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The challenges of the regulatory review of diversification mergers

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ABSTRACT

Electric and natural gas utility merger activity has increased over the past several years. These proposed mergers, however, differ from those experienced in past decades since they are motivated by diversifying utility operations to address a number of risks associated with changing energy markets and policy. While the benefits of these recently-proposed utility combinations appear to be relatively convincing to shareholders, the value proposition for regulators and ratepayers is not quite so evident. The regulatory review of these proposed diversification mergers can be difficult since, by their very nature, they are designed to minimize risk, not generate synergies or efficiencies. This raises a number of hard questions and tough choices for regulators. In fact, many of the larger policy challenges in the regulatory evaluation of several of these recent merger proposals surrounds the degree to which ratepayer benefits are created, and the degree to which ratepayer risks are reduced. This research addresses three major issues in recent utility merger proceedings that include: (1) assessing merger standards of review; (2) understanding ratepayer benefits; and (3) managing potential financial risks.

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1. Introduction

Merger activity in the electric and gas business has virtually exploded over the past several years (Table 1). Cheap money, decreasing fossil fuel prices, uncertain environmental regulations, and challenged demand and customer growth are leading utility management to re-assess their business models and the positions of their respective companies in this changing new world.

In some ways, the current spate of utility merger announcements looks very similar to the merger mania of the 1990s, another era of rapid industry change. Yet in many other ways, the mergers arising in today's utility industry are uniquely different, and while the benefits of these recently proposed utility combinations appear to be relatively convincing to shareholders, the value proposition for regulators and ratepayers is not quite so evident.

The last era of utility mergers, arising throughout the 1990s, revolutionized the corporate structure of utilities (Fig. 1). Mergers of that era were unprecedented in their number and transaction value and designed to maximize corporate size and scope, expand operations into new markets, and leverage back-office energy commodity and other trading investments. Examples of the newly formed companies arising from the mergers of the 1990s include Sempra Energy (Southern California Gas Company and San Diego Electric & Gas Company); Entergy (Middle South Utilities and Gulf South Utilities); Westar (Kansas Power & Light Company and Kansas Gas & Electric Company), and Cinergy (Cincinnati Gas & Electric Company and Union Light, Heat and Power Company).

The end of the 1990s saw a series of "mega-mergers" that tested the merger limitations of the Public Utilities Holding Company Act of 1935 (15 U.S.C. § 2C), which required utility mergers at that time to be restricted to a single "integrated public-utility system," defined as a geographically contiguous utility (P.U.H.C.A. of 1935, Title 1 §11(b)(1)). These mega-mergers tended to be comprised, and characterized, as a "merger of equals" and led to the formation or expansion of such companies as Exelon (Commonwealth Edison and Philadelphia Electric Company), NiSource (Northern Indiana Public Service Company and Columbia Gas), AEP (Central & Southwest Corporation and AEP), and Progress Energy (Carolina Power & Light and Florida Progress Corporation).

The 2000–2001 recession, the Enron debacle, the rise of natural gas prices, and the subsequent energy market meltdown created by all these new challenges put the brakes on a decade's worth of heightened merger activity. Utilities immediately pulled back on expanding their geographic footprints and diversification into competitive energy commodity and generation markets. The wisdom of this contraction was underscored by the dramatic changes in post-2005 natural gas markets. Utilities during the time period between the last two recessions (2000–2001 and

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Table 1
Recently-Announced Major Electric & Gas Utility Mergers (2014 to Current).

Transaction Date	Buying/Surviving Entity	Acquired Entity	Reported Transaction Amount ($ Billion)
5-Apr-14	Laclede Group, Inc. (The)	Energen Corp.	$1.60
29-Apr-14	Exelon Corporation	Pepco Holdings Inc.	$12.35
1-May-14	Berkshire Hathaway Inc.	SNC-Lavalin Group Inc.	$5.97
22-Jun-14	Wisconsin Energy Corporation	Integrys Energy Group Inc.	$9.07
17-Oct-14	Macquarie Infrastructure	Cleco Corp.	$4.68
17-Nov-14	SunEdison, Inc.	First Wind Holdings	$2.37
3-Dec-14	NextEra Energy, Inc.	Hawaiian Electric Industries	$3.96
25-Feb-15	Iberdrola, S.A.	UIL Holdings Corp.	$4.76
9-Aug-15	Hunt Consolidated, Inc.	Energy Future Holdings Corp	$18.90
23-Aug-15	Southern Company	AGL Resources	$11.53
4-Sep-15	Emera Incorporated	TECO Energy Inc.	$10.18
24-Oct-15	Duke Energy Corporation	Piedmont Natural Gas Co.	$6.51
1-Feb-16	Dominion Resources	Questar Corp.	$4.40

Source: SNL Finanical and "Doninion Resources, Questar Corporation to Combine," (Febuary 1, 2016), Dominion Resources Press Release.

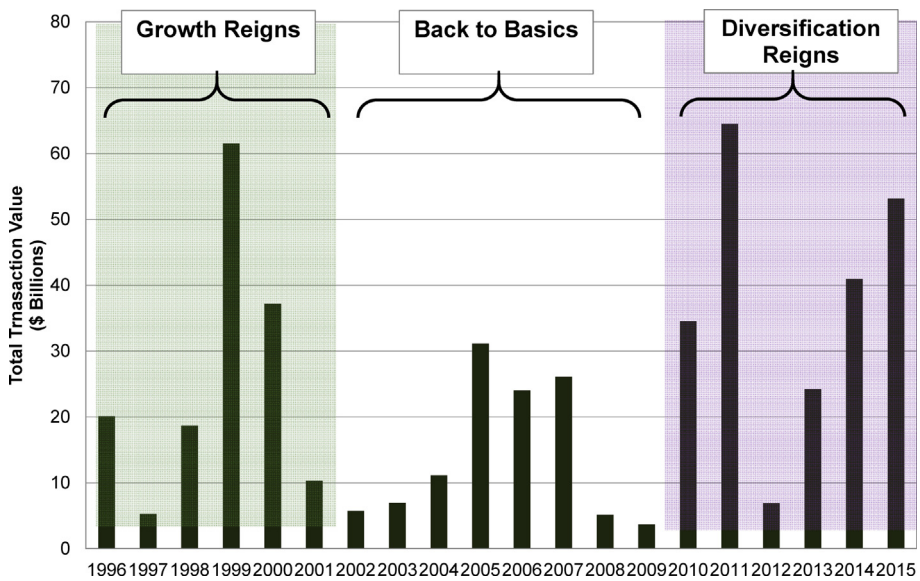

Fig. 1. Electric & Gas Utility Merger Transactions and Values (1996–2016).

Source: SNL Financial

2008–2009) effectively doubled down on what has commonly been referred to as a "back-to-basics" business strategy emphasizing regulated wires and pipes operations.

The 2008–2009 global financial crises and recession marked another turning point for electric and natural gas utilities. Once again, the industry is witnessing a market and policy re-alignment that forces utility management to reassess and calibrate its "back to basics" business strategies. The new opportunities and challenges arising in today's energy markets include:

- ***Cheap money (opportunity)***: U.S. and global central banks pursued very aggressive monetary expansion in the aftermath of the 2008–2009 recession. At issue was the stability and integrity of the world banking system, and the liquidity underpinning that system. U.S. monetary policies led to record-low interest rates that continue to this day. Investors, seeking opportunities for diversifying their earnings opportunities beyond equities, have increasingly been turning to the corporate debt markets (Alloway, 2015). The demand for corporate debt, particularly high-quality debt of the type commonly reflected by many U.S. utilities, is currently outpacing supply. This gives well-positioned utilities an opportunity to use relatively low-cost debt to leverage mergers, acquisitions, other transactions and investments that can assist utilities in meeting their overall corporate diversification strategies.
- ***Dramatic energy market changes (opportunity)***: The shale revolution has changed the dynamics of energy markets in ways that are still not entirely appreciated. Shale-based natural gas supplies have reduced commodity costs and price volatility in a fundamental and structural fashion. At the same time, public policy, technological innovation, and expanding low-cost manufacturing is leading to substantial renewable energy development opportunities. Utilities that once were skeptical, or even hostile, to renewable energy are now seeing considerable value in renewable investments. Business models that strongly support investment in renewables and natural gas, as well as their supporting infrastructure, represent exceptionally attractive earnings opportunities for many utilities.
- ***Questionable traditional growth drivers (challenge)***: The U.S. economy has technically recovered from the 2008–2009 financial meltdown and recession. But the damage done to energy demand during this time period has been considerable. According to some estimates, the U.S. has lost as much as a decade's worth of power generation demand as a result of the

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