 F.E.R.C. ¶ 61,293, at p. 62,243 (2002) (finding that given UtiliCorp’s favorable interest coverage ratio, the issuance would not “impair the utility’s ability to perform as a public utility”). In this proceeding, the author represented the Kansas Commission.

101 See FPA § 204(f) (“The provisions of this section shall not extend to a public utility organized and operating in a State under the laws of which its security issues are regulated by a State commission.”).


103 An Illinois statute requires that the “money, property or labor to be procured or paid for by such [security] issue [must be] reasonably required for the purpose or purposes specified in the [regulatory approval] order.” 220 Ill. Comp. Stat. 5/6-102(a).

104 A Minnesota statute requires that the amount of debt or equity issued must “bear a reasonable proportion … to the value of the property, due consideration being given to the nature of the business of the public utility, its credit and prospects, [and] the possibility that the value of the property may change from time to time.” The Commission also must consider the issuance’s effect on the “management and operation” of the public utility. Minn. Stat. § 216B.49. See also Md. Code Ann., Pub. Util. § 6-101 (securities issuance must be “consistent with the public convenience and necessity”); Ariz. Rev. Stat. § 40-301 (securities issuance must be “compatible … with sound
authorize or require commissions to set conditions and limits on the size and use of the financing’s proceeds.\textsuperscript{105}

But again, these features apply only when the issuer is a utility, not its holding company or a non-utility affiliate.

Lacking statutory authority to regulate the holding company directly, commissions can use merger conditions to regulate the holding company and its non-utility affiliates indirectly. We turn now to the merger conditions regulators use.

### 7.4.8.2 “Ring-fencing”: necessary but not sufficient

Ring-fencing aims to reduce contagion—a utility’s exposure to and harm from its holding company’s business risks. Typical ring-fencing measures do the following:

- prohibit the holding company from extracting excess funds from the utility.
- prohibit the utility from charging ratepayers for any debt costs or equity costs attributable to the holding company’s business risks.
- prevent the holding company from forcing the utility to join the holding company in bankruptcy. One such measure is a “special purpose entity” (SPE), placed between the holding company and the utility. The SPE is controlled by an independent director whose affirmative vote is required for the utility to enter bankruptcy.\textsuperscript{106}
- prohibit the utility from financially supporting, or bearing any risk associated with, affiliated non-utility businesses—such as by loaning money to, guaranteeing loans of, pledging its assets to support the debt of or otherwise supporting the debt of, any holding company affiliate.\textsuperscript{107}

Any early version of ring-fencing appeared in a stipulation attached to the Oregon Commission’s order approving MidAmerican’s acquisition of

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\textsuperscript{105} See, e.g., \textit{Ariz. Rev. Stat.} § 40-302 (authorizing the commission to condition issuances “as it deems reasonable and necessary”).

\textsuperscript{106} In Figure 3.2, depicting Exelon’s corporate structure, notice the SPE between Exelon Energy Delivery Company (the holding company for all the utility companies) and PHI (the holding company for Pepco, Delmarva Power & Light and Atlantic City Electric).

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PacifiCorp in 2006. (MidAmerican was a holding company owning several other utilities.) The stipulation included these elements:

• **Separate financing:** PacifiCorp (the acquired utility) must maintain its own debt and preferred stock, as well as its own ratings for its long-term debt and preferred stock.
• **Dividend limits:** Without Commission approval, PacifiCorp may not pay to its holding company owner any dividends that would reduce the utility’s equity ratio below Commission-specified levels. Nor may the utility pay any dividends if its debt ratings fall below specified levels.
• **Limits on holding company leveraging:** The holding company’s capital structure must maintain specified percentages of equity for five years.
• **No utility support of non-utility businesses:** Without Commission approval, PacifiCorp and its subsidiaries may not loan or transfer funds to, or assume liabilities on behalf of, or pledge assets as security for, any of the merged company’s subsidiaries.
• **Insulation from debt costs:** PacifiCorp may not seek in rate cases a cost of capital higher than what the cost would have been absent the acquisition. And if PacifiCorp refinances its debt within a year of the acquisition, its rates cannot rise due to the refinancing. Also, if a rating agency downgrades PacifiCorp’s senior long-term debt and attributes the downgrade to the acquisition, the Commission will not allow in rates any cost increase associated with the downgrade.
• **Information access:** Both the utility and the holding company must provide the Commission all credit rating agency reports relating to MidAmerican and PacifiCorp, and any information about non-utility affiliates that might affect the utility.
• **Bankruptcy avoidance:** The holding company must provide the Commission a “non-consolidation opinion” demonstrating that these ring-fencing provisions are sufficient to prevent the utility from being pulled into the holding company’s bankruptcy. ¹⁰⁸

And in conditioning its approval of Exelon’s acquisition of Constellation (Constellation was the holding company for Baltimore Gas & Electric), the

¹⁰⁸ MidAmerican Energy-PacifiCorp Merger, 2006 Ore. PUC LEXIS 113, at *64. See also Iberdrola-Energy East Merger, 2008 N.Y. PUC LEXIS 448, at *23–24 (requiring each New York utility subsidiary of Iberdrola, a Spanish holding company, to register with major bond rating agencies and maintain at least investment grade ratings, as a condition of allowing the utility subsidiaries to pay dividends to the holding company).
Maryland Commission adopted much of the Oregon model, with these additions among others:

- BGE can make no dividend payments to its holding company for two years. After that period it must notify the Commission 30 days before paying any new dividend (and provide calculations showing that BGE’s equity ratio will not fall below 48 percent).
- Exelon may not seek a change in the acquisition approval order’s financial conditions for three years, and then only if there is a material change in circumstances.
- For any reorganization that does not trigger Commission jurisdiction, Exelon must give the Commission 90 days’ notice. That notice must include an opinion from bankruptcy counsel either (a) stating that the change will not diminish the existing protections’ effectiveness, or (b) specifying the new steps necessary to maintain that effectiveness (in which case Exelon must commit to taking those steps).  

Ring-fencing is like a seatbelt. A seatbelt reduces the probability of harm; it does not address the sources of harm—bad driving, unsafe roads, dangerous car design. Similarly, ring-fencing does not address the causes of harm. It does not limit the amount, type, location, financing or timing of the holding company’s non-utility investments. As a result, ring-fencing leaves utilities vulnerable in the following five ways.

**Loss of utility’s access to equity capital:** Ring-fencing does not eliminate the risk that non-utility business losses will leave the holding company unable to supply the utility with sufficient equity capital. (Recall that the holding company is the utility’s sole source of equity.) Ring-fencing prevents the holding company from draining capital from the utility; it doesn’t make the holding company put sufficient capital into the utility.

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109 Exelon-Constellation Energy Group Merger, 2012 Md. PSC LEXIS 12. See also Aquila-Black Hills Merger, 2007 Iowa PUC LEXIS 341, at *9–14 (approving the acquisition by Black Hills, a multistate utility, of Aquila’s natural gas assets in Iowa; expressing concern about Black Hills’ already “low investment-grade rating” and including conditions (a) barring any financial support by Black Hills’s Iowa utility for Aquila’s non-utility businesses, (b) barring loans from the non-utility businesses to the utilities, (c) requiring regulatory approval for any utility dividend payments that would put Black Hills’s standalone equity level below 40 percent of total long-term capitalization, (d) requiring that sales from the utility to the affiliates be at the higher of cost or market price, and (e) requiring the utilities to hold their public service assets in their own names).

For a more advanced form of ring-fencing, see Appendix A.3. This Appendix excerpts ¶¶ 61–107 of the D.C. Commission’s March 2016 Order approving the Exelon-PHI transaction.
Utility’s cost of debt: The higher the holding company’s investment risks, the less certain its ability to financially support the utility, the more risk the utility’s lenders bear, the higher interest rates they charge. Ring-fencing does nothing to prevent this result, because it does nothing to limit the holding company’s risk-taking. Exelon admitted as much:

Despite [Exelon’s proposed] ring-fencing measures, the credit ratings of [Exelon’s utilities] ComEd, PECO or BGE could remain linked, to some degree, to the credit ratings of Exelon. Consequently, a reduction in the credit rating of Exelon could result in a reduction of the credit rating of ComEd, PECO or BGE, or all three. A reduction in the credit rating of ComEd, PECO or BGE could have a material adverse effect on ComEd, PECO or BGE, respectively.¹¹⁰

Merger applicants typically commit not to raise utility rates to reflect holding-company-caused increases in the utility’s cost of debt. But if due to financial troubles the utility needs the rate increase to continue serving, the commitment has no real value.

Utility default: While ring-fencing typically prevents the holding company from forcing the utility into bankruptcy, it doesn’t prevent the utility from entering bankruptcy on its own. If, for example, the holding company is in bankruptcy, the bankruptcy court could limit the holding company’s capital flows, leaving the utility without sufficient financial support. The utility then could default on its debts and enter bankruptcy. Because ring-fencing does not address the sources of risk, it leaves this problem unsolved. The commission could require that someone—either an SPE or an independent director on the utility’s board—hold a “golden share”—a share having the power to veto any utility decision to enter bankruptcy voluntarily. But if the utility’s own failures require bankruptcy, nothing prevents a golden-share holder from voting for it. Indeed, Exelon admitted that the SPE structure “is not intended to” do any of the following: “protect a PHI utility from increases in the cost of capital experienced by the holding company”; “protect a PHI utility from increases in debt cost when lenders worry that insufficient equity will be available to the utility from the holding company because of the holding company’s business risks”; or “protect a PHI utility against competition for capital within the holding company family.”¹¹¹

Disruption to central services: Most holding companies have a central service affiliate that provides support services to all affiliates, including the utility. Under this arrangement, the utility does not retain its own attorneys,

¹¹⁰ Exelon Corp., supra note 9, at 46.
¹¹¹ Responses to GRID 2.0 Data Requests for Formal Case No. 1119, supra note 6, at DR 1-114.
accountants, fuel purchasers, human resources experts or other input providers; the utility buys these services from the service affiliate. The holding company’s cash flow problems, caused by non-utility business failures, could disrupt those services. Ring-fencing does not address this problem.

* * *

Ring-fencing has obvious value, but the phrase overstates its effects. “Ring” implies that the protections encircle the utility fully; “fence” implies that the protections have no holes. Neither implication is accurate.

7.4.8.3 Patching ring-fencing’s holes: six measures
To patch ring-fencing’s holes—to keep the utility undistracted and unaffected by the holding company’s unrelated activities—regulators have available six measures. They can limit the holding company’s business risks, separate the non-utility activities from the utility activities, prohibit the holding company from interfering with utility management, prohibit the utility from supporting the non-utility businesses, establish service metrics and prevent the opportunistic sale of the utility.

7.4.8.3.1 Limit the holding company’s business risks
To shield a utility from its holding company’s risks fully requires divesting all non-utility businesses. Less effective are limits and reviews. The commission could:

- limit the corporate family’s business activities to some percentage of the utility’s assets—a percentage low enough to prevent unrelated business failure from harming the utility or its customers;
- prohibit specified activities or transactions as inherently risky, such as nuclear power construction or operation, commodities trading or banking;
- require commission approval for any business activity defined by the commission as potentially harmful;
- require that no non-utility businesses be owned by the utility;
- require commission access to all books and records of all affiliated interests, to the extent relevant to the utility’s health;
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- require an annual affiliated interest report, to include an organization chart, a description of each affiliate, financial statements of each affiliate, and a record of all inter-affiliate transactions and their compliance with the commission’s affiliate pricing rules; or

- require the holding company to notify the commission prior to (a) any acquisition of a business resulting in a specified percentage relationship to the utility’s or the holding company’s capitalization, or (b) any material change in control of the utility or any of its direct or indirect owners.\textsuperscript{112}

A commission also could create a set of tiered reviews, based on the type of transaction:

- Minor or routine: No commission review necessary.
- Possibly risky: The holding company must provide details; if the commission takes no action for 60 days, the transaction can proceed.
- Definitely risky with risks potentially mitigatable: Affirmative commission approval required.
- Inherently dangerous, due to type of business, size of financing or other factors: Prohibited without review.

Exelon’s CEO complained that conditions like these would “cripple [Exelon’s] ability to adapt to a continually changing marketplace and to make decisions that are in the best interests of all of Exelon’s stakeholders.”\textsuperscript{113} This comment exemplified the parent-utility conflict that commissions must remove. A holding company’s “marketplace” is not the commission’s concern; the utility’s performance is. And when utility performance matters, the only relevant “stakeholders” are the customers of the utility service, and the investors whose investments are necessary to provide that service. A holding company’s aspirations for “marketplace” success are irrelevant.

\textsuperscript{112} For examples of these limits, see MidAmerican Energy-PacifiCorp Merger, 2006 Ore. PUC LEXIS 113, at *23–27; and Baltimore Gas & Electric-Pepco Merger, 1997 Md. PSC LEXIS 205, at *134–36 (conditioning the later-withdrawn BGE-Pepco merger on the merged company’s agreeing to report unregulated utility activities as they take place, and to develop a cost allocation methodology to prevent discrimination in favor of non-utility operations). See also Wis. Stat. § 196.795(5)(g) (providing that “[n]o holding company system may be operated in any way which materially impairs the credit, ability to acquire capital on reasonable terms or ability to provide safe, reasonable, reliable and adequate utility service of any public utility affiliate in the holding company system”).

7.4.8.3.2 Separate the utility business from its non-utility affiliates
Addressing market power and unearned advantage, Chapter 6.5.4 described the three main ways to separate the utility business from the non-utility businesses: divisional unbundling, corporate unbundling and divestiture. The same options can address the consumer risks discussed in this chapter. Corporate separation, for example, produces separate accounting, financing and financial statements. With inter-corporate dealings backed by contracts and invoices, commission auditors can look for cross-subsidies and favoritism, such as inter-affiliate prices that deviate from arm’s-length dealings. Separation—not just of finances but of management—also allows each entity to focus solely on its distinct business purpose.

7.4.8.3.3 Prohibit the holding company from interfering with utility management
To reduce parent-utility conflict, a commission should prohibit parent-utility interference. It can require that (a) utility management create its own budget without holding company limits, and that (b) the holding company provide the utility with all funds necessary to carry out the utility-created budget. The holding company could modify the utility’s budget, above some minimum amount, only with commission approval. And if the commission orders a utility expenditure that exceeds the utility’s budget, adjusting the utility’s rates appropriately, the holding company could not block the expenditure—although it could protest and appeal the order.

No commission has limited a holding company’s control in these ways. The Oregon Commission did require PacifiCorp’s holding company acquirer to ensure that senior [utility] management personnel located in Oregon continue to have authority to make decisions on behalf of PacifiCorp pertaining to (1) local Oregon retail customer service issues related to tariff interpretation, line extensions, service additions, DSM [Demand-Side Management] program implementation and (2) customer service matters related to adequate investment in and maintenance of the Oregon sub-transmission and distribution network and outage response.

114 See, e.g., Southern California Edison Co., 1988 Cal. PUC LEXIS 2, at *12 (holding that “[w]ith the exception of the fully-compensated sharing of a small number of corporate officers,” the utility must have a “utility management team dedicated solely to utility activities,” so as to prevent utility management from becoming “preoccupied with nonutility activities to the detriment of utility activities”); BNG, Inc., 1996 Md. PSC LEXIS 41, at *12–22 (requiring financial separation of natural gas brokering services from regulated activities, and administrative separation of employees from the regulated and unregulated operations).

115 MidAmerican Energy-PacifiCorp Merger, 2006 Ore. PUC LEXIS 74, at *89.
But no limit applied to the holding company’s control of the utility’s major capital expenditures, its rate case strategies or its board membership.

7.4.8.3.4 Prohibit the utility from providing financial support to non-utility businesses

To prevent a holding company from using its utility’s financial strength to support non-utility activities, a commission should take these measures:

- require the holding company to supply the utility with sufficient equity;
- prohibit the utility from paying, and the holding company from extracting, excess dividends;\(^\text{116}\)
- prohibit the utility from incurring any debt other than that necessary to finance its own operations and capital expenditures; and
- prohibit the utility from pledging or encumbering any of its assets or revenues to support any business activities other than its own franchise obligations.\(^\text{117}\)

7.4.8.3.5 Establish service quality metrics

To cover acquisition debt and business risks, a holding company will be tempted to extract excess funds from the utility. To protect the utility’s operations, some commissions have accompanied merger approvals with service quality metrics, reliability spending requirements, monitoring procedures and penalties. Consider the following examples.

**Baselines and penalties:** The Washington State Commission adopted a Customer Service Guarantee and Service Quality Index (SQI). The SQI established performance baselines for customer satisfaction, service reliability, safety and business office performance. Substandard performance could trigger up to $7.5 million in penalties.\(^\text{118}\) The Oregon Commission required merger applicants to (1) propose service quality standards for industrial

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\(^{116}\) See, e.g., Oncor Electric Delivery-NextEra Energy Merger, 2017 Tex. PUC LEXIS 807, at *15 (finding that the Oncor Board’s “ability … to make an independent decision about when it is appropriate to pay dividends and when it is necessary to retain funds for operations, without undue interference from a parent company, is an essential part of the ring fence”).

\(^{117}\) See, e.g., Melnyk & Lamb, supra note 72, at 23 n.86. The article describes how Enron’s gas pipeline subsidiaries, Northern Natural Gas Company and Transwestern Pipeline Company, pledged their pipeline assets as collateral for loans of $450 million and $550 million. The loan proceeds went to Enron. When Enron declared bankruptcy, both pipelines were left with the debt. FERC found that the two pipeline companies imprudently increased their credit risk and their cost of capital. *Investigation of Certain Financial Data*, 100 F.E.R.C. ¶ 61,143 at P 16 (2002).

customers, focusing on high-tech companies; (2) make best efforts to achieve specified transmission infrastructure improvements; and (3) commit to continue, for a specified period, then-existing customer service guarantees and performance standards.\textsuperscript{119}

\textit{Spending requirements:} In its order approving Exelon’s acquisition of Constellation, the Maryland Commission accepted the applicants’ commitment to (a) “maintain [utility subsidiary] BGE’s capital and O&M expenses for 2012 and 2013 at or above 95 percent of its projected needs”; and (b) provide comparisons of projected and actual capital and operations and maintenance (O&M) spending for the first two years after the merger. The Commission also required post-acquisition BGE to comply with the Commission’s recently updated service quality standards.\textsuperscript{120}

\textit{Monitoring:} Concern about cost-cutting has led some states to create special monitoring procedures. The Idaho Commission accepted the merging companies’ commitment to submit post-merger outage reports and customer complaint data.\textsuperscript{121}

\subsection*{7.4.8.3.6 Prevent opportunistic sale of the utility}

Chapter 4.1 explained that an acquisition serves the public interest only if it emerges from a competition based on performance rather than price. Whoever wins that competition should understand that its future acquirers will face the same situation: a competition based on performance rather than price. Commissions can ensure this understanding by embedding it in the merger approval conditions: specifically, by stating that should the acquirer later seek to sell the utility, it must use competitive procedures designed by the commission to produce the most cost-effective acquirer. Assisted by this clarity, each acquirer will avoid paying an excessive premium when it buys, because it will not be receiving an excessive premium when it sells.

\subsection*{7.4.8.4 Enforcement: financial and structural sanctions}

As with speeding and jaywalking, merger rules and conditions are only as good as their enforcement. Enforcement requires consequences. Consequences fall

\begin{footnotesize}
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\item \textsuperscript{119} MidAmerican Energy-PacifiCorp Merger, 2006 Ore. PUC LEXIS 74.
\item \textsuperscript{120} Exelon-Constellation Energy Group Merger, 2012 Md. PSC LEXIS 12, at *156–58.
\item \textsuperscript{121} Washington Water Power-Sierra Pacific Power Merger, 1995 Ida. PUC LEXIS 89 (withdrawn). \textit{See also} Baltimore Gas & Electric-Pepco Merger, 1997 Md. PSC LEXIS 205, at *143 (commission will “monitor carefully customer observations concerning the quality of service”).
\end{itemize}
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into two categories: financial and structural. Financial sanctions penalize misbehavior; structural sanctions change the corporate characteristics that breed misbehavior.

Financial sanctions have a direct cost feature and a deterrent feature. The direct cost feature should make the wrongdoer compensate victims for the costs it causes: excess customer charges, reduced service quality and competitors’ lost profits. The deterrent feature should make the wrongdoer lose more than it gained. Structural changes limit the holding company’s ability to invest in non-utility businesses. Stronger medicine is to return to simpler times, by disaffiliating the utility from its holding company.

Financial and structural sanctions can work together. When the California Commission authorized utilities to create affiliates to compete for retail customers in the utilities’ service territory, it warned against giving those affiliates competitive advantages:

[U]tilities and their affiliates should not perceive potential penalties as simply a cost of doing business. To this end, we may consider such penalties as not allowing a utility affiliate to switch any new customers to it for a specified period of time, or we may consider penalties for severe or recurring violations such as revocation of an affiliate’s registration.

Comments on financial and structural measures follow.

7.4.8.4.1 Financial penalties on shareholders
Shareholder penalties include fines, cost disallowances from the revenue requirement and reductions in the authorized return on equity. These measures all share two practical problems.

First, the larger the abuse, the greater the penalty; but the greater the penalty, the more likely it is to weaken the company, so the less likely it is that the

122 A third category is criminal. Frank J. Boehm, a vice president and director of Union Electric, was convicted of lying to an SEC hearing officer during a proceeding under the Public Utility Holding Company Act of 1935. The SEC found that the utility “had engaged for a long time in the practice of collecting a fund of money in cash, or a slush fund, by means of rebates from attorneys and supply companies and by means of padded expense accounts, and that the fund was used for various political purposes.” The conviction was upheld in Boehm v. United States, 123 F.2d 791 (8th Cir. 1941).

123 For a detailed discussion of FERC’s penalty system, see Conrad Bolston, Improving FERC’s Penalty Guidelines: A Comparative Analysis (2012) (originally published at electricitypolicy.com) (on file with the author).

Regulator will impose it. Absent an alternative company ready, willing and able to replace the incumbent, the public interest in having a viable supplier competes with the public interest in holding the erring company accountable. This moral dilemma exists in every too-big-to-fail setting. The too-big-to-fail premise deserves skepticism, however. Acquirers regularly compete to buy a utility franchise at a premium. They would be even more willing to buy one at a discount—a likely result if the commission were revoking the incumbent’s franchise due to misbehavior.

Second, penalizing shareholders for violations committed by executives and employees lacks logic and effectiveness. Regulators should focus on penalizing the individual violators, discussed next.

### 7.4.8.4.2 Financial penalties on specific individuals
Absent personal penalties, executives have a “perverse incentive”: if a venture succeeds, they get bonuses; if it fails, shareholders take the loss. And so “major players are encouraged to take outsize risks because they can earn princely amounts from their actions. At the same time, they know that they rarely have to … face … costly consequences from taking dangerous actions.” The same problem afflicts utility regulation. If undetected violations produce bonuses for executives, while detected violations produce penalties on shareholders, violations will occur. Regulators can fix this problem only by penalizing individual violators. One solution is to require executives to put part of their compensation into a “performance pool.” Penalties for violations—anyone’s violations—get paid first from the pool, and then from shareholder profits. (Shareholders still should have skin in the game, so that they elect the right board members who then hire the right executives.)

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125 See, e.g., Exelon-Constellation Energy Group Merger, 2012 Md. PSC LEXIS 12, at text accompanying nn.319–20 (stating that in some situations fines “would not be sufficient to bring a public service company into compliance and may even be counterproductive”).

126 In addressing Pacific Gas & Electric’s responsibility for the San Bruno gas line explosion, the California Commission found that under section 2107 of the California Public Utility Code, the statutorily permissible fine could be anywhere from $9 billion to $254 billion. But the statute also required the Commission to consider the penalty’s financial effects on the utility. The Commission concluded that the penalty “must be significantly decreased from that potential level in consideration of PG&E’s financial resources.” The Commission dropped the penalty to $1.6 billion. Pacific Gas & Elec. Co., 2015 Cal. P.U.C. LEXIS 230, at *124–26, *147.


128 Id.
Commissions also should require the holding company to create, prior to merger approval, internal training programs, independent auditing procedures, and consequences for violators sufficient to detect and prevent all violations. Equally important, the holding company should demonstrate that no employee, executive or board member has any financial or career incentive to violate the rules.

Of course, the best way to prevent conflicting incentives for executives and employees is to eliminate conflicts within the corporate family. That point brings us full circle. This chapter started with the problem’s source: parent-utility conflict. The most direct paths to ending that conflict are disaffiliation and franchise revocation, discussed next.

7.4.8.4.3 Disaffiliation and franchise revocation

We have explained that when state commissions lack statutory authority to regulate a holding company directly, they can do so indirectly through merger conditions. What if the acquiring holding company accepts the conditions, completes the acquisition, then violates the conditions—arguing that the commission lacks statutory authority to enforce them? Challenges could also come from entities aligned with the holding company—bondholders, shareholders or contractors—who are not bound by the conditions. What if the court agrees that the conditions are unenforceable? The commission then has two related choices: order disaffiliation of the utility company from the holding company; or revoke the utility’s franchise.

Disaffiliation: Because the utility’s stock is wholly owned by the holding company, the utility cannot disaffiliate on its own. The holding company needs to act—by selling the utility to a third party or by spinning it off to the holding company’s ultimate shareholders. Here is a draft merger condition that reserves the commission’s authority to order those actions:

By consummating this transaction, the acquirer accepts the commission’s authority to order the acquirer to spin off the acquired utility to the acquirer’s ultimate shareholders or to sell the utility to a third party approved by the commission, under procedures to be determined by the commission. The Commission may issue this order if it (a) finds that the holding company, any affiliate, or any employee of either has violated any commission rule or condition; or (b) determines that the utility’s continuing affiliation with the holding company conflicts with the public interest. This condition does not diminish any authority the commission has under current law.

What events could trigger disaffiliation? Here is a non-exhaustive list:

- The holding company has blocked utility actions required or approved by the commission.
• The holding company has declined to provide equity capital to the utility in amounts and types the commission deems necessary.
• The utility’s cost of equity or debt exceeds what it would have been absent its affiliation with the holding company.
• The magnitude or types of holding company business activities have reached a level that creates unmitigable risk for the utility.
• A rating agency has downgraded, or has indicated the serious possibility of downgrading, the utility’s debt due to its affiliation with the holding company.
• The utility is a party to an inter-affiliate transaction that violates the commission’s rules.
• The holding company or an affiliate resists reasonable requests, by the commission or others, for information about holding company or affiliate business activities that could affect the utility.
• The holding company has interfered in the utility’s decision-making in a way that could adversely affect the utility’s operations or raise its costs.
• The holding company or utility has failed to honor commitments it made to win merger approval.

If one or more of these events occurred, the commission first would decide whether disaffiliation would solve the problem without causing other problems, like loss of economies of scale. Then, if disaffiliation is the right result, the commission would establish a process for choosing the utility’s new owners.

Franchise revocation: If the holding company resists disaffiliating, the commission can revoke the utility’s franchise. Revoking the utility’s franchise would eliminate the utility’s value to the holding company. At that point a rational holding company, wanting at least to get back the utility’s book value, would more likely comply with the commission’s order to sell or spin off the utility or its business to a commission-appointed franchisee.

Placing the disaffiliation and revocation options within the merger conditions creates accountability. To win merger approval, applicants must offer benefits and commit to complying with the commission’s requirements. Making the value of their transaction depend on both elements disciplines the benefit claims and induces compliance. And the disaffiliation and revocation conditions create symmetry. If the transaction doesn’t work out for the holding company it can depart—by selling the utility to a third party or spinning it off to its shareholders. If the transaction doesn’t work out for the commission, it will have its own exit.

Both disaffiliation and revocation became conditions on the 2012 merger of the Exelon Corporation (then the owner of Commonwealth Edison and Philadelphia Electric) and Constellation Energy Group (then the owner
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of Baltimore Gas & Electric). The Maryland Commission explained that imposing fines for violations would, in some situations, “not be sufficient to bring a public service company into compliance and may even be counterproductive.” So the merger approval conditions included settlement language authorizing the Commission to order BG&E’s “severance” from Exelon if the Commission finds one of four facts:

(i) a nuclear accident at an Exelon facility that results in a material disruption of operations and material financial loss to Exelon that is not covered by insurance or indemnity, or the permanent closure of a material number of Exelon nuclear plants as a result of such accident, (ii) a bankruptcy filing by Exelon or a subsidiary, subject to certain additional conditions, (iii) the rating for Exelon’s senior unsecured debt is downgraded to a rating that indicates “substantial risk” by two of three major credit rating agencies for a period of more than six months, or (iv) Exelon and/or BGE have committed a pattern of material violations of lawful Commission orders or regulations, and after notice and an opportunity to cure, have continued to commit those violations.

In adopting this language, the Commission distinguished among (a) its pre-existing franchising authority, (b) its divestiture authority, and (c) the authority reserved to it by the settlement language. The Commission held, preliminarily, that its “implied and incidental powers needed or proper to carry out its functions” already included the authority to revoke a franchise. But the Commission saw “no necessity, and certainly no expediency, in threatening to revoke the exercise of a franchise to indirectly accomplish the end of getting a holding company to divest a utility … Instead, under extreme circumstances, the Commission would have the authority to require the divestiture of BGE directly.” The Commission then explained that the settlement did not, and could not, restrict its pre-existing authority to order divestiture; on the contrary, the settlement meant only that if any of the four listed circumstances arose, the holding company had waived any right to contest the divestiture. Under other circumstances, the Commission could order divestiture with its existing authority, but the Applicants would be free to challenge the order.

Disaffiliation and revocation conditions have two weaknesses—one legal, the other practical. First, as already discussed, disaffiliation or revocation

129 Exelon-Constellation Energy Group Merger, 2012 Md. PSC LEXIS 12, at *147. In this proceeding, the author was a witness for the State of Maryland and the Maryland Energy Administration. He proposed a divestiture condition in his rebuttal testimony.

130 Id. at *139–40.

conditions accepted by the merging companies could be challenged, by them or others, as unauthorized by statute. Second, at the time of merger approval, the commission cannot know whether at the time of disaffiliation or revocation an appropriate entity will be available to replace the non-compliant incumbent. Both these uncertainties should give a commission pause. For if the commission lacks the legal and practical means to undo the affiliation it has approved, it should avoid that affiliation to begin with—unless the transaction’s long-term benefits outweigh its long-term risks.

### 7.4.8.4.4 Enforcement resources

Corporate complexity stretches regulatory resources. Commissions need to track new affiliate investments and assess their risks, monitor dividend payments, audit inter-affiliate transactions, and sort out the effects of holding company investments on the utility’s costs of debt and equity. Commission resources sufficient to regulate a pure-play utility are not sufficient to protect a utility subsidiary of a multi-state, multi-industry holding company. When commissions impose merger conditions, they need to address their capacity to enforce those conditions.

But no state commission has conditioned its merger approval on the merged company committing to compensate the commission for the necessary resource costs. No state commission has rejected a merger due to the insufficiency of its resources. Except California. Its merger statute required the Commission to consider whether the merger preserves its capacity “to effectively regulate and audit public utility operations in the state.” In assessing the Southern California Edison-San Diego Gas & Electric merger, a transaction that would mix utility and non-utility businesses, the Commission cited Southern California Edison’s past inter-affiliate abuses, then declared:

> The discovery of these abuses is also an example of how our regulatory system can uncover and remedy such unlawful activities. But expanded markets and service areas will increase our staff’s responsibilities and tax our resources to uncover future self-dealing, especially in light of Edison’s intransigence in obeying the information access requirements set forth in the holding company decision.

Based on this factor and others, the Commission rejected the merger.

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132 The 1935 Congress saw the problem: holding companies’ “activities extending over many States are not susceptible of effective control by any State and make difficult, if not impossible, effective State regulation of public-utility companies.” PUHCA of 1935 § 1(a), 15 U.S.C. § 79a(a) (repealed 2005).


Holding companies are hierarchical and conflicted: hierarchical because the parent controls the subsidiaries, conflicted because the non-utility subsidiaries’ profit goals do not align with the utility subsidiaries’ service obligations. The holding company’s desire for earnings growth puts pressure on the utility’s finances; while its desire to maintain the utility’s dominant market position puts pressure on regulators’ efforts to introduce competition. These conflicts bring multiple risks: excess acquisition debt, rate increases to pay for merger costs, non-utility business failure, and regulatory hesitance to introduce financial and competitive discipline if those measures could weaken the debt-bearing holding company.

One set of solutions calls for merger conditions that seek to protect utility customers from these conflicts. But the more effective solution is to prevent the couplings that cause these conflicts.