Removing Disincentives: State Regulatory Treatment of Merger Savings

Success in achieving merger-enabled savings has the potential to be a win-win situation for utility shareholders and customers alike. But ratemaking policies that penalize the combined utility by failing to provide a fair opportunity to share in the benefits of a merger will create perverse disincentives.

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I. Introduction

Mergers in the fully regulated electric utility industry have often been an exercise in futility. Regulators often seek a large percentage of the merger benefits for customers, leaving little incentive for companies to pursue these economies.[1]

By repealing the Public Utility Holding Company Act of 1935 (PUHCA), the Energy Policy Act of 2005 (EPAct 2005) removes a major barrier to mergers in the electric and gas utility industries. While some commissions have explicitly recognized the benefits that can flow from a well-planned merger, obstacles remain. State regulatory policies that pass through to customers all of the benefits of efficiency-enhancing mergers—while at the same time ignoring the recovery of merger costs—are a substantial barrier to further rationalization of the U.S. utility industries in those jurisdictions.

The principle that applies here is clear: utilities will more completely pursue opportunities for greater efficiency if they have a meaningful opportunity to share in the benefits of their efficiency-enhancing actions. A primary focus of the regulatory framework must be to provide incentives

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for greater operational and organizational efficiency, high-quality service to meet utility customers' expectations, and investment in infrastructure. These improvements would, over time, allow utility customers to benefit from electric utilities' more efficient operation and organization in ways that would not otherwise occur.

This brief article focuses on the importance of removing artificial *disincentives* to the pursuit of mergers. Utilities should be encouraged to work to lower their costs of providing electric and gas services to their customers in any and all available ways. While mergers and acquisitions provide a unique opportunity to achieve economies of scale and scope that benefit customers, the calculation of merger benefits should not be limited narrowly—mergers will refresh a utility's management with new corporate governance. The benefits of doing so should be shared between customers and the utility's shareholders.

II. Regulatory Mechanisms

> *[I]n an environment of rising real electricity prices, company managers and regulators may eventually realize that these economies of scale are ways to hold down the rising real price of electricity.*[2]

Rate cases are again ''looming on the radar screen'' for electric and gas utilities.[3] As they come before the various commissions, state ratemaking policies should provide mechanisms to allow utility shareholders to share in the benefits of mergers, thereby reducing disincentives for utilities to pursue mergers.

There are a number of methods that state regulators can use to accommodate sharing of the benefits and costs of mergers. As shown in **Figure 1**, the initial question is whether the regulator allows explicit recovery in rates of the acquisition premium and out-of-pocket costs. If not, then some other regulatory mechanism to accommodate sharing of the benefits of a merger can be devised, which can either be merger-specific or take the form of a negotiated rate freeze or performance-based ratemaking (PBR) plan.

A. Explicit recovery of merger-related costs

Regulatory policies that increase uncertainty about how a utility recovers the costs associated with particular efficiency-enhancing actions will tend both to lower and skew the utility's

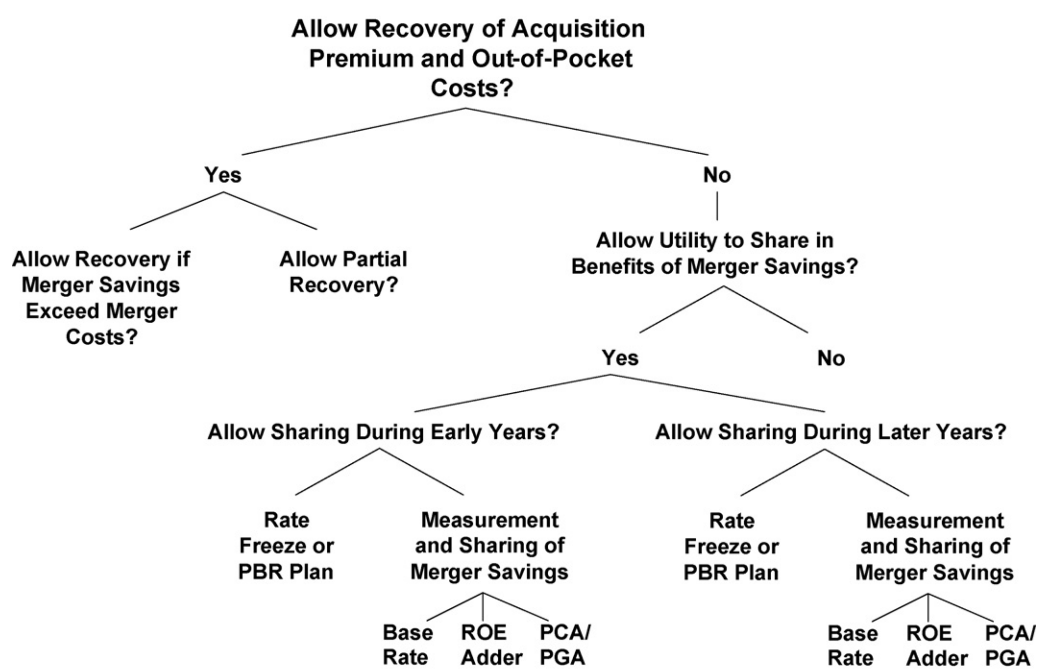

Figure 1: Utility Shareholders Should Have the Opportunity to Share in the Benefits of a Merger—And There Are a Number of Ways to Accomplish This

incentive intensity. Incentive intensity refers to the degree to which a party can ''reliably appropriate the net receipts (which could be negative) associated with the party's efforts and decisions.''[4] Recovery of the acquisition premium and out-of-pocket costs in rates, where it is clear that customers will still enjoy net benefits, is a reasonable way to prevent this from happening.

As a check against the possibility that the acquisition premium will be somehow ''inflated,''[5] state regulators may require that merger costs will only be recovered in rates to the extent that merger benefits exceed merger costs.[6] This approach requires that the utility show, in its rate case filing, that there are net merger savings. Thus, as part of the first rate case following the approval of a merger, the utility could show that merger savings have exceeded merger costs.[7]

Massachusetts and Nevada are examples of states that allow the explicit recovery of merger costs in rates. In Massachusetts,[8] the Massachusetts Department of Telecommunications and Energy (DTE) found that ''[r]ecovery of a reasonable acquisition premium should be considered a worthwhile initial investment in obtaining greater efficiencies for the future benefit of ratepayers.[9] In one 1999 case dealing with the quantification of net merger savings, the Department's order found that:

> [E]ven without consideration of merger-related savings that may continue beyond the ten-year savings time frame, the total costs related to the merger of $486.7 million are still considerably less than the merger-related savings of $632.5 million. Accordingly, upon this conclusive showing, the Department finds that the merger will produce significant benefits for customers and, as discussed below, will allow the merger-related costs proposed by the Joint Petitioners to be included in the cost of service of any future rate proceeding.[10]

In a Nevada case, the Public Utilities Commission found that:

Some states still do not allow recovery of the acquisition premium and out-of-pocket costs in rates, even where it can be shown that there are net merger savings.

> The Commission believes the record evidence supports NPC's [Nevada Power Company's] claim that merger savings exceed merger costs in the test year and that total merger savings exceed total merger costs. . . . The analysis supports the conclusion that the merger savings are at least $8.8 million.[11]

Some state regulators have used ''ad hoc'' or ''inconsistent'' approaches that allow partial recovery of the acquisition premium in rates, *e.g.*, by allowing a return *of* but not *on* the acquisition premium.[12] The problem with these approaches is that opportunity costs are legitimate costs that must be recovered. If that is not recognized, the utility will not, in fact, have a full opportunity to recover fully the costs that were prudently incurred to complete the merger, resulting in a disincentive to pursue mergers in the future. With this approach (and many other aspects of utility ratemaking), the key question is whether the ''end result'' of the regulatory treatment of merger-related costs is reasonable for both customers and investors.

B. Sharing of net merger benefits

Some states still do not allow recovery of the acquisition premium and out-of-pocket costs in rates, even where it can be shown that there are net merger savings (or, at least, no net harm to customers). In those states, other ratemaking mechanisms that share the net benefits of a merger or acquisition between customers and investors can be used. Following a merger, attention to this issue in both basic service rate cases and power cost adjustment (PCA)/purchased gas adjustment (PGA) proceedings is needed in order to provide balanced incentives to the utility.

1. Measurement and sharing of merger savings

Ways can readily be devised to allow sharing of net merger savings between customers and shareholders. Potential mechanisms include: (1) rate case mechanisms, such as an adjustment to the revenue requirement to share merger savings or an

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''adder'' to the allowed ROE; and (2) adjustment of the rates set in power cost adjustment or purchased gas adjustment cases to reflect sharing of merger-related power procurement cost savings. The exact form of the sharing mechanism will vary depending on regulatory preferences in a particular jurisdiction and the nature of the net merger savings that are being shared. For example, if the net savings have to do with improved fuel procurement capabilities subsequent to a merger, the savings could be part of a PCA or PGA mechanism. **Table 1** provides examples of regulatory approaches that allow sharing of merger savings between customers and shareholders.

Table 1: Examples of Regulatory Approaches that Allow Sharing of Net Merger Benefits Between Customers and Shareholders

Allow Utility to Share in Benefits of Merger Savings?
[C]onsistent with the Department's determination that merger-enabled non-gas costs should be shared between ratepayers and shareholders, the Department will allow the sharing of merger-enabled gas-cost savings that result from an approved Gas Cost Reduction Plan. These savings, which will flow to ratepayers through the PGA, will be shared 50/50 between shareholders and ratepayers. To effectuate this sharing, 50% of after tax merger-enabled gas-cost savings measured under a Department approved method will be allocated to shareholders through the ESM. Connecticut Department of Public Utility Control, *Application of Connecticut Natural Gas Corporation for a Rate Increase - Phase II* ("CNG IRP Decision"), Docket No. 99-09-03PH02, May 9, 2001. [Subsequently, a settlement provided for an 80/20 sharing arrangement between customers and shareholders.]
The Board finds that the merger of the holding companies and the subsequent restructurings reflect management's ability to anticipate and respond to change and are an important factor relevant to the Board's determination of Midwest Gas's management efficiency.... The Board finds Midwest Gas's extraordinary management efficiency has resulted in tangible financial benefit to ratepayers. The Board finds that it is appropriate to reward Midwest Gas for its management efficiency. The Board will adjust the cost of common equity upward by 50 basis points as a management efficiency reward. Iowa Utilities Board, *Re Midwest Gas, a Division of Iowa Public Service Company,* Docket No. RPU-91-5, Order dated May 15, 1992, at 22-23.
Interstate's extraordinarily efficient manner of operation results in tangible benefits to ratepayers and warrants an upward management efficiency adjustment of one percent on return on equity beginning on July 1, 1987, if Interstate files tariffs with rate designs based on an acceptable cost-of-service study. Iowa Utilities Board, Docket Re: Interstate Power Company, Docket No. RPU-86-8, Order dated March 2, 1987, at 6.]
The Applicants will implement a mechanism similar to that utilized in the Entergy merger to capture actual savings. The [Savings Sharing Mechanism] will track the actual savings generated by the merger as well as any other cost of service reductions generated by productivity improvements implemented by SWEPCO. Fifty percent of all actual savings will be flowed through directly to Louisiana ratepayers via annual filings by SWEPCO. Louisiana Public Service Commission, Re Southwestern Electric Power Company (SWEPCO), Docket No. U-23327, Sept. 16, 1999. PUR 1999 WL 1487502 (La.P.S.C.).
On Jan. 13, 2003, LG&E and KU filed applications to continue their surcredits and to modify the original [merger surcredit] mechanism.... On Aug. 26, 2003, the parties submitted a unanimous settlement agreement.... The Settlement set forth in Appendix A to this Order and the tariff changes included in Exhibit 1 to the Settlement are approved. Kentucky Public Service Commission, In the Matter of Kentucky Utilities Company's and Louisville Gas and Electric Company's Plan to Address the Future of the Merger Surcredit Approved by the KPSC in Case No. 1997-00300, Case Nos. 2002-00429 and 2002-00430, Order dated October 16, 2003, at 1, 3, and 5.

Realistic, objective, and practical ways must be used to determine real-world merger-enabled savings and costs—so that both utility customers and shareholders are treated fairly and so that a utility has incentives to pursue all possible means of improving its economic efficiency. The most critical issue is that a methodology for calculating merger-enabled savings begins with a reasonable benchmark against which to measure the utility's actual performance. A ''but-for'' scenario (also known as a ''counterfactual'' analysis) compares the outcomes under the merger with the results that would otherwise have been produced.

The obvious difficulty with any ''but-for'' analysis is that it is difficult to know for sure what would have happened if the merger (or other action) had not occurred. There is a real danger that contrived analyses of merger savings, based upon unreasonable assumptions, could lead to the over- or underestimation of merger-enabled savings. In this type of analysis, it is very important to recognize what would likely have been the case if the merger had not been completed. More specifically, if an ''old'' management showed no visible signs of intending, or being able, to adopt more efficient approaches, it is inappropriate for regulators to assume a highly efficient benchmark that ''might have been.''

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Speaking more broadly, a new management usually brings forth a new operating style for a firm, which can result in a wide range of operating changes. The economic literature on the ''market for corporate control''[13] suggests that where a management team fails to realize the full potential of a firm's resources and thereby fails to generate sufficient value for investors, a competing firm will notice this poor performance and if it feels it is positioned to do a better job, it can displace the firm's previous management via takeover. It does not matter that some of these changes theoretically could have occurred absent the merger—what matters is that the combined entity achieves operating efficiencies that, but for the merger, would not likely have been achieved.

An overly narrow ''but-for-the-merger'' standard that takes away efficiency gains merely because the former separate utilities could *somehow* have achieved them—even though they did not in fact do so—would fail to recognize the important insights provided by the economic literature on the market for corporate control. Mergers are an important means of ensuring that a firm's managers pay attention to achieving every possible economic efficiency for their shareholders and customers.

The focus should be on whether the merger led to benefits, and not whether those benefits could have been achieved without a merger. Through a merger, utilities can engage in reciprocal adoption of methods to achieve operating efficiencies, which can minimize the cost of providing utility service, thereby enhancing consumer welfare over time. An overly-narrow perspective on what would have happened but for the merger would fail to identify the full set of net benefits flowing from a merger.

Either rate freezes or incentive ratemaking approaches can work well, allowing the utility to share in the benefits of its efficiency-enhancing actions.

2. *Incentive-based PBR plans and rate freezes*

Rate freezes have been used in many of the utility merger approvals of the past 10 years. More complicated, incentive-based ratemaking approaches (such as price cap adjustment plans) have been used somewhat less frequently, but have the potential to provide a more durable ratemaking framework, which can reduce uncertainly about how ratemaking will be done during the term of the plan. While we do not examine these approaches in detail here, PBR can have an important, conceptually separate,[14] role to play in reducing disincentives for utilities to pursue mergers.[15]

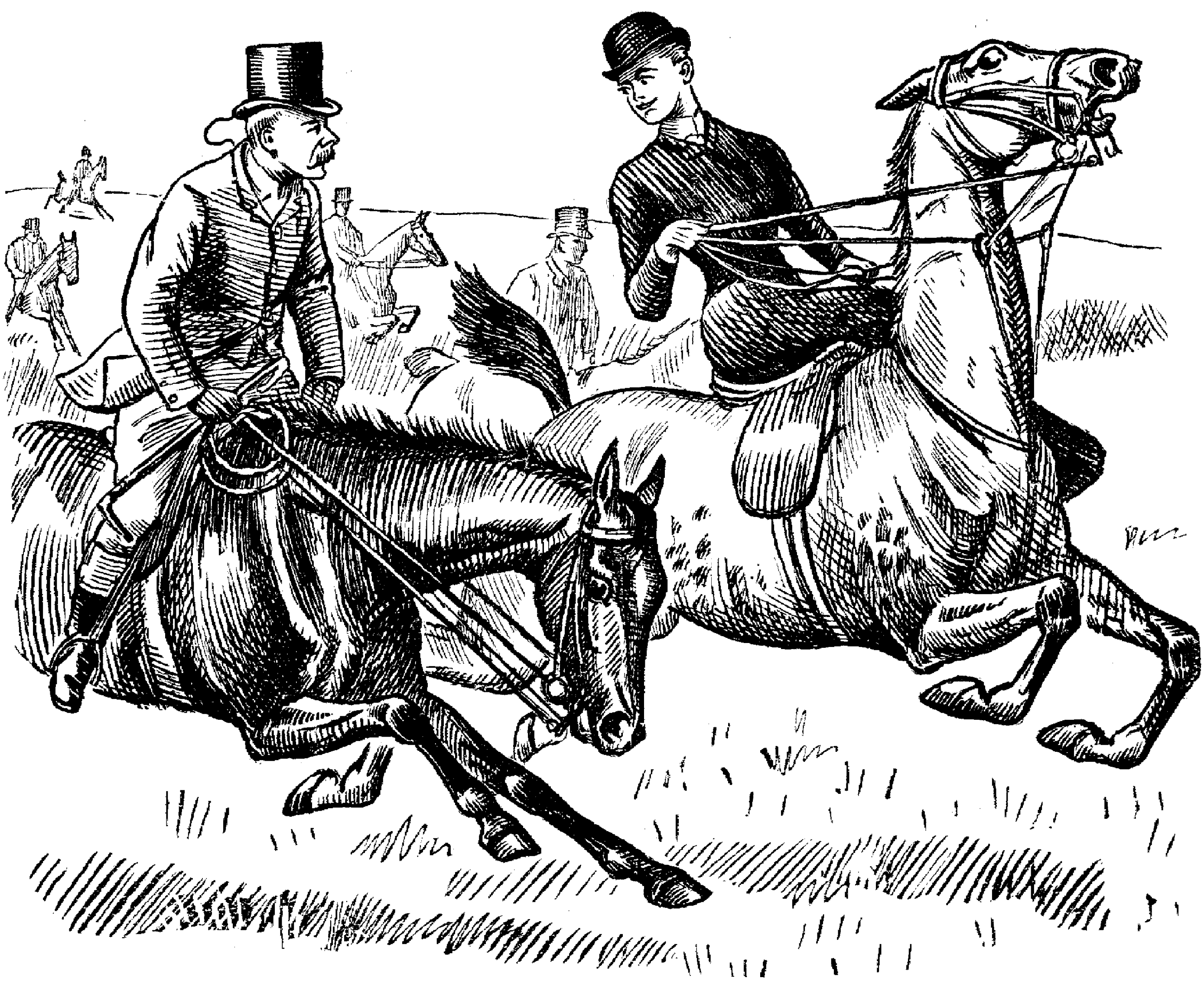
Incentive ratemaking plans are generally intended to provide improved efficiency incentives relative to traditional rate-of-return ratemaking.[16] They do so by providing efficiency incentives that increase the utility's ability to appropriate the benefits that derive from its efforts to increase its efficiency and, concurrently, decreases the utility's ability to pass cost increases on to customers. Customers can benefit in a number of ways, such as greater price stability and predictability and reduced regulatory administration costs.

Either rate freezes or incentive ratemaking approaches can work well (although we lean towards the PBR approach, as it is likely to prove more durable), allowing the utility to share in the benefits of its efficiency-enhancing actions during the term of the plan. One approach would be to set base rates as if the merger had not been completed—and then allow sharing of earnings above and below a target rate of return on equity. For example, there could be a 50/50 sharing of earnings at least 200 basis points above or below the allowed return on equity.

Massachusetts has used incentive ratemaking in conjunction with mergers. Formal incentive rate plans have been successfully used to provide efficiency incentives, better cost control, lower rates, and the other public policy goals.[17]

III. Conclusion

The market for corporate control is a process by which a new management comes in and does what the old management did not do, perhaps by bringing to the table resources that the old management did not have access to. To successfully achieve merger savings, the new management team that takes charge of an acquired firm must generate maximal value for shareholders by realizing operating efficiencies. Success in achieving merger-enabled savings has the potential to be a win-win situation for utility shareholders and customers alike. But ratemaking policies that penalize the combined utility by failing to provide a fair opportunity to share in the benefits of a merger will create perverse disincentives. Mergers and acquisitions can provide an effective way to reduce costs borne by consumers, and increase the value that they receive, by achieving economies of scale, scope, and learning. Given the potentially significant efficiency benefits that mergers can provide, ensuring that the combined utility's shareholders receive a share in the benefits of the merger is more than reasonable, it is an essential regulatory tool.



Success in achieving merger-enabled savings has the potential to be a win-win situation for shareholders and customers alike.

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Regulators that do not allow the utility to share in the benefits of a merger should not be surprised if utilities lose interest in pursuing mergers. This would be unfortunate given that mergers can be a uniquely effective way to achieve economies of scale, scope, and learning—and can, in turn, reduce a utility's need to file a rate case.■

Endnotes:

1. James Dobson, Alex Kania, and Erica Piserchia, *Standing at the Precipice, or Investing at the Trough?*, ELEC. POWER MONTHLY, Deutsche Bank, Feb. 4, 2004, at 7.

2. Dobson *et al.*, *supra* note 1.

3. *See*: Hethie Parmesano and Jeff D. Makholm, *The Thaw: The End of the Ice Age For American Utility Rate Cases—Are You Ready?*,'' ELEC. J., July 2004, at 69.

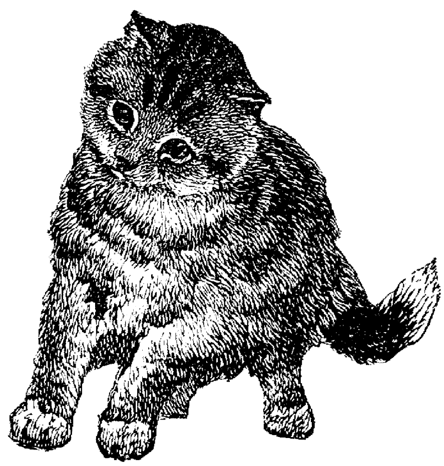
4. OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE (New York: Oxford Univ. Press, 1996), at 378.

5. PUHCA of 1935 was passed, in part, due to abuses of this type. EPAct 2005 deals with this concern by requiring that federal and state regulators have access to the books and records of affiliates of the electric or gas utility in a holding company system.

6. Regulators often require such things as ''tangible customer benefits and operating efficiencies,'' ''actual benefits to ratepayers,'' or ''actual benefit to ratepayers from the transaction giving rise to the adjustment.'' Minnesota, for example, ''requires a showing that acquisition costs are matched or exceeded by benefits to ratepayers that are quantifiable and are directly attributable to the acquisition.'' *See*: LEONARD SAUL GOODMAN, THE PROCESS OF RATEMAKING, Vol. II (Vienna, VA: PUR, 1998), at 796–797. *See* also: Re Midwest Gas, a Div. of Iowa Pub.Svc.Co., 127 PUR4th 173 (Minn.PUC, 1991).

7. In subsequent rate cases, recovery of merger costs would continue so long as merger benefits are identifiable and continue to exceed merger costs.

8. In 1994, while one of the co-authors, Dr. Gordon, was Chairman, the Massachusetts DPU eliminated the *per se* barrier against mergers that had previously been in place (refusal to consider allowing acquisition



premium in rates) because the Department found that ''[w]here the potential benefits for customers exist, it would not be in [customers'] interests to maintain a *per se* barrier against mergers.'' The Department instead decided to address these issues on a case-by-case basis. Mass. D.P.U. 93-167A (1994), Investigation By The Department On Its Own Motion . . . For The Purpose Of Establishing Guidelines And Standards For Acquisitions And Mergers Of Utilities, And Evaluating Proposals Regarding The Recovery Of Costs For Such Activities, p. 8 of 12.

9. Massachusetts Department of Telecommunications and Energy, Joint Petition of Eastern Enterprises and Essex County Gas Company for approval of a merger by the Department of Telecommunications and Energy, pursuant to G.L. c. 164 § 96. . . ., Docket No. 98-27, Sept. 17, 1998, at 70.

10. Massachusetts Department of Telecommunications and Energy, Joint Petition of Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and Commonwealth Gas Company for approval by the Department of Telecommunications and Energy pursuant to G.L. c. 164 § 94 of a Rate Plan, Docket No. DTE 99-19, July 27, 1999, at 44. [footnotes in original not included]

11. Nevada Public Utilities Commission, In re Application of Nevada Power Company for authority to increase its annual revenue requirement for general rates. . . .'' Docket Nos. 03-10001 and 03-10002, Mar. 26, 2004, at 216 and 221.

12. Robert L. Hahne and Gregory E. Aliff, *Accounting for Public Utilities*, Release No. 18 (Newark, NJ: Matthew Bender, Nov. 2001), at 4–12.

13. *See*: Henry G. Manne, *Mergers and the Market for Corporate Control*, J. POL. ECON., Apr. 1965, at 110–20.

14. As time passes following a merger, explicit sharing of merger savings may become less realistic. Incentive rate plans could have a role to play in this situation.

15. *See*: Wayne P. Olson and Kenneth W. Costello, *Electricity Matters: A New Incentives Approach for a Changing Electric Industry*, ELEC. J., Jan./Feb. 1995, at 28–40.

16. While traditional ratemaking practices also have impacts on the utility's incentives, incentive ratemaking approaches are more explicitly focused on developing regulatory approaches that provide incentives that lead the regulated firm—following its own self-interest—to behave in a manner more reflective of a competitive firm in an unregulated market.

17. In Massachusetts, formal incentive rate plans have been successfully used to provide efficiency incentives, better cost control, lower rates, and the other public policy goals that were laid out in the Department's Incentive Regulation Policy Order (Docket No. 94-158) in 1995.

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