Legislative Analysis

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PSC REVIEW OF MERGERS, SALES, AND ACQUISITIONS OF REGULATED GAS AND ELECTRIC UTILITIES

House Bill 6358 (Substitute H-1)
Sponsor: Rep. John Proos
Committee: Energy and Technology

Revised First Analysis (9-22-06)

BRIEF SUMMARY: The bill would require notice to the Public Service Commission (PSC or Commission) of proposed mergers, sales, acquisitions and certain other transactions relating to regulated gas and electric utilities. The bill would authorize the Commission to hold hearings and issue advisory comments regarding the impact of the proposed action on ratepayers and the public interest.

FISCAL IMPACT: This bill has the potential to increase Public Service Commission administrative expenditures as a result of its expanded oversight. Additional full-time equivalent employees may be needed to analyze the impact of proposed utility mergers and acquisitions, or such analysis may need to be provided by an independent third party. The estimated amount and nature of such additional expenditures, if any, will need to be provided by the Public Service Commission.

THE APPARENT PROBLEM:

Until February 2006, when repeal of the federal Public Utility Holding Company Act of 1935 (PUHCA) became effective, the Securities and Exchange Commission had comprehensive oversight authority over mergers or acquisitions of publicly-regulated utilities. In light of PUHCA repeal, oversight of merger and acquisition actions has been shifted to the Federal Energy Regulatory Commission (FERC) and to the states.

Michigan is one of only three states (Michigan, Florida, and Montana[1]) with no law directly authorizing its public utility commission to review proposed mergers or acquisitions of regulated utilities.[2]

[1] A summary of state commission merger review authority statutes and codes can be found in the National Regulatory Research Institute's website at http://nrri.ohio-state-edu/bluepages. Although listed as having no merger review statute, it may be that Nebraska has a law but has no utilities subject to its law because none of its utilities is investor-owned, as the Commission testified. (9-6-06)

[2] Michigan's Public Service Commission Law, 1939 PA 3, MCL 460.1, *et seq*., vests the Public Service Commission with broad jurisdiction over public utilities in the state including the power to regulate "all rates, fares, fees, charges, services, rules, conditions of service, and all other matters pertaining to the formation, operation, or direction of public utilities. The public service commission is further granted the power and jurisdiction to hear and pass upon all matters pertaining to, necessary, or incident to the regulation of public utilities…."

Most industry analysts expect a wave of merger and acquisition activity affecting utilities in light of PUHCA repeal that could result in substantial concentration of ownership of investor-owned utilities.

THE CONTENT OF THE BILL:

The bill would add a new section to the Public Service Commission Law to provide for review by the PSC of certain transactions involving a change in ownership or control of a regulated gas or electric utility. Specifically, the bill says that "[a] person shall not acquire, control, or merge, directly or indirectly, in whole or in part, with a regulated utility nor shall a regulated utility sell, assign, transfer, or encumber its assets to another person without first complying with the requirements of this [bill]." On the other hand, acquisitions or transfers of assets acquired or sold in "the normal course of business" are not covered. Regulated utility is defined in the bill as "an investor-owned electric utility, electric cooperative, or a natural gas distribution utility with rates subject to the jurisdiction of the Commission."

Orders and rules. The bill requires the Commission to issue an order, after notice and hearing, defining what constitutes acquisition, transfer, or merger activities subject to the review process. This order is required not later than 90 days from the effective date of the act. In addition, the Commission is required to promulgate procedural rules for the review process, including materials required for filings.

Review procedure. A proponent of a covered action would be required to file required materials with the PSC at least 180 days before the effective date of the proposed action. Within 15 days from the date of a filing, the Commission is required to notify the party whether the filing is complete. The Commission would then have 30 days from the date that it receives a complete filing to determine whether it intends to investigate or hold hearings on the proposed action. At the end of the 30-day period, or 120-day period if the Commission extends the time for review, the Commission must issue advisory comments on whether the proposed action is in the best interest of the ratepayers of the regulated utility and what impact the action may have on energy service in the state.

Access to books and records. All parties to a proposed action subject to the bill would be required to provide the Commission with access to any books, records, accounts, documents, and other data and information that the Commission needs for a review limited to the factors set forth in the bill.

Relevant factors. The bill permits the PSC to review and make advisory comments on one or more of the following factors:

- Whether the proposed action would have an adverse impact on affected customers' rates.
- Whether the proposed action would have an adverse effect on the safety, reliability, or adequacy of energy service.

- Whether rates paid by the customers of the regulated utility would subsidize a nonregulated activity of the new entity.
- Whether the action would significantly impair the regulated utility's ability to raise capital or maintain a reasonable capital structure.
- Whether the action would have an adverse impact on competition.
- Whether the action is otherwise inconsistent with public policy and interest.

MCL 460.6r

BACKGROUND INFORMATION:

The federal Energy Policy Act of 2005 repealed the longstanding Public Utility Holding Company Act of 1935 (PUHCA), effective February 2006, replacing it with the much more limited PUHCA of 2005, under which Federal Energy Regulatory Commission (FERC) and the states are empowered to regulate utility sales and mergers. PUHCA was enacted in 1935 in response to abuses that had occurred in the gas and electric industry during the first quarter of the 20th century. PUHCA broke up the nation's gas and electric utility holding companies and limited their ability to recombine. According to the SEC, "the abuses [leading to passage of PUHCA] included misuse of the holding company structure, inadequate disclosure of the financial position and earning power of holding companies, unsound accounting practices, excessive debt issuances, and abusive affiliate transactions."[3] Many utility companies went bankrupt as a result of the abuses.

The repeal of PUHCA of 1935 removes limitations on the types of combinations and ownership structures that are allowed. Utility companies are now freer to merge with geographically remote utilities, including foreign corporations, and can diversify beyond utilities. As a 2005 report by the American Public Power Association[4] described the impact on electric utilities:

> Repeal…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.
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> The effect will 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

[3] "Testimony Concerning the Enron Bankruptcy, the Functioning of Energy Markets and Repeal of the Public Utility Holding Company Act of 1935" by SEC Commissioner Isaac C. Hunt before the Subcommittee on Energy and Air Quality Committee on Energy and Commerce, U.S. House of Representatives, February 13, 2002, available online at http://www.sec.gov/news/testimony/021302tsich.htm.

[4] The Electric Utility Industry After PUHCA Repeal/What Happens Next?" October 2005, American Public Power Association. Available online at www. Appanet.org/files/PDFs/APPAreportAfterPUHCARepeal.pdf.

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 relationship and large and complex corporate structures will make it more difficult for regulators to monitor financial transactions between affiliates.

Most states have armed their public utility commissions with specific merger review authority. Information provided by the Public Service Commission indicates that 23 state commissions have clear authority within their statutes to approve or deny merger and acquisition activity. Another 18 state commissions have the authority to approve a merger or acquisition prior to the transaction, but authority to outright deny a merger is not explicit. All 41 of these states have the authority to deny certificates of public convenience and necessity and/or place conditions on utility merger and acquisition activity within their jurisdiction. Five more states have partial review authority for certain utility groups, but not all, and do not appear to have authority to deny a merger. One state, Nebraska, appears to have review authority for "public utility" merger and acquisition activity, but has no utilities that qualify, as it has only municipal and consumer-owned utilities. Michigan is one of only three states (Michigan, Florida, Montana) with no specific statutory review authority at all.

A recent briefing paper by the National Regulatory Research Institute, "Repeal of the Public Utility Holding Company Act of 1935: Implications and Options for State Commissions," identified three major problem areas for states to review to determine whether their state commission has adequate authority to address merger and acquisition activity in light of PUHCA reform:

- **Transfer pricing**. As the report put it, among other potential problems, "[w]henever a utility and its subsidiary or affiliate engage in transactions with each other, there is an incentive for the subsidiary or affiliate to charge above-market or above-cost prices for goods and services, counting on the utility to be able to pass through the expense in its rates."
- **Cost allocation and cross-subsidies**. "Problems of cost allocation and the potential for cross-subsidies arise whenever a utility and its subsidiary and/or affiliate share joint and common administrative, capital, or operating costs. Such are commonplace in a holding company environment."
- **Financial abuses**. PUHCA repeal potentially opens the door to financial abuses in both blatant and subtle forms, according to the NRRI. An example of a blatant abuse would be using the regulated utility's assets as collateral to finance an affiliate's activities.

The NRRI report goes on to detail a number of more subtle forms of financial abuse concerning purchased power costs, loss of managerial expertise from the regulated utility to unregulated activities, a potential loss of synergistic benefits from too much diversification, and the potential for utility expenditures to support technological advances favoring not the regulated utility but corporate affiliates.

The report concludes that each state must decide for itself how it wishes "to balance the need to assure consumer protection against the possibility of additional investment in electric utility infrastructure (particularly transmission and distribution) that the repeal is expected to stimulate."

Supporters of PUHCA 1935 repeal intend that it will lead to an economically efficient consolidation of the electric and gas industries and stimulate additional investment.

ARGUMENTS:

For:

Michigan needs to empower its Public Service Commission to review the impact of mergers or acquisitions of regulated utilities on ratepayers and the public interest, as have approximately 47 other states. Currently, Michigan is one of only three or four states that do not have a law providing for public review of mergers and acquisitions of regulated utilities. Approximately 47 states, and the District of Columbia, have a law providing for some degree of merger review. With no specific law, Michigan would have no clear mechanism for holding hearings and bringing to light the potential negative effects of proposed mergers or acquisitions.

Michigan needs the PSC to be the "watchdog" with respect to mergers and acquisitions to protect consumers and the public interest. This bill will allow the Commission to evaluate proposed transactions, balance the interests of consumers and the state against the potential additional investment that could result, and issue advisory comments.

With industry analysts expecting rapid consolidation of utilities, the state needs to place a statute in place before the anticipated consolidation is complete. Many industry analysts expect a large amount of merger and acquisition activity affecting gas and electric utilities in the near future as a result of PUHCA repeal. To be effective, any proposed new law needs to be passed before the industry has already consolidated.

Response:

Some people question whether a merger review statute is necessary. The PSC has indirect authority now to review mergers under its general authority and the entity created by the merger or acquisition would still need to come before the Commission for rate review which would indirectly discourage corporate abuses.

Against:

A merger review bill is necessary, but the bill needs to give the PSC more authority to at least attach conditions if it determines that a proposed merger or acquisition would have adverse effects on consumers or the public interest. Otherwise, the bill is essentially a "notice" law that adds regulatory cost to the merger and acquisition process but does not give the PSC any authority to protect ratepayers or the public interest. It is not enough to give the PSC a "bully pulpit." At the end of the statutory review period, the parties to the proposed merger or acquisition would be free to go forward with the sale or merger—regardless of the potential impact on Michigan ratepayers and the public—and the PSC would not be in a position to stop it or even place conditions on the approval of a merger.

Some examples of conditions of the type of conditions the PSC would like to have the authority to attach are: (1) reporting requirements; (2) restrictions on certain intra-corporate transactions; (3) prohibitions on the regulated utility bearing the costs of the merger or acquisition; (4) prohibitions on the use of regulated assets as collateral for non-regulated activities.

Industry analysts expect most states to "leverage their new regulatory powers" to "extract commitments that assure financial health and service at reasonable costs."[5] Without a law to give Michigan this authority, most other states' commissions will be extracting commitments to protect their consumers, while Michigan would not be.

Also, the bill should cover the telecommunications industry, as well as regulated gas and electric utilities.

POSITIONS:

AARP Michigan indicated support for the bill (but would prefer that it include merger review for large telecommunications firms). (9-6-06)

Communications Workers of America Council of Michigan supports the bill. (9-6-06)

Michigan Consumer Federation indicated support for the bill. (9-6-06)

The Michigan Electric and Gas Association testified that it is neutral on the bill. (9-6-06)

Michigan Alliance for Competitive Telecommunications (MiACT) supports the bill but provided a written statement in support of adding telecommunications mergers to the bill. (9-6-06)

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

[5] See, for example, "Power and Utilities M & A: Focus on North America, " by Chris Nicholson, Deloitte Touche Tohmatsu, 2006, available at www.deloitte.com