Preparing for Mergers: A Commission's Bottom Lines

Scott Hempling
March 2013

Utilities propose, regulators react. Last month's essay "Utility Mergers: Who Has a Vision?" explained that despite dozens of merger approvals, U.S. regulation has no consistent vision for corporate couplings in our infrastructural industries. The prevailing principle is Hippocratic: "Do no harm"—merge if you want, just don't raise rates, don't reduce competition and don't degrade service. Some states do require "positive benefits," but those benefits, with rare exceptions, are merely permission prices: short-term rate reductions, or handouts not attributable to real merger efficiencies (e.g., new local headquarters, broadband expansion, charitable donations).

In contrast to regulators' reactivity, utilities merge for a purpose: to preserve and increase shareholder value. (A few commissions depart from reactivity; California and Montana, for example blocked transactions by articulating clear corporate structure visions. And a few utilities have merged to improve their customer performance. But these are the exceptions that prove the rule.) This contrast in perspectives has produced market structures unintended by any regulator. No commissioner who approved a simple shell holding company 20 years ago intended his modest utility to end up one of 20 affiliates in a conglomerate reaching from Florida to Indiana.

This disparity in determination between regulators and the regulated, and the resulting unintended consolidation, can be corrected only if commissions articulate and enforce their own merger policy. But first, they must have a policy. They must establish the corporate characteristics that best serve the public. Those characteristics will then become the screen that aligns parties' proposals with the commission's purposes. Here are three subjects to address.

Business Activities and Ownership Relationships

What justifies regulation is tension: the potential for conflict between a utility's public service obligation and its private business priorities. In the merger context, tension has two sources. The first is *business activities*. A standalone utility, affiliated with no other business, serving a single local territory, causes no tension. Tension grows as the utility grows. "Geographic expansion" can benefit customers if there are increasing economies of scale; it can hurt customers if remoteness impairs operations. "Type-of-business expansion" is a distinct two-edged sword: Non-utility affiliates can support a utility (as might a subsidiary experienced in acquiring land); or distract it (like affiliates buying banks and hedge funds).

The second source of tension is *ownership or control*: the power to ease or exploit the tensions. A utility can be owned (1) by ultimate shareholders (e.g., individuals, mutual funds and pension funds); or (2) by a holding company that also owns other companies. And it can be controlled or influenced by a non-owner. So found the Maryland Commission in

2009. Electricite de France (EDF, a French utility holding company) proposed to buy, indirectly, a 49.99% share of the nuclear plant-owning subsidiary of Constellation Energy Group (CEG, the top-level holding company that owned the utility Baltimore Gas & Electric). The Commission found that EDF could control the flow of dividends from the nuclear affiliate to CEG, in turn influencing CEG's decisions about when, and at what cost, to support BGE's capital needs.

Consumer Risks

Corporate complexity creates three risks. The first is distraction from non-utility investments. Failures force management to spend time saving or selling the losers. Successes inspire management to find more winners. The second is affiliate abuse, of two types: (a) The utility affiliate overpays the non-utility for services, and (b) the non-utility affiliate underpays the utility affiliate for services. These schemes harm consumers through overcharges and undercompensation. They harm competition by granting affiliates unearned advantages.

The third risk is a weakened utility. Every month, customers give it cash. When non-utility affiliates fail, that cash flow tempts the holding company to draw dividends to help the bleeding businesses. And because utilities are capital-intensive, their assets are attractive collateral for third-party loans to the failing affiliates. The utility, initially strong from ratepayer support, becomes infected by its siblings' sinkage.

Protective Tools

Protections come in four forms. *Disallowances* deal with harm that escapes the structural limits, by excluding non-utility costs from customer rates. *Penalties* disgorge the wrongdoer's ill-gotten gains, with a multiplier to make future risk-takers calculate conservatively before acting improperly. But these financial forms have a weakness: The larger the utility error, the shakier the regulatory will. Disallowances and penalties can (a) leave the utility less able to meet its service obligations, and (b) cause capital sources to demand higher returns for fear the weakened utility will default on its debt. This moral dilemma inheres in every too-big-to-fail setting. Regulators hesitate to impose the consequences that would deter the risk-taking that regulation is supposed to prevent.

Penalties, therefore, must be subordinate to prevention. *Structural reviews* require corporate separation and interaffiliate prices that aim for arm's-length relationships between the utility and its non-utility affiliates. Limits on investments in non-utility businesses, by amount and type, allow regulators to control the corporate family's risks. Bans on abusive arrangements, like utilities backing non-utility businesses, fit into this category.

Finally, whereas financial sanctions penalize the misbehavior, *structural sanctions* prevent its repetition. The cleanest version is divestiture of the utility from its holding company, a possibility preserved by the Maryland Commission when approving the Exelon-Constellation merger. Divestiture returns the utility to simpler times, when its sole purpose was to serve its customers.

* * *

In the utility space, corporate complexity offers little but risks much. To guide mergers toward public interest results, the regulator must make the first move. Without a studied, public position on business activities, ownership relationships, and consumer risks, without protective tools and the will to use them, a regulator is a passenger on someone else's plane. Imagine a town without zoning. With no established preferences for lot size, industrial location, parks or traffic patterns, the zoning board reacts to each developer's request. Two dozen developments later, how well will the town work?