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Antitrust Modernization Commission
Attention: Public Comments

Last fall the American Public Power Association (APPA) issued two papers addressing merger activities, particularly as related to the electric utility industry. It was recently suggested to us that the Antitrust Modernization Commission (AMC) might have an interest in these papers. Although AMC's due date for comments on these topics has passed, the time-line for the AMC report indicates that staff is still in the drafting phase of the report. Thus APPA is encouraged to believe that that AMC might be able to make use of these two reports.

The first paper – "The Post-Merger Experience" – responds to AMC's request for comments on merger enforcement, specifically in regard to questions raised by AMC on efficiencies in merger analysis.

The paper reviews the recent history of mergers, and surveys reports and studies that explain why mergers fail and what merger failure means for industry finance. The first part of the report looks at whether or not mergers live up to expectations. The evidence demonstrates that promises of major cost savings and financial gain go unfulfilled in a majority of cases, especially as far as utility mergers are concerned. The second part relates the skepticism that credit analysts have developed about utility mergers, and analyzes the deleterious impact mergers can have on utility credit ratings. Finally, the third part examines how management overlooks the potential perils of mergers, and explains why mismanagement is a significant contributing factor to failed merger activity.

The second paper – "The Electric Utility Industry After PUHCA Repeal: What Happens Next?" – responds to AMC's request for comments on regulated industries, specifically in regard to electric utilities.

The paper discusses changes to the oversight of electric utility mergers enacted as part of the Energy Policy Act of 2005, and the resulting potential for greater industry concentration and the exercise of market power. Companies are now free to propose mergers of geographically remote utilities and can pursue diversification strategies beyond those businesses related to the electric industry. Utility ownership is easier for both foreign companies and companies outside of the industry. For example, General Electric and General Motors can now propose to buy regulated electric utilities. The effect will likely be greater consolidation of the electric industry, greater concentration of ownership, more complex company structures, and

more opportunities for the exercise of market power. Current wholesale electric markets are not fully competitive and cannot be until underlying structural issues are addressed. Greater concentration in ownership of generating assets will only add to the structural problems, increasing the potential for market manipulation. The increased number of affiliate relationships and large and complex corporate structures will make it more difficult for regulators to monitor financial transactions between affiliates.

While the paper does not address the role of antitrust agencies in the review of electric utility mergers, nothing in the Energy Policy Act of 2005 changed these agencies' ability to review these mergers. Given the potential for increased structural problems in the industry, all agencies with merger oversight must make good use of their powers to ensure that the public interest is protected. APPA's paper recommends several important actions:

- Conducting in-depth merger reviews that require compelling evidence of merger benefits and a complete accounting of merger costs;
- Emphasizing the importance of industry structure on the development of competitive wholesale markets by disallowing—or imposing strong divestiture requirements—on mergers and acquisitions that increase market concentration;
- Establishing stringent regulations limiting financial transactions between the utility and its affiliates; and
- Examining holding company books and records on a regular basis.

APPA submits these comments in the hope that they will prove valuable to the Commission. Thank you for your consideration.

Sincerely,

Diane Moody
Director, Statistical Analysis

Enclosures – 2

The Electric Utility Industry After PUHCA Repeal

What Happens Next?

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THE ELECTRIC UTILITY INDUSTRY AFTER PUHCA REPEAL: WHAT HAPPENS NEXT?

The repeal of the Public Utility Holding Company Act of 1935 (“PUHCA”) represents a significant change in how large electric utility holding companies are regulated. The repeal, enacted as part of the Energy Policy Act of 2005, removes the Securities and Exchange Commission (“SEC”) as the main overseer of these holding companies, and in its place allows the Federal Energy Regulatory Commission (“FERC”) and state regulators greater access to the companies’ books and records. The 2005 law also gives FERC some additional authority in overseeing mergers, including oversight of utility acquisitions of generating assets.

Repeal also removes limitations on the types of combinations and ownership structures allowed. Companies are now free to propose mergers of geographically remote utilities and can pursue diversification strategies beyond those businesses related to the electric industry. Utility ownership is easier for both foreign companies and companies outside of the industry. For example, General Electric and General Motors can now propose to buy regulated electric utilities.

The effect will likely be greater consolidation of the electric industry, greater concentration of ownership, more complex company structures, and more opportunities for the exercise of market power. Current wholesale electric markets are not fully competitive and cannot be until underlying structural issues are addressed. Greater concentration in ownership of generating assets will only add to the structural problems, increasing the potential for market manipulation. The increased number of affiliate relationships and large and complex corporate structures will make it more difficult for regulators to monitor financial transactions between affiliates.

FERC and state utility commissions must make good use of their new and existing powers to ensure that the public interest is protected. Important actions include:

- Conducting in-depth merger reviews that require compelling evidence of merger benefits and a complete accounting of merger costs;
- Emphasizing the importance of industry structure on the development of competitive wholesale markets by disallowing—or imposing strong divestiture requirements—on mergers and acquisitions that increase market concentration;

Greater concentration in ownership of generating assets will only add to the structural problems, increasing the potential for market manipulation.

- Establishing stringent regulations limiting financial transactions between the utility and its affiliates; and
- Examining holding company books and records on a regular basis.

Predictions for the Electric Industry After PUHCA Repeal

Financial analysts and energy consultants were already anticipating increased merger activity prior to the passage of PUHCA repeal. Roger Gale, CEO of GF Energy, predicts mergers between healthy, aggressive, growth-driven companies. He sees the best pay-offs in mergers or acquisitions that consolidate significant amounts of generating capacity under the control of innovative managers with experience in streamlining operating costs. One driver is pressure to keep up with the large companies being created in the current round of mergers. However, the large size of these new companies will increase the potential for market power, necessitating a restructuring of transmission assets into transmission-only entities. Gale summarized what the post-PUHCA-repeal world will look like:¹

A decade from now, the total number of investor-owned utilities will be way down, the American marketplace will be far more internationalized, and there will almost certainly be more unbundling of assets to minimize the negative impacts of the market power problems these large mergers will create. It will mean transmission markets will be far larger than those we see today.

Others expecting strong merger activity include the CEO of Constellation Energy, who predicts that the number of major electric utilities will drop from 100 to 50 within a few years, a Lazard investment banker, who believes the electric utility sector will be “white-hot” for the next few years,² and the CEO of Exelon, who anticipates four or five large utility mergers “fairly quickly.”³

¹ Roger W. Gale, CEO of GF Energy, “What the New Mergers Will Mean,” published in *EnergyBiz Magazine*, July/August 2005.

² Quoted in “Will PUHCA Repeal Hasten Utility Consolidations,” published in *Project Finance Newswire*, Chadbourne & Parke, August 2005.

³ Jim Brumm, “Juice: Merger Horizons & Utility Futures,” published in *California Energy Circuit*, August 26, 2005.

Many people “trying to fan the flame of merger mania today” are advisors who would work on these deals.

Scott Madden & Associates expects a great deal more non-utility participation in the mergers and acquisition market.⁴

On the other end of the spectrum are those who believe the effects of PUHCA repeal will be more moderate, with most merger activity between smaller utilities. Panelists at a Chadbourne & Parke forum expected some increase in merger activity, but not a “land rush” of consolidations. Concern over merger conditions imposed by state regulators and the potentially long approval process could make many mergers appear unattractive.⁵

Analysts commenting in Chadbourne & Parke’s monthly newswire were even more cautious. Michael Hogan of Centrica North America believes that the effects of PUHCA repeal will be felt only at the margins. He, like Peter Rigby of Standard & Poor’s (“S&P”) credit rating agency, questions the value of mergers in terms of realizing projected benefits.

Along the same lines, Stephen Reynolds, CEO of Puget Sound Energy, said that his utility, formed from a 1997 merger of electric and gas companies, has been slow to achieve financial strength since the merger. He also noted that many people “trying to fan the flame of merger mania today” are advisors who would work on these deals. David Haug of Arctas Capital Group expanded on this point, predicting more merger activity because of a variety of financial incentives:⁶

If two big utilities merge, CEOs and CFOs get a lot more money, the regulatory guys have a lot more staff, the accountings [*sic*] have a lot more staff, and all the people in the acquiring company are going to have an incentive to do the deal just from personal and career perspectives. The investment bankers will make huge fees. The process of going through the regulatory approvals will generate lots of fees for people.

⁴ Bradley Kitchens, President & CEO, Scott Madden & Associates, quoted in *M&A Review*, Volume 1, Issue 6, July 2005, published by SNL Energy.

⁵ “Early takes on new energy law see major gains for transmission, bolder merger role for states,” *Electric Utility Week*, August 29, 2005.

⁶ “Will PUHCA Repeal Hasten Utility Consolidations,” *Project Finance Newswire*, August 2005.

I don't want to sound cynical. The paper that Standard & Poor's did is really good. It points out that you can have a lot of consolidation activity without any underlying substance. It is always hard to argue that having your local utility owned a long way away by people who aren't your neighbors is a good thing, and I don't think it will get any easier. However, there will be huge drivers to get such deals done because [of] the M&A industry and the amount of private capital looking for a home. Merely moving money back and forth may not create synergy, but it creates a lot of fees and lots of economic wealth.

Thus, a certain percentage of companies will make bad decisions and enter into unproductive merger deals.

APPA takes the middle-view forecast of the post-PUHCA world. The pace of mergers will increase—but well short of consolidation from 100 to 50 major utilities—and at least some of the new mergers will follow the “get big” pattern of the proposed Exelon-Public Service Enterprise Group (“PSEG”) and Duke-Cinergy mergers. At the same time, managers will not suddenly become prescient. Thus, a certain percentage of companies will make bad decisions and enter into unproductive merger deals. Outside companies will be attracted to the industry, some perceiving convergence opportunities, some looking for the earnings stability of regulated utilities, and others—pursuing a “buy low, sell high” strategy—hoping to turn a quick profit on the assets.

Recent Trends in Mergers and Acquisitions

To understand the effects of the predicted increase in merger activity, it is first necessary to take account of the industry consolidation that has already occurred and to assess the current status of the industry. The Energy Policy Act of 1992 and subsequent FERC orders providing for more competition in wholesale markets resulted in a wave of mergers and acquisitions throughout the 1990s. Electric utilities merged not only with other utilities, but with other energy companies, such as gas pipelines, natural gas utilities, and independent power producers. The idea was to diversify into other, related businesses and to take advantage of growth opportunities.

Utilities also bought or built generating assets, as the new law allowed them to own merchant generation outside of their own region. At the same time, state restructuring laws encouraged or required regulated utilities to sell off generating assets or move them into unregulated affiliates. For the first time, the unregulated sector, including a large number of utility affiliates, owned a significant amount of generating assets. In summary, the industry was becoming more consolidated:

- Electric utilities were part of 42 mergers completed between 1997 and 2000;
- Assets of utility mergers completed in 2000 alone totaled \$260 billion (excluding assets involved in mergers with foreign utilities);
- Between 1999 and 2002, about 90 percent of the 160,000 megawatts (“MW”) transferred from regulated utility ownership was sold or divested to unregulated affiliates of investor-owned utilities.

The California energy crisis and investigations into Enron’s activities set in motion a dramatic shift in merger and acquisition activity. These events revealed the potential for manipulation of energy prices and led to a loss of confidence in the energy-trading sector. In 2002, many merchant power companies encountered serious liquidity problems, the result of low power prices, overcapacity, a slowdown in demand, and large maturities of short-term debt.⁷ This caused a tremendous sell-off of assets as companies attempted to raise cash and avoid bankruptcy. Asset sales included whole lines of business, such as telecommunications ventures and service companies, as well as natural gas fields, pipelines and infrastructure, and to a lesser degree, electric generating plants. In addition, many investor-owned utility companies sold off or closed their trading affiliates, and three generating companies—NRG, Mirant, and National Energy & Gas Transmission (a subsidiary of PG&E Corporation)—entered bankruptcy.

In contrast to the strong pace of asset sales, there were almost no merger announcements in the 2002 to mid-2004 time period.⁸ However, the pace of mergers in the electric utility industry has picked up sharply since then. Since mid-2004, four major mergers have been announced—MidAmerican Energy Holdings is acquiring PacifiCorp; Duke Energy is purchasing Cinergy; Exelon Corp. is acquiring PSEG; and PNM Resources acquired TNP Enterprises. All four mergers are between companies that are primarily in the electric utility business, reflecting the currently popular back-to-basics strategy.

⁷ Arleen Spangler, “Standard & Poor’s Updates Refinancing Needs for the Energy Market Sector,” *Utilities & Perspectives*, published by Standard & Poor’s, April 28, 2003.

⁸ From 2002 to mid-2004, Ameren Corp. announced agreements to acquire two electric utilities in Illinois, and two separate investment groups proposed to acquire Portland General Electric and UniSource Energy. State regulatory commissions rejected both of the investment group proposals.

The Emerging Role of Financial Companies

Companies trying to sell generating assets had a difficult time finding buyers at an acceptable price during 2002–2003, and many plants that traded hands became the property of creditors. But beginning in 2004, sales of generating assets increased dramatically, primarily because financial companies became active. All in all, financial investors are responsible for about 45,000 MW of the approximately 70,000 MW of capacity sold since 2002. In the short run, the trend is expected to continue. Analysts at Credit Suisse First Boston forecast that another 90,000 MW of generating capacity will be put up for sale, and they see financial companies continuing to play a major factor in acquiring this generation.⁹

Some financial companies, such as Goldman Sachs, have bought generating assets in support of their energy trading activities. Investment banks have significantly increased their presence in wholesale power markets, as Morgan Stanley and Goldman Sachs (through its J. Aron subsidiary) ranked among the top five power traders for the first quarter of 2005, and Merrill Lynch was thirtieth.

However, it appears that most financial buyers are in the market because they see an opportunity to acquire under-valued assets. In 2004, more than half of generating assets sold were merchant assets—those without a contract for power sales—and the price received for these assets averaged \$220 per kilowatt, compared to \$480 per kilowatt for contracted assets.¹⁰ Buyers include capital investment companies, such as Kohlberg Kravis Roberts & Co. and The Carlyle Group, and hedge funds, such as Citadel Group and CitiGroup. In addition to owning generating assets, hedge funds have purchased equity in major generating companies and are very active in energy trading. By one estimate there are now more than 100 hedge funds active in the energy market.¹¹

⁹ “Power plant sales, not privatization, to flourish,” *Electric Power Daily*, June 30, 2005.

¹⁰ Michael T. Burr, “Going to the Bank,” *Public Utilities Fortnightly*, June 2005.

¹¹ Denise Furey, “Trading Places: New and Different Participants in Wholesale Energy Markets—Part Two,” *Global Power Quarterly*, published by Fitch Ratings, October 2004.

Many utilities now consider plant ownership a more stable option, making them less subject to the price volatility and uncertainty of power markets.

There are pluses and minuses to the emergence of these financial players. On the plus side, they add liquidity and capital to the market. On the minus side, financial institutions that own generating assets can have a conflict of interest between their market activities and their traditional roles with clients that may be their competitors or customers in certain markets. These roles include advising companies on merger and acquisition strategies or financing plans, and floating bonds for utilities. In regard to hedge funds, the major concern relates to their involvement in energy trading and its effect on market prices. The Fitch ratings agency notes that hedge funds like to operate in volatile markets because they hope to take advantage of inefficiencies that can occur during periods of high volatility. The technical trading models typically used by hedge funds can increase this volatility and further destabilize the market.¹²

Even those that are supportive of the role of private equity and hedge funds in the utility industry believe that they will exit the market as it recovers. In general, these players have a high risk tolerance and are willing to invest in merchant assets; they expect to turn a profit on the assets and get out of the market. Reliant Energy's CEO predicts that by the end of the current decade many of these companies will have divested themselves of utility operations, and most of the market players will be traditional merchant generators.¹³ The markets are already seeing turnover by financial companies. For example, a group of private-equity firms purchased Texas Genco from CenterPoint Energy in 2004. In October 2005, the investor group entered into a deal to sell Texas Genco to NRG Energy at a price more than double the price paid to CenterPoint one year earlier.¹⁴

Regulated utilities have also been major purchasers of generating plants over the past two years, as many utilities now consider plant ownership a more stable option, making them less subject to the price volatility and uncertainty of power markets. Owning its own generation ensures the regulated utility that it will have power available to meet its native load at a relatively stable price, and also provides the utility with a guaranteed rate of return on the asset. American Electric Power, Dominion Resources, PSI Energy, Southern Company, Entergy and others have purchased large plants in the past year in order to bolster their regulated utilities' generating capacity. While adding generating assets to its rate base might

¹² *Ibid.*

¹³ "Reliant Energy CEO sees private equity firms as short-timers, leading to future plant sales," *Power Markets Week*, June 20, 2005.

¹⁴ "NRG Bets on Texas with Big Power Plant Buy," *The Energy Daily*, October 4, 2005.

be a good strategic move for a utility, it raises concerns over the number of remaining independent generators available to sell into wholesale power markets.

Competitive Market Structure Is a Necessity

In electricity markets, companies with relatively small market shares can exercise market power in specific situations and time frames.

Competition in the economic sense requires a market structure defined by the absence of market power by any competitor. There are low barriers to entry, and customers benefit because they have an informed choice of suppliers selling at the lowest prices possible. The rivalry between suppliers is what keeps the prices low. True rivalry, or competition, occurs only when markets are structurally competitive, not in oligopoly or monopoly markets.

In electricity markets, companies with relatively small market shares can exercise market power in specific situations and time frames. For example, transmission constraints, the location and availability of generation supply, and gas supply or other fuel constraints can limit the availability of power. Since there is almost no ability to store electricity and the market has limited demand-response mechanisms, there can easily be a very small number of bidders available to supply the last megawatt needed during a high-demand period.

A generator can manipulate market price by raising a unit's offer price above its marginal cost, or by withholding output. In Regional Transmission Organizations ("RTOs") where a single "market-clearing price" establishes the price paid to all sellers, an entity with more than one generating asset in the market has an incentive to raise prices by strategically withholding some of its capacity. In periods of tight supply, this forces the system operator to accept power from less efficient units charging higher prices, and raises the price paid to all suppliers—including the other generation units of the entity that withheld capacity. Keeping a specific generator off-line can also benefit a multi-unit owner if it results in higher congestion costs paid to the owner's other generating units.

In addition, the conditions are present for tacit collusion between suppliers in RTO markets, as pointed out in the 2005 market review conducted for the Virginia State Corporation Commission.¹⁵ Suppliers

¹⁵ Kenneth Rose and Karl Meeusen, "2005 Performance Review of Electric Power Markets: Update and Perspective," conducted for and published by the Virginia State Corporation Commission, August 23, 2005. The publication

have some knowledge of each others' cost structures, and interact in the market on an hourly and daily basis:¹⁶

This allows suppliers to gather information on rivals and how they respond in different market conditions. They may not know specifically which supplier bid and at what price, but suppliers can see the price results and the results of their own bidding under various market conditions.

In addition to valuable information gathering, the repeated interaction by the firms can lead to collusive behavior, where they attempt to cooperate with each other in order to raise the price, as seen in California during the 2000–2001 power crisis. The repeated interaction also makes it easier to enforce an agreement to control prices. While direct cooperation and collusion would violate anti-trust laws, “tacit collusion” could form with close interaction that reinforces the mutually beneficial action that will lead to higher profits for all suppliers.

Current Market Structure: The PJM Example

Given the history of periodic market dysfunction, repeated rule changes to modify market behavior, and the continuing need for price caps in certain markets, it is clear that the current industry structure does not support competitive wholesale markets. The most recent report of the Market Monitoring Unit (“MMU”) of the PJM RTO—widely considered the most successful RTO to date—offers a good example of the continuing structural problems.

The 2004 report of PJM’s MMU concluded that **results** in energy, capacity, and regulation markets were competitive, but that significant market structure issues were present in all three markets.¹⁷ In regard to capacity, market power is endemic to the capacity markets’ structure, and the problem will become worse with smaller locational markets. Similar problems exist in PJM’s ancillary services markets, and the MMU

(footnote continued from previous page)

presents persuasive evidence that the structure of wholesale power markets is oligopoly, not competition.

¹⁶ *Ibid.*, page 76.

¹⁷ PJM Market Monitoring Unit, “2004 State of the Market Report,” March 8, 2005, pages 20–21.

recommended that these markets continue to operate on a cost basis. In regard to energy markets, the report noted that strong supply, moderate demand and the behavior of participants offset structural issues in 2004.

The PJM market monitor analyzes market structure indicators to assess the potential for the exercise of market power. These include measures such as ownership concentration and pivotal suppliers. For energy markets, the 2004 report found moderate ownership concentration in the baseload segment, and high concentrations in both the intermediate and peaking segments, as measured by the Herfindahl-Hirschman Index (“HHI”). The HHI for intermediate plants averaged over 2,500 and the HHI for peaking plants averaged over 4,800; high concentration is defined as over 1,800, or equivalent to five or six firms with equal market shares. The Commonwealth Edison (“ComEd”) section of the market exhibited high concentrations for all three segments (baseload, intermediate and peaking).

For capacity markets, the report found moderate ownership concentration in PJM’s short-term markets, with average HHI of approximately 1,500 for the year, and high concentration in long-term markets, with average HHI of 3,000. Ownership concentration was high in both short and long-term capacity markets in the ComEd market. The report concluded:¹⁸

Given the basic features of market structure in both the PJM and ComEd Capacity Markets, including high levels of concentration, the relatively small number of nonaffiliated LSEs [load-serving entities], the capacity-deficiency penalty structure for LSEs, supplier knowledge of the penalty structure and supplier knowledge of aggregate market demand if not individual LSE demand, the MMU concludes that the likelihood of the exercise of market power is high.

Industry Consolidation and Market Power Issues

The market structure problems identified by PJM’s MMU will become worse if supply conditions become tighter or if concentration ratios increase. Both of these scenarios are likely: The industry is emerging from a condition of over-supply in many parts of the country, and PUHCA repeal will result in increased industry consolidation.

¹⁸ *Ibid.*, page 33.

The RTOs are managing prices and incentives through capped rates and various capacity payments and proposing still other capacity schemes.

In regard to supply conditions, as demand rises, new capacity will be needed, but with market-based rates, new generation will not be built until prices rise enough to make investment in capacity appear profitable. The 2004 MMU report's measure of generation investment profitability indicates that revenues from all PJM markets would not have covered first-year fixed costs for new combustion turbine, combined-cycle or pulverized coal plants. ISO-New England came to a similar conclusion in its 2004 state-of-the-market report.¹⁹

All RTOs are now facing capacity issues, because it appears that their markets do not send appropriate price signals to encourage adequate transmission or capacity additions. This is not surprising given the "lumpy" nature of capital investment in utility plants and the time needed to bring a new plant on line. Letting the market respond to price signals will result in prolonged periods of tight supply and very high prices—with strong opportunities to manipulate prices and earn monopoly rents—that will last until additional capacity can be built. As a result, the RTOs are managing prices and incentives through capped rates and various capacity payments and proposing still other capacity schemes, for example, Locational Installed Capacity ("LICAP") in ISO New England and the Reliability Pricing Model ("RPM") in PJM.

In regard to industry consolidation, the first merger wave has already resulted in larger companies and increased concentration, as previously noted. The latest round of proposed mergers, if consummated, will result in two extremely large utility systems with annual revenues of more than \$25 billion: Exelon-PSEG and Duke-Cinergy. The third major proposed merger, MidAmerican Energy's acquisition of PacifiCorp, involves about \$10 billion in annual revenue, and MidAmerican has already spoken of its interest in acquiring additional utility assets.²⁰ The new wave of mergers anticipated after PUHCA repeal will add to the consolidation, particularly as other utilities look to merge in an effort to keep up with the new "largest" utility.

¹⁹ Robert G. Ethier, Director, Market Monitoring, ISO New England, "ISO New England State of the Market Report 2004," presentation at NEPOOL Annual Meeting, June 23, 2005. The presentation states that there is insufficient net revenue from ISO markets to support investment in new gas turbine or combined-cycle units.

²⁰ Gail Kinsey Hill, "On horizon: mega-utility," *The Oregonian*, June 24, 2005.

The parent company's focus on profit and earnings goals provides an incentive for the regulated utility subsidiary to favor its affiliates.

Several factors point to increased consolidation in the generating sector in particular. After the repeal of PUHCA, wires-only utilities will be able to acquire regulated utilities in other geographic areas, and will sell off any generating assets acquired in the transaction in accordance with the wires-only strategy.²¹ In addition, as the supply market tightens, prices for generating assets will rise, and hedge funds and private equity groups that are in the generation market for the short term will sell their assets. On the buy side, companies will no longer be hindered by ownership restrictions imposed by PUHCA or the Public Utility Regulatory Policies Act ("PURPA"), as the Energy Policy Act of 2005 also revised PURPA to eliminate the 50 percent limitation on utility ownership of qualifying facilities.

Buyers could include large merchant generators that believe they need to be larger to compete with the largest utility generators. For example, the president of Dynegy's power generation sector recently stated that merchant power companies must merge to compete with the large regulated utilities that own sizeable portfolios of generation assets. These include Exelon/PSEG, Cinergy/Duke, AEP, and Southern.²² But merchant generators may be hampered in their efforts to acquire generation by their still-ailing financial health. A second major group of buyers will be regulated utilities, continuing the trend of purchasing or leasing capacity to add to their rate base, rather than relying on wholesale power markets.

One additional market power concern raised by increased consolidation is the potential for tacit or explicit collusion between affiliates. The parent company's focus on profit and earnings goals provides an incentive for the regulated utility subsidiary to favor its affiliates. Examples include providing access to information before it is provided to other market participants, preferential access to transmission, and favoritism in awarding power supply contracts.

²¹ Robert Shapiro, Adam Wenner and Dan Rogers, "U.S. Remakes Playing Field For Gas and Electricity," published in *Project Finance Newswire*, Chadbourne & Parke, August 2005.

²² "Merchant power companies must merge: Dynegy's Dreyer," *Electric Power Daily*, May 16, 2005.

Increased Importance of Merger Reviews

The Energy Policy Act of 2005 strengthened FERC's review of electric utility consolidations by adding authorities over the acquisition of stand-alone generating assets and mergers between holding companies.²³ FERC can use its merger authority to scrutinize the increasingly complex combinations that will be proposed in the post-PUHCA era to ensure that they meet the Federal Power Act's "public interest" standard. Greater scrutiny is necessary because consolidation typically results in greater opportunities for the exercise of market power and undue preference to affiliates.

A more vigorous interpretation of the public interest standard is needed by FERC and state utility commissions. FERC should place a higher priority on achieving a market structure that can support competition—a goal clearly in the public interest. Thus, in its review of mergers, FERC should either disallow mergers that increase market concentration or allow the amassing of undue market power, or require divestiture of problem assets and broader ownership of transmission assets.

Both FERC and state regulators should require substantial evidence that mergers will benefit the public. For example, FERC should require that any potential benefits claimed by the merging parties not only exceed costs, but are not available through other means, for example, joint ventures or coordination agreements. There is significant evidence that prospective merger benefits are often exaggerated or do not materialize. (See APPA's recent paper, "The Post-Merger Experience."²⁴) Thus, regulators should require merging parties to describe concrete and measurable benefits, rather than simply claiming "synergies."

Regulators should further consider all costs of implementing the merger—including realistic estimates of the costs of combining business functions. FERC and state commissions should also require assurance that the purchase price reflects the underlying costs and benefits of the merger. Often the acquiring company pays a significant premium in order to woo

²³ See Section 1289 of the Energy Policy Act of 2005. The section also increases the merger review threshold to transactions valued at more than \$10 million.

²⁴ American Public Power Association, "The Post-Merger Experience," published October 2005. The paper describes the generally negative results of mergers in all sectors of the U.S. economy and in the electric industry, in particular.

shareholders of the acquired company. This weakens the financial health of the acquiring company, and leaves the merged company with less capital for innovation and productivity improvements.²⁵

PUHCA Repeal and Utility Financial Health

Changes in PUHCA regulation in the 1990s allowed registered utility holding companies to own merchant generating assets outside of their own regions and to diversify into energy-related businesses, subject to certain restrictions. Diversification into non-core businesses generally had a negative effect on a regulated utility's credit rating. The added risk can raise the cost of the utility's business (through a higher cost of capital) and in severe cases, lead to financial distress for the regulated utility itself. S&P analyzed the effect of PUHCA on utility credit, and found that the lessening of PUHCA restrictions in the 1990s had hurt utility investors.²⁶

To a significant extent, the 1990s' wave of utility mergers and diversification ventures—by all types of utilities, whether regulated by PUHCA or not—was unsuccessful, and the result was a large sell-off of assets unrelated to the electric business. The current round of mergers is so far more narrowly focused on the electric utility industry, but this does not mean a return to regulated utility structures. The largest proposed new mergers involve companies owning both regulated distribution utilities and significant amounts of unregulated generating plants. The Duke Energy Corp. merger with Cinergy Corp., for example, includes more than 16,000 MW of unregulated generation.²⁷

²⁵ Scott Hempling, "The Public Utility Holding Company Act of 1935 and S. 1766," testimony before the Committee on Energy and Natural Resources, United States Senate, February 6, 2002, page 17.

²⁶ Jeffrey Wolinsky, CFA, Standard & Poor's, "Is PUHCA Beneficial or Detrimental to U.S. Utilities' Credit?" published in Standard & Poor's *Utilities & Perspectives*, February 23, 2003.

²⁷ The amount may ultimately be less than 16,000 MW; Duke has announced its intention to sell 6,200 MW, of its approximately 10,000 MW of merchant capacity, in order to focus on Midwest markets. See, for example, "Duke Energy may auction 6,200 MW of DENA generation," *Electric Power Daily*, September 15, 2005.

The higher-risk profile of unregulated businesses increases the potential that the utility's credit rating will fall.

It is doubtful that the current back-to-basics trend will continue. The improving financial health of the industry, the repeal of PUHCA allowing unlimited investment opportunities, and the incentive to grow quickly to keep up with competitors all point to a new round of merger and diversification ventures. After PUHCA repeal, companies will have a much greater ability to invest in unrelated businesses, and companies completely outside of the electricity industry will be able to acquire regulated utility assets. Either way, the higher-risk profile of unregulated businesses increases the potential that the utility's credit rating will fall.

In a 2004 article, Moody's Investors Service described how diversifying into unregulated areas was the primary cause of downgrades for regulated utilities:²⁸

A small number of regulated utilities, however, were pressured by their parent company's expansions into riskier, unregulated—and often unprofitable—areas, which necessitated the upstreaming of significant dividends to support parent level obligations. As a result, some regulated entities sustained ratings downgrades during 2000–2003.

Both Allegheny Energy and TECO Energy, for example, had their credit ratings lowered because of the unregulated activities of their parent companies. Moody's notes that to protect utility credit ratings, it is important for utility holding companies engaged in risky activities—such as energy trading or the acquisition of unregulated generating plants—to shield, or “ring fence,” the utility from the added risk.

State or federal regulators can impose financial restrictions to protect the public interest and maintain credit quality.

The Fitch ratings agency has addressed the benefits of ring-fencing techniques and their effect on utility ratings. For example, state or federal regulators can impose financial restrictions to protect the public interest and maintain credit quality. These are stronger ring-fencing mechanisms than policies established by the corporation itself, because the corporation can always change its policies. Fitch believes that while ring-fencing does not provide a utility total protection from problems of an insolvent parent company, good ring-fencing mechanisms can earn a utility significantly

²⁸ Moody's Investors Service, “Revisiting United States Electric Utilities' Management Strategies for Competition, Growth and Change: An Overview of Regulated and Unregulated Business Operations,” December 2004.

better credit ratings than its parent. Fitch highlights the difficulty of providing total protection:²⁹

Furthermore, even if affiliates are segregated in numerous ways, the presence of a single important unifier, such as a large intercompany loan or an intercompany supply contract critical to continuing operations, may nullify all other ring-fencing efforts.

Along with PUHCA repeal came new regulations allowing both FERC and state utility commissions better access to the books and records of all companies in the holding company structure. These agencies should use their new powers to the fullest to ensure that enforceable ring-fencing mechanisms are in place to isolate regulated utilities from the financial risks of their parent or affiliates. Effective ring fencing includes oversight of affiliate transactions, dividend policies, securities issuances, ownership changes, diversification investments, and asset transfers.

Of particular importance are restrictions that keep the utility from being used as a “cash cow”—in other words, using utility liquidity to support unregulated investments. Regulators should evaluate current rules regarding pooling of resources or access to cash to determine if these standards are sufficient to protect the utility from the draining of capital by the parent or affiliate. Stronger standards may well be needed, especially for utility companies with numerous affiliates or complex holding company structures.

Accounting and Cost Allocation Issues

Advocates of PUHCA repeal argued that the statute was no longer needed because improvements in state and federal regulatory powers since the law was enacted in 1935 gave the SEC, FERC and state utility commissions sufficient oversight of utility holding companies. However, the problems revealed in connection with the financial meltdown of significant players in the electric industry in 2001–2002 indicate that regulatory oversight has not been adequate. Enron is the prime example, but other energy companies as well used accounting techniques to hide debt and inflate revenues. These practices included off-balance sheet financing, structuring transactions to look like sales revenue rather than loans, and participating in round-trip trades (mirror-image trades with the same counterparty). In

²⁹ Fitch Inc., “Rating Linkage Within U.S. Utility Groups: Ring-Fencing Mechanisms: Utilities, Holding Companies and Affiliates,” April 8, 2003.

Regulatory agencies must be diligent not only in enforcing their rules and statutory authorities, but in looking for new instances of questionable accounting or manipulative behavior.

addition, FERC's accounting office discovered that regulated utilities held billions of dollars in cash pools that were accessible to affiliates.

The major Congressional response to these problems was the Sarbanes-Oxley Act. The aim of this act is to improve corporate governance and oversight, and the SEC has instituted new regulations in line with the law. FERC has made several changes as well, establishing new rules restricting cash management and money pooling arrangements between utilities and their holding companies, and specifically banning certain market behavior, including round-trip trades. In addition, the Energy Policy Act of 2005 prohibits energy market manipulation and the filing of false information on wholesale power prices or the availability of transmission capacity.³⁰

However, effective oversight cannot be taken for granted. Regulatory agencies must be diligent not only in enforcing their rules and statutory authorities, but in looking for new instances of questionable accounting or manipulative behavior. Potential problems are not limited to the financial interactions between the utility and its holding company, but also concern how costs are apportioned between affiliates. The increased presence of companies in other energy fields (gas or oil, for example) or in completely unrelated fields will provide new opportunities for affiliate interactions. Of key concern is the holding company's ability to pass inflated costs from an affiliate to a regulated company to recover in regulated rates.

As previously noted, FERC approval of a merger or acquisition requires a finding that the transaction is in the public interest. The Energy Policy Act of 2005 adds a second condition, requiring FERC to consider whether or not the transaction will result in cross-subsidization of a non-utility affiliate.³¹ Thus, FERC merger proceedings should include evidence on how affiliate companies will conduct business, and FERC should impose conditions necessary to ensure that commercial transactions between affiliates are made at arm's length.

However, FERC must not limit its oversight of affiliate transactions to merger proceedings. The Commission can use its authority under Section 204 of the Federal Power Act to ensure just and reasonable rates—along with its new authority providing access to the books and records of holding companies—to monitor affiliate relationships and cross-subsidy opportunities.

³⁰ See Sections 1282 through 1284 of the Energy Policy Act of 2005.

³¹ See Section 1289 of the Energy Policy Act of 2005.

Conclusion

With PUHCA repeal, utility ownership will be much more diverse—including private investment funds, financial companies, other non-energy companies, and foreign-owned companies—and the structure of the companies will be complex—with the potential for numerous utility affiliates and subsidiaries, and several layers of ownership. Providing regulators with increased access to holding company information was a crucial step in mitigating the effects of PUHCA repeal, but it is by no means sufficient to guarantee effective consumer protection.

Both state and federal regulators must develop the expertise to interpret the new, more complex company structures, and impose ring-fencing requirements and other protections for consumers where necessary. In addition, regulators must be more diligent in evaluating the costs and benefits of mergers and pay particular attention to the potential for increased market power.