F L O R I D A   P U B L I C   S E R V I C E   C O M M I S S I O N

A Regulator's Guide to Electric Mergers and Acquisitions in Florida

PREPARED BY:

Division of Policy Analysis & Intergovernmental Liaison

August 2001

The Value of Mergers and Acquisitions

Mergers ("the fusion of two or more companies into one") and acquisitions ("the taking over of one firm by another") are occurring in many industries in the U.S., especially in the electric power industry. Many utilities have anticipated deregulation coming quickly and some believe they need a partner to improve their competitive positions. The trend toward consolidation most likely will increase as the industry becomes more competitive. Firms are generally faced with either a merger or acquisition in order to increase operational size or to combine common business units whose assets may later be separated into functional divisions such as generation, transmission and distribution. Consequently, most state commissions will be charged with reviewing the implications of mergers for both shareholder and ratepayer interests. The objective of this working paper is to identify who has authority to approve mergers and acquisitions and the benefits associated with state and federal regulators possessing authority over current and future mergers and acquisitions within a state.

There are many reasons for firms to merge. Some mergers lead to economic benefits for the firm, while others create societal benefits. The following describes elements of a successful merger.

a. Cost reductions and improved competitive position.

b. Earnings enhancements through synergies. Being able to reduce internal costs through synergies is a plus to shareholders.

c. Diversification of business to minimize risk. These include efforts to expand the utilities' customer base, spread the business risks resulting from regulation over several states, and widen the mix of generation fuels.

d. Enhancing size. Bigger numbers on the bottom of balance sheets seem to support more diverse investment strategies.

e. Solving succession issues. All successful mergers to date have had a well defined management succession plan.

The following four elements are considered less critical for mergers, but all or some of them have been and will be part of past, present and future mergers.

f. Reducing vulnerability to an unwanted takeover.

g. Lowering a utility's dividend profile.

h. Offsetting exposure to stranded investment risk, by blending and averaging the risk of stranded assets.

i. Accessing higher growth, unregulated ventures. It makes sense for utilities to try to enter unregulated energy businesses or make equity investments overseas, where growth--and, unfortunately, risk--are potentially higher.[1]

Regulators Role in Mergers and Acquisitions

Federal and State Regulators have several roles in reviewing mergers and acquisitions. David and Kimberly Dismukes, of the Center for Energy Studies at the Louisiana State University, outline a state regulator's role in their article, "Electric Mergers and Acquisitions: A Regulator's Guide." The article notes that many regulators believe mergers should be reviewed based upon quantifiable (objective) and nonquantifiable (normative) criteria. For instance most public utility commissions (PUCs) have outlined quantifiable/objective criteria and nonquantifiable/normative criteria.

The quantifiable/objective criteria proposed by most PUCs include: 1) rate impacts; 2) reasonableness of the purchase price of the acquired utility; 3) potential financial condition of the merged utility; 4) investment community's view of the proposed merger; and 5) any advantages in short- or long-term financing for the surviving company as a result of the merger.[2] The proposed nonquantifiable/normative criteria include: 1) service quality; 2) reliability issues; 3) potentially streamlined administrative function; and 4) improved management control and supervision.[3]

Of the objective and normative criteria, rate impacts, savings, synergies, financial integrity, reliability and quality of service seem to be the common criteria used in processing most merger applications. However, the importance of each of these criteria depends upon the circumstances of the proposed merger and the priorities of the PUC reviewing the merger application. Each of these criteria are discussed separately.

Rate Impacts: Changes in rate levels and structures are often the first and best indicators of how a merger will affect ratepayers. In past mergers, some utilities have proposed rate decreases, others have proposed rate freezes, some have proposed one-time refunds, and still others have proposed rate ceilings or caps. Despite the popularity of such proposals, regulators must ensure that any promised rate changes are consistent with the circumstances of the merger. In particular, are the rate proposals and projected cost savings consistent? Also, are proposed rate changes caused by the merger or an external condition like emerging competition?

Savings: Savings begs the question "Compared to what?" Regulators should establish an expense baseline before authorizing a merger. Properly defined, the baseline can be used as part of a tracking mechanism to compare forecasted (pre-merger, stand-alone) and actual (post-merger) expenses. The baseline, however, needs to be adjusted annually to account for changes in inflation, using the difference between actual expenses and those established in the inflation-adjusted baseline to approximate merger-related savings.

---

[1]Cate Jones, "Inside utility mergers: Trends within trends", Electrical World, (January, 1996), p. 60.

[2]Re Gulf States Utils. Co., Dkt. No. 11292, Dec. 29, 1993, 154 PUR4th 176, 183 (Tex. P.U.C.).

[3]Ibid.

Synergies: The biggest selling point in any proposed merger is the anticipated cost savings. It seems all merger proposals loosely throw about claims of "synergies," "economies," and "efficiencies." Regulators should require some accountability for such claims.

Financial Integrity: Financial integrity carries long-term implications. A historic and projected financial analysis of merging companies should be performed on both a stand alone and combined basis. Financial factors to examine include: capital structure ratios, bond ratings, cost of debt, preferred stock and common equity, cash flow, interest coverage ratios, dividend payout ratios, and the financial community's response to the proposed merger. Other related factors that influence the overall financial strengths and risk of the individual and combined companies include customer mix, generation mix, customer growth potential, and geographic diversity.

Reliability and Quality of Service: In keeping with the public interest standard, regulators must evaluate the effects of a merger on the quality of service provided to customers. This would include reviewing the customer service records of both companies, proposed customer service office consolidations and/or eliminations, merger-related changes to reliability, and maintenance programs. In addition, regulators should ensure that their own actions do not threaten service quality--for example, allowing maintenance to be deferred if projected merger savings fail to materialize. While regulators may discover some minor short-run problems, mergers should not have any long-run negative impacts on quality of service.[4]

Regulatory Oversight of Mergers and Acquisitions

There is a history of federal and state legislation intended to protect society against the efficiency losses associated with anticompetitive mergers. The Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914 empowered the Department of Justice (DOJ) and the Federal Trade Commission (FTC) to address mergers involving any U.S. industry or market. Mergers involving public utilities may also be subject to the oversight of one or more of the following regulatory bodies: the Securities Exchange Commission (SEC), the Federal Energy Regulatory Commission (FERC), a state attorney, or a public service commission.

Department of Justice and the Federal Trade Commission Mergers and Acquisitions Role

The regulatory entities responsible for the enforcement of the federal antitrust statutes are the DOJ and the FTC. Revised in 1992 and again in 1997, the joint agencies' Horizontal Merger Guidelines provide the framework to be used in determining whether a merger is likely to substantially lessen competition. In brief, the DOJ and the FTC assess a prospective merger by examining the expected change in the following: (1) competitive entry and market concentration

[4] David and Kimberly Dismukes, "Electric Mergers and Acquisitions: A Regulator's Guide," Public Utilities Fortnightly, (January 1, 1996).

(i.e., through the Herfindahl-Hirschman Index (HHI)[5]); (2) efficiency; and, (3) business failure. The two agencies only exercise their authority over mergers and acquisitions when it is suspected that the merger would be unacceptably anticompetitive.[6]

FERC's Mergers and Acquisitions Role

The FERC has approved about 45 mergers in the past four years in an average of 117 days each.[7] The Federal Power Act grants the FERC authority over mergers involving electric utilities engaged in interstate commerce when the utility sells electric power for resale, supplies unbundled transmission service, or owns hydroelectric facilities. The FERC considers four primary factors in analyzing proposed mergers.

First, when the FERC is confronted with a proposed merger it defines its role by examining whether the relevant states have adequate authority to protect their state's interest. When the state commissions have adequate authority, the FERC limits its role to protecting the regional or national interest. The FERC will examine a merger's effects on retail competition only if a state says it lacks statutory authority to address the issue adequately. Second, the FERC analyzes the expected effect of the merger on competition. The FERC examines the expected competitive entry and market concentration, efficiency, and business failure. This examination employs the same criteria and methodology used by the DOJ and FTC when they review a proposed merger. Third, the FERC considers the impact of a proposed merger on customer rates. The FERC requires applicants to propose rate protection plans for customers and encourages the parties to engage in discussions to further develop ratepayer safeguards. Finally, the FERC considers whether the newly combined firm will be in compliance with its requirements regarding affiliate transactions.

In November 2000, the FERC revamped their guidelines for reviewing electric utility mergers to include more details to help to them determine whether a merger will give one company too much influence over electricity pricing. Under 18 CFR Part 33 (Docket No. RM98-4-000; Order No. 642), the FERC has asked electric companies to provide information about strategic alliances they have with other parties, such as with natural gas companies; the impact of any mergers that have been proposed, though not yet completed; and whether the combined companies plan to be part of a regional transmission organization. This new rule became effective January 29, 2001.

---

[5]The HHI is the sum of the squared market shares of firms in the market. The HHI values range from zero, a perfectly competitive market, to 10,000 a pure monopoly. Specific HHI values are used as indicators of whether a proposed merger results in pre-and post-merger market concentration levels sufficient to warrant further investigations.

[6]Florida Public Service Commission, "Merger Fundamentals for Public Utility Regulators," (December, 1997).

[7]A Bloomberg News Report, "FERC sets new merger guidelines", Tampa Tribune, (November, 2000).

States that have Approval Authority

As previously mentioned, most states have their own individual legislation that addresses mergers. This legislation may or may not specifically mention public utilities or public utility commissions. State jurisdiction may lie with the Attorney General's office and/or a public service commission. Only Florida, Michigan, and Montana do not expressly have direct legal authority to approve or deny mergers involving electric utilities. The other forty seven states have conferred direct authority to their public service commissions to approve or deny mergers involving public utilities. North Carolina's statutes were examined for the purpose of this working paper. This state was chosen because of the recent merger of Florida Power Corporation and Carolina Power and Light in North Carolina, to form Progress Energy (the continued operations and combined company).

North Carolina Statutes grant the North Carolina Utilities Commission (NCUC) significant authority so that as requests for mergers and acquisitions arise, the NCUC may deny or approve the mergers and acquisitions deemed best for the ratepayers and the utilities:

> **North Carolina Statutes, § 62-111. Transfers of franchises; mergers, consolidations and combinations of public utilities.** (a) No franchise now existing or hereafter issued under the provisions of this Chapter other than a franchise for motor carriers of passengers shall be sold, assigned, pledged or transferred, nor shall control thereof be changed through stock transfer or otherwise, or any rights thereunder leased, nor shall any merger or combination affecting any public utility be made through acquisition or control by stock purchase or otherwise, except after application to and written approval by the Commission, which approval shall be given if justified by the public convenience and necessity. Provided, that the above provisions shall not apply to regular trading in listed securities on recognized markets.

> **North Carolina Statutes, § 62-161. Assumption of certain liabilities and obligations to be approved by Commission; refinancing of public utility securities.** (a) No public utility shall issue any securities, or assume any liability or obligation as lessor, lessee, guarantor, indorser, surety, or otherwise, in respect to the securities of any other person unless and until, and then only to the extent that, upon application by such utility, and after investigation by the Commission of the purposes and uses of the proposed issue, and the proceeds thereof, or of the proposed assumption of obligation or liability in respect of the securities of any other person, the Commission by order authorizes such issue or assumption.

The North Carolina statute is just one example of state PUC merger authority. States may have different merger or acquisition authority language. However, a common theme is protecting ratepayers' interest.

Conclusion

The difficulty for regulators in any merger review lies in ensuring that "pre-merger" promises truly represent "post-merger" realities. It is usual for many promises to be made by the two merging parties before a merger or acquisition is exercised. These promises include, but are not limited to, the issues previously discussed of rate impact, savings, synergies, financial integrity, reliability and quality of service. Any promises made during merger proceedings should be held to the strictest accountability. As the New Hampshire PSC noted:

> "[P]romises must be weighed in accordance with the underlying financial strength of the enterprise. This ensures that our evaluation is an objective analysis of the merits of the proposed acquisition. To do otherwise would be to risk illusory benefits to ratepayers based upon unsound fundamentals."[8]

Mergers often combine utilities that operate in one or more states, thus placing the combined company under the jurisdiction of several state commissions, as well as the FERC. This naturally increases potential problems for the companies, and their respective PUCs, in allocating cost savings and other benefits. Each jurisdiction will strive to claim the most benefits to their native state, while possibly minimizing the allocation of any merger related benefits to the foreign state. This could be detrimental to a state that does not possess merger approval authority.

With the merger trend increasing, ratepayers in Florida could benefit if the FPSC was given statutory authority to approve, disapprove, or set forth conditions on mergers and acquisitions by regulated utilities within the state. The FPSC is in a better position than most Federal agencies to analyze and evaluate the impacts of mergers involving its native utilities. Possessing this authority would allow Florida the ability to set requirements for, but not limited to, the criteria previously mentioned. At a minimum, utilities should be required to meet the minimum requirements before merger approval is conferred. State PUCs should have approval authority to review all aspects of the merger and the merging utilities should understand that regulatory action will be taken if ratepayers are adversely affected by anticompetitive practices. This authority would help ensure that "pre-merger" promises become "post-merger" realities.

[8] Re Eastern Utils. Associates, DF 89-085, Order No. 20,094, Apr. 1, 1991, 121 PUR4th 441, 461 (N.H.P.U.C).