Source of Merger Harm: Hierarchical Conflict

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Customers of merged companies face three risks: overcharges, acquisition debt pressure, and non-utility business failure. These risks come from a common source: the inherent conflict between the acquirer's business goals and the utility subsidiary's service obligations.

Holding company vs. utility subsidiary: Conflicting objectives

Unlike a utility, a holding company has no statutory obligation to customers. Its primary legal obligation is to its shareholders. True, no holding company is indifferent to its utility's health or operational performance. But the holding company aims to maximize the value of its total portfolio, not the performance of any one subsidiary. From this fact comes conflict, over substance and over money. Consider two examples.

Conflicts over substance: A wires-only company wants low generation prices; a generation company wants high generation prices. When Exelon acquired Pepco, Delmarva Power and Atlantic City Electric, three wires-only utilities were acquired by a generation-heavy holding company. So when making financial decisions and taking policy positions, the holding company benefits by placing its generation interests ahead of its customers' interests.

Conflicts over money: When a holding company acquires all of a utility's stock, it becomes the utility's sole source of equity. That fact presents a problem. While the utility has a legal obligation to put its customers first, the holding company has no legal obligation to put its utility first. The holding company will invest its funds where the return is highest, not where the customers' needs are greatest. And most commissions have no legal authority to tell the holding company otherwise, because their jurisdiction covers the utility only.

What about independent directors? Hoping to quiet concerns about holding company-utility conflict, merger promoters put a few independent directors on the acquired utility's board. But a utility's independent directors are independent of the utility's management, not of the utility's parent. Their responsibility is to the holding company, not to the customers.

Overcharge risk

Ever-present in monopoly regulation, overcharge risk rises with a merger. Consider three examples.

Regulatory lag: Cost-based ratemaking bases rates on reasonable costs. If the merger reduces costs, but post-merger rates still reflect pre-merger costs, customers will be overcharged. This risk favors the merged company, because commissions find it hard to synchronize rate

reductions with cost reductions. Why? Because not all merger-related savings occur at identifiable points in time. A cost-lowering change in gas supplier has a definite start date, but a productivity gain from new software doesn't. If the merged entity can control two key decisions—when to effect savings and when to seek new rates—it can control the timing and amount of the overcharges. Doing so means displacing the regulator as decisionmaker on who gets the merger savings. Some commissions even displace themselves, by committing to keep the pre-merger rates in place after the merger.

Allocation of savings: Overcharges add to earnings. So the acquirer will base its acquisition price on its expectation of overcharges. If the commission then tries to allocate the savings to customers, the acquirer and its financiers will pressure the commission to back off lest it rattle the bondholders or lower the utility's stock price. If the commission complies, cost-based rates will have given way to acquisition strategies.

Double-leveraging: To buy a utility is to buy its equity. Acquirers usually finance their acquisitions in part with debt. Debt costs less than equity. If the acquirer persuades the acquired utility's commission to authorize an equity-level return on the portion of the utility's equity purchased with debt—say, a 10 percent return on a purchase made with 4 percent debt—this financial engineering makes customers pay rates exceeding reasonable cost.

Acquisition debt risk

When acquisition debt enters the merged entity's capital structure, four risks arise.

Lenders want the acquirer to control the acquired utility's finances: Acquisition debt is low-cost only if the acquired investment is low-risk. Acquisition lenders face lower risks if the acquirer controls the acquired utility's cash flow. Seeking to buy the Texas utility Oncor, NextEra said it could lower its own debt costs if it controlled Oncor's finances—its operational spending, infrastructure spending and dividend payments. Not wanting its local utility's finances controlled by a remote holding company, the Texas Commission correctly said no. NextEra walked.

Acquisition debt exposes the acquired utility to financial risk: Since debt is contractual, the acquirer pays its creditors before it funds its utility. But because the acquirer is the utility's sole source of equity, the utility's financial health depends on the acquirer's financial health. If a weakened utility makes the utility's lenders worry, they will raise the utility's interest rates.

On default, who controls the utility? The most anxious acquisition lenders might insist on the most aggressive protection: making the utility's stock the collateral for the acquisition loan. But if the acquirer then defaults, its lenders become the utility's owners—an outcome remote from the stable ownership promised by the merger's promoters. And if default leads to bankruptcy? The bankruptcy trustee, statutorily bound to maximize the bankruptcy estate's value, will auction the utility off to the highest bidder, not the best performer.

Acquisition debt limits commissions' future options: A utility's acquirer incurs acquisition debt because it expects the utility to grow post-acquisition earnings. Those earnings depend on

regulatory decisions. What if those regulatory decisions produce earnings below the expectations? Dissatisfaction follows, loudly—from capital markets, bond rating agencies, and the acquirer's executives. If regulators then back down—like by failing to disallow imprudent costs, or by letting new infrastructure opportunities default to the utility instead of awarding them to the best performers—the acquirer's self-interest tail will have wagged the regulatory policy dog. Debt-financed acquisitions reduce regulators' flexibility.

Non-utility business risks

In many mergers, the acquirer's non-utility businesses involve risks large enough to trigger federally imposed disclosure obligations. Before Exelon could buy Pepco, Delmarva and Atlantic City Electric, it had to disclose to investors its risks from generation failure, climate change, low-cost fuel sources like shale, and nuclear power—not only nuclear accidents, but also the uncertainties that go with storing nuclear waste for millennia. The word that bond rating agencies use to describe these risks? Contagion.

And what gets disclosed are only those risks known when the acquisition is announced. Once the deal is done, the acquirer can buy still more companies—of any type or size, located anywhere—usually without getting permission from, or even informing, its utilities' regulators.

The "speculation" defense

Merger applicants like to label these concerns as "speculative." True, the probability, type, timing and level of harm are uncertain. But identifying risks is not speculating—not given two undisputed facts: that (1) the post-acquisition company can acquire non-utility businesses of any type at any time, without any commission's permission or even knowledge—the risks and costs emerging only after regulators cede control; 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 is controlled by a holding company, one that is free to engage in unlimited and unrelated business activities, the utility and its customers will never face harm. That is the real speculation.