Merger Rejected: Common Sense from Washington

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Washington State, that is. The Washington Utilities and Transportation Commission has rejected the proposed acquisition of Avista (formerly Washington Water Power) by Hydro One, the government-controlled utility serving in Ontario, Canada. The Commission's December 2018 Order emphasized two problems: (1) risks to Avista from political interference by Hydro One's 47% owner, the Province of Ontario; and (2) benefit-lopsidedness, with Avista's shareholders getting 6-12 times what its ratepayers would get. The Commission has produced a fact-filled, logically reasoned model for analyzing corporate structure risks and benefit-cost mismatch.

But the Order has one odd aspect: It attributes Avista's risks entirely to Hydro One's government ownership. (The opinion often associates the noun "interference" with the adjective "political.") Interference is interference, whether the utility's holding company owner is controlled by a government entity or a for-profit entity. In the last 30 years, dozens of U.S. state commissions have allowed for-profit, risk-taking holding companies to take control of their states' local utilities. With these approvals, commissions have diminished their influence over the utility and its decisionmakers, while subjecting their utilities to unavoidable conflict—between the holding company's pecuniary aims and the utility's public service obligations.[1] Had these other commissions applied the Washington Commission's reasoning (minus its implication that for-profit interference is somehow less harmful than political interference), today's electric industry would be less concentrated, more diverse, less risky, safer for customers and conservative investors, and less labor-intensive for regulators.

Parent-utility conflict

Hydro One's controlling shareholder was Ontario, so Ontario called the shots. (Hydro One has other shareholders, but under Hydro One's charter no other person can own more than 10%.) Due to state commission approvals, most U.S. utilities also have a controlling shareholder—a holding company—so the holding company calls the shots. The utility must obey its owner's instructions. The central instruction: Maximize earnings, then (1) use those earnings to finance utility capital expenditures that produce more earnings; or (2) dividend the earnings to the holding company, which then can either invest them in its other businesses or pay them out to its ultimate shareholders.

A utility's duty to its customers sits uncomfortably with its duty to the holding company. The utility must spend as necessary, and no more than necessary, to serve customers reliably and cost-effectively. But the holding company has no customer service obligation. So it is free to use the utility's earnings to support its other investments, rather than use its earnings to

support the utility's responsibilities. That legal freedom puts the utility at risk, because the typical U.S. holding company, as the 100% owner of the utility's equity, is the utility's sole source of equity.

Of course, the holding company is not a lawless landlord, bleeding its properties while the residents suffer. The holding company wants its utility healthy. But the utility fills just one place in its owner's portfolio. Duty-bound to its ultimate shareholders, the holding company aims to maximize the total value of the portfolio, not the health of any one part of that portfolio. And so we have conflict—between the utility's specific obligation to its customers, and the holding company's general obligation to its ultimate shareholders. That conflict leads to the multiple problems discussed next—problems Washington's order exposed; problems most other commissions endure.

Interference with the utility's independence

Hydro One had promised not to interfere with Avista's operations. But the Commission found that Ontario's political players undermined that promise "more or less completely." Even as the Avista application was pending, those players (1) forced the resignations of Hydro One's entire board and CEO; and (2) committed electorally to reducing Hydro One's rates, without considering effects on safety, reliability, and finance. The result: "significant losses of shareholder value at both corporations, downgrades to Hydro One's credit ratings, [and] downgrades by equity analysts." Another result: continuing uncertainty about whether Hydro One's new board and CEO, "whose identity remains unknown," would share the Washington Commission's values; or whether instead they would interfere with Avista—just like the Ontario politicians interfered with Hydro One.

The Washington Commission condemned Ontario's actions as "political interference." But Ontario's control over Hydro One is the same control every holding company has over its utilities. Holding company control covers every utility decision affecting holding company earnings: the types and timing of utility infrastructure investments, the magnitude and timing of rate increase requests, the tolerance or intolerance of competitive challenges to the utility's monopoly, the acceptance of or resistance to technologies that assist customer choice, and the use or misuse of the utility's monopoly franchise to advantage other holding company businesses. A standalone utility makes its own decisions, accountable only to its regulators. But a utility acquired by a holding company makes the decisions demanded by its holding company. Political or apolitical, interference is interference. By allowing holding companies to buy their local utilities, regulators introduce conflict—unavoidable, continuous conflict.

The problem does not disappear with "independent" directors. They are independent only of the utility's management, not of the utility's sole shareholder—the holding company. Indeed, independent directors are independent of management to ensure their sole allegiance to that sole shareholder. So if the independent director sees a conflict between the holding company's

interest and the utility customers' interest, the holding company's interest prevails. That is how fiduciary duty works. Independent directors don't solve the problem; they entrench the problem.

Unknown future investments

Unlike a government-owned holding company, an investor-owned company promises its shareholders "growth." Growth comes from increasing profits from existing customers, and taking risks to enter new markets and gain new customers. Regulators who allow a holding company to acquire their utility expose customers to those risks. These regulators cross a Rubicon, because most commissions have no statutory power over the holding company's future acquisitions. So the simplest transaction—a utility's executives placing a shell holding company above the utility—can transform a pure-play utility into a conglomerate's subsidiary, because that simple shell holding company can make unlimited acquisitions outside the state commission's jurisdiction. And those acquisitions bring risks, like the ones Exelon listed in its 2013 10-K Report to the Securities and Exchange Commission: "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."

This new kind of holding company attracts a new kind of investor. Historically, utilities had conservative, widow-and-orphan investors—individuals who buy-and-hold patiently, seeking stable dividends and modest value growth. Nearly a hundred holding company acquisitions—all approved by state commissions—have shrunk this sector, leaving risk-averse utility investors with few options. Holding company investors seek higher-risk, higher-return opportunities; so they see the utility not as a conservative investment but as a source of financial support for, and a hedge against, those higher-risk opportunities. Less patient, less willing to accept modest returns, these new investors can pressure the holding company's leadership to seek more growth requiring more risks, thus—as Exelon said—"distract[ing] management from current operations."

Gaps in ring-fencing's fence

This Commission statement deserves headline treatment: "Although the Stipulation [proposed by the applicants and intervenors] contained numerous features of modern ring-fencing . . . we must not miss the forest for the trees. We must consider at a high level the suitability of Hydro One as a potential new owner for Avista in light of everything we know today." Exactly. Why write gobs of words seeking to protect the utility from its new owner when what matters is that owner's character?

I'm referring to what acquirers call "ring-fencing"—dense legal language that attempts to reduce a utility's exposure to the holding company's business risks. These measures aim to prevent the holding company from (1) milking the utility for funds; (2) charging ratepayers for

costs caused by the holding company's other businesses; (3) forcing the utility to financially support those other businesses; and (4) pulling the utility into the holding company's own bankruptcy proceeding. Ring-fencing's purposes make sense.

But ring-fencing aims only to reduce the probability of harm; it leaves in place the sources of harm: the holding company's character, its acquisition appetite, its incentives and opportunities to control the utility's decisions. "Ring-fencing" is a misnomer because the ring doesn't close and the fence has gaps. If the holding company's other business pressures disable it from supplying the utility sufficient funds, or distract utility management from their service responsibilities, ring-fencing offers no help. This problem attaches to any utility owned by a holding company, whether government-controlled or for-profit-controlled.

Off-ramps uncertain

If the holding company misbehaves and the ring-fencing fails to ring-fence, can the regulator unscramble the acquisition? The Washington Commission called unscrambling "impossible," one Commissioner analogizing it to unringing a bell.

Impossible, no; uncertain, yes. Unscrambling means disaffiliating the utility from its holding company. Technically, disaffiliation can occur only if the holding company sells off its utility stock. But the commission has no authority over the holding company, so it can't directly order the holding company to sell its utility stock. The commission needs to reserve that disaffiliation power as a condition of approving the original holding company's acquisition. Yet dozens of commissions have approved nearly 100 holding company acquisitions without creating this off-ramp.

Alternatively, a commission could, on discovering holding company misbehavior, declare it will revoke the utility's franchise unless the holding company sells the utility off. Since a franchise-less utility would have little value to the holding company, the rational holding company will agree to disaffiliate. And if the commission makes clear that the new acquirer must be the best performer rather than the highest bidder, we get a public interest result. But again—no commission has ever taken this step. And a practical problem remains: What if, at the time of the disaffiliation, no appropriate acquirer appears—no one that satisfies the commission's criteria for excellence? Disaffiliation does allow a commission to unring a bell, but the uncertainties demand regulatory caution before ringing that bell. To mix the metaphor: If a plane lacks landing gear, the control tower should keep it on the runway.

Benefit lopsidedness

The Commission criticized the benefit lopsidedness: customers, $74 million; shareholders, $450-900 million. Most mergers suffer from similar asymmetry. NextEra's acquisition of

Hawaiian Electric (rejected by the Hawai'i Commission), and Exelon's acquisition of Pepco and its affiliates (approved by the D.C. and Maryland Commissions) had shareholder-to-customer ratios of 10:1 and 12:1, respectively. (Using the applicants' numbers, I offered both calculations as an expert witness in those cases.) Selling control of a government-granted franchise is lucrative for the acquired utility's shareholders, not for its customers. The Washington Commission recognized a bum deal. Most commissions don't.

Government or for-profit, holding companies are holding companies

Having described the negatives of a government-controlled holding company, the Washington Commission identified the positives of a for-profit holding company. The decisions of "private business people . . . would be driven fundamentally, if not exclusively, by commercial considerations of what would be in the best interests of the utility they wished to acquire . . ." This essay has argued otherwise. The holding company strives to maximize its portfolio value. Its utility is but one part of that value. The holding company's priorities conflict with the utility's obligations. If a commission wants the utility controlled by people "driven . . . exclusively . . . by . . . the best interests of the utility," then the commission should leave the utility be, not approve acquisitions that subordinate the utility to holding company priorities. And if the commission does permit those acquisitions, then instead of allowing the utility to choose acquirers based on the highest price (the common occurrence), it should require the utility to choose the acquirer that offers the best performance. That way, and only that way, will private and public interests align.

The Commission's omission

The Commission blamed Ontario and looked skeptically at Hydro One. But what about Avista? Hydro One could not have agreed to acquire Avista if Avista had not agreed to be acquired by Hydro One. The Commission Order thus omits the central question: Why did Avista even consider, let alone sign, an acquisition agreement with an entity so unsuitable? What Commission policy emboldened this utility to sell control of its government-granted franchise to the highest bidder rather than the best performer? (For a 24% premium, who wouldn't sell out?) One hopes that the Washington Commission, having issued an excellent order blocking Avista's imprudent action, will now clarify its merger policy to correct Avista's misunderstanding. A utility franchise is a privilege and a responsibility. It belongs with those who offer the best performance, not those who seek the greatest gain.

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[1] I detail these problems, for the FERC context, in my recent article "Inconsistent with the Public Interest: FERC's Three Decades of Deference to Electricity Consolidation," Energy Law Journal (Fall 2018).