Legislative Analysis

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PSC REVIEW OF PURCHASES AND SALES OF REGULATED GAS AND ELECTRIC UTILITIES

House Bill 6358 as passed by the House
Sponsor: Rep. John Proos
Committee: Energy and Technology

Second Analysis (11-28-06)

BRIEF SUMMARY: The bill would authorize the Public Service Commission (PSC or Commission) to conduct a limited review of certain utility-related transactions, including the purchase and sale of regulated gas and electric utilities. After a review taking no longer than 120 days after the parties submitted all necessary documents, the Commission could recommend modifications or changes to the structure of a covered transaction but would *not* have the authority to approve or disapprove a purchase or other acquisition or to place conditions on the transaction.

In general, the PSC review process would apply to purchases or sales involving 51 percent or more of a regulated gas or electric utility's stock; purchases or sales of a controlling interest in the utility; or purchases or sales of all or a substantial part of the utility's operating assets.

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 Commission.

THE APPARENT PROBLEM:

Until February 2006, when the federal Public Utility Holding Company Act of 1935 (PUHCA 1935) was replaced with the more limited PUHCA of 2005, the Securities and Exchange Commission (SEC) had comprehensive oversight authority over mergers or acquisitions of publicly-regulated utilities. In light of PUHCA 1935 repeal, oversight of mergers and acquisitions of regulated utilities has been shifted from the SEC to the Federal Energy Regulatory Commission (FERC) and to state utility commissions. Claims that PUHCA 1935 was no longer necessary for ratepayer protection were premised in part on the argument that states were fully empowered to address the type of abuses that originally prompted enactment of the statute, and a "savings clause" in PUHCA 2005 permits a state utility commission to exercise its jurisdiction under its laws to protect utility consumers.

Most industry analysts expect a wave of merger and acquisition activity affecting utilities in light of PUHCA 1935 repeal that could result in substantial concentration of ownership

of utilities. Michigan is one of only three states (Michigan, Florida, and Montana) with no law directly authorizing its public utility commission to review proposed mergers or acquisitions of regulated utilities.[1] Proponents of the bill would like to authorize the PSC to review mergers and acquisitions involving Michigan's regulated utilities to protect Michigan's utility consumers from unacceptable risks without discouraging the infusion of investment capital into utility sectors.

THE CONTENT OF THE BILL:

The bill would add a new section (MCL 460.6r) to the Public Service Commission Law to provide for PSC review of certain transactions involving a change in ownership or control of a regulated gas or electric utility.

Transactions subject to PSC review. Subsection 6r(1) specifies the types of transactions covered by the PSC review process established in the bill:

- The purchase or sale, or other acquisition or disposition, of 51 percent or more of the then-outstanding shares of a regulated utility's stock, or of a controlling interest in a regulated utility, either directly or indirectly.
- The purchase or sale, or other acquisition or disposition, of all, or a substantial part of, a regulated utility's existing and operating assets used or useful in providing regulated service in Michigan at the time of the transaction.

On the other hand, acquisitions or transfers of assets acquired or sold in "the normal course of business" are excluded. Pending transactions subject to a written agreement entered into before the effective date of the bill are also excluded.

"Regulated utility" is defined in the bill as "an investor-owned electric utility, an electric cooperative, or a natural gas distribution utility with rates subject to the jurisdiction of the [PSC]." "Person" is defined as "an individual, corporation, association, partnership, or any other legal private or public entity."

Rules. The Commission is required to promulgate procedural rules for the administration of the review process established in the bill.

Required materials; additional requested materials. Within a "reasonable period" after entering into an agreement for a covered transaction (as defined in Section 6r(1), and before the transaction was complete,[2] the parties to the transaction would be required to file all of the following material with the PSC under Section 6r(3) of the bill:

[1]Although Michigan has no specific merger review statute, 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…."

[2] Section 6r(1) requires a person to comply with "this section," i.e., the new Section 6r created by the bill, *before completing* a covered transaction.

- A concise summary of the terms and conditions of the proposed transaction.
- Copies of the material transaction documents, if available.
- A summary of the "projected impacts" of the transaction on rates and regulated utility services in Michigan.
- Pro forma financial statements relevant to the transaction.
- Copies of the parties' public filings with other state or federal regulatory agencies regarding the same transaction including any regulatory orders issued by the agencies regarding the transaction.

In addition, under Section 6r(6), the Commission could make written requests for documents reasonably related to making its advisory comments within 30 days of the initial filing.

The Commission would then have 30 days--beginning on the date it receives all of the documents required under Section 6r(3) or requested under 6r(6)--to determine whether to conduct any investigations or hearings. The PSC may extend the time for reviewing the proposed transaction to a period of not more than 120 days. At the end of the 30-day period, or the extended 120-day period, the Commission would have to issue either:

- Advisory comments that could include proposed recommendations, modifications, or changes to the structure of the proposed transaction based on the relevant factors set forth in of the bill.
- A written statement that PSC review is completed and no further comment is necessary.

Confidentiality of documents. Non-public information and materials submitted by a person "clearly designated by the person as confidential" are exempt from disclosure under the Freedom of Information Act. The bill says that the Commission "shall" issue protective orders as necessary to protect information designated by a person as confidential.

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 the rates of Michigan customers regulated by the Commission (under MCL 460.6a).
- 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, to the extent prohibited by a Code of Conduct established by the Commission under Section 10a(4) [MCL 460.10a; applicable to electric utilities].
- 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 a material adverse impact on competition.

BACKGROUND INFORMATION:

The federal Energy Policy Act of 2005 repealed the longstanding Public Utility Holding Company Act of 1935 (PUHCA 1935), effective February 2006, replacing it with the more limited PUHCA 2005, under which Federal Energy Regulatory Commission (FERC) and the states are empowered to regulate utility sales and mergers. PUHCA 1935 was enacted in response to abuses that had occurred in the gas and electric industries during the first quarter of the 20th century. The law 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 during this era.

PUHCA 2005 removed 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. Companies outside of the industry, moreover, can seek to purchase regulated utilities. Multi-state, or even multi-national, gas and electric companies or combined gas/electric companies are allowed. A critical 2005 report by the American Public Power Association[4] offered this description of the impact on electric utilities:

> *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 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.*

Supporters of PUHCA 2005 say that it will lead to an economically efficient consolidation of the electric and gas industries and stimulate additional capital investment in energy infrastructure. The old law, they said, was outmoded, and that in the six decades since PUHCA was enacted, other federal and state regulations have been enacted to protect the interests of consumers, rendering PUHCA unnecessary at best and, at worst, an impediment to the upgrading of the nation's energy system.

A savings clause in the new federal law permits states to protect utility consumers under state legislation. Most states have armed their public utility commissions with specific

[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.

merger and acquisition review authority. A PSC analysis 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 or place conditions on utility merger and acquisition activity within their jurisdiction, or both. Five more states have partial review authority for certain utility groups, but 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, and 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* (August 2006), identified 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 or revenue streams as collateral for upstream or affiliate loans.

The NRRI report goes on to detail a number of more subtle problems including negative impacts on the regulated utility's credit rating or risk, abuses 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."

ARGUMENTS:

For:

Michigan needs to empower its Public Service Commission to review the impact of mergers or acquisitions of regulated utilities on utility consumers. Currently, Michigan is one of only three states that do not have a law directly providing for public review of mergers and acquisitions of regulated utilities. With no specific law, Michigan would have no clear mechanism for bringing to light any 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 and issue advisory comments. Although the oversight authority granted to the PSC in the bill would be very limited, it is better than no review authority. A balance has been struck between overly-restrictive regulation and no review at all.

With industry analysts expecting rapid consolidation of utilities, the state needs to enact a statute before the anticipated consolidation is complete. The Legislature should act quickly so that the PSC can protect the interests of utility consumers during this wave of consolidation.

The bill will not impose undue burdens on the business and investment community because the review process in the bill has an expedited timeframe and limited scope, and the PSC can suggest, but not require, modifications to a proposed transaction. In fact, so long as the regulatory process is not protracted, investors often like the certainty provided by state approval of mergers. Compliance with a state merger review procedure would be a typical condition of a merger or sale agreement.

Response:

Some people question whether a merger review statute is necessary. They argue we should allow market forces, rather than regulators, to determine ownership structures in the industry. Further, the PSC has indirect authority now to review mergers under its general authority, and the entity ultimately created by a merger or acquisition would still need to come before the Commission for subsequent rate reviews, which would indirectly discourage financial abuses.

Against:

Even if the PSC is not given authority to deny approval of a merger, it should at least be given authority to at attach conditions if it determines a proposed merger or acquisition could adversely affect utility consumers. If the PSC only has authority to issue advisory comments, the bill is essentially a "notice" law that adds time and cost to the process but has no teeth; the PSC could not prevent a transaction from going forward or directly protect utility consumers.

Some examples of conditions that the PSC says would be useful 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; and (4) prohibitions on the use of regulated assets as collateral for non-regulated activities.

Some of these conditions fall into the category of what is known in the industry as "ring-fencing"--a variety of mechanisms designed to isolate regulated utilities from the financial risks of their corporate parent or affiliates. According to the American Public Power Institute, "[o]f 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."[5] With no ring-fencing, financial risks could be transferred from a holding company or affiliate to a regulated utility possibly leading to a lower credit rating, increased capital costs, or, in severe cases, financial distress for the regulated utility. Moreover, if other states are protecting their utility consumers with ring-fencing, and Michigan is not, more risk might be transferred from other states to Michigan.

Ring-fencing in Oregon apparently saved utility consumers from the worst effects of the Enron bankruptcy. When Enron acquired Portland General Electric Company (PGE) in 1997, the Oregon Public Utility Commission required that several ring-fencing protections be put in place, including that PGE maintain separate debt from Enron. These ring-fencing mechanisms largely insulated PGE and its customers from Enron's bankruptcy late in 2001. Closer to home, in recent years, Aquila, Inc. sought to use regulated utility assets from several states as collateral for loans. Because Michigan had no law prohibiting companies from using utility assets for collateral, Michigan assets were used as collateral to finance debt while states with stronger laws prohibited regulated utility assets from being pledged in this way.

The scope of PSC review contained in the current version of the bill is weaker than in earlier versions. For example, the "catch-all" section allowing the PSC to comment on whether a transaction is "otherwise inconsistent with public policy and interest" has been removed. Also, the section dealing with cross-subsidies has been modified so that the PSC could only evaluate cross-subsidies "to the extent prohibited by a Code of Conduct established by the Commission under Section 10a(4)." As Section 10(a)(4) appears to only apply to electric utilities, the PSC would arguably have no authority to review potential cross-subsidy abuses involving stand-alone natural gas utilities.

Further, some people who support the bill in general believe it should also apply to mergers of large telecommunications firms; 35 states are said to have some telecommunication merger authority.

Response:

It would be a mistake to over-regulate so as to discourage beneficial restructuring in the energy utility sector. Proponents of mergers and acquisitions say they can result in significant new capital investment in utility infrastructure to the benefit of ratepayers, investors, and workers.

[5] The Electric Utility Industry After PUHCA Repeal/What Happens Next?" at p. 16, October 2005, American Public Power Association. Available online at www. Appanet.org/files/PDFs/APPAreportAfterPUHCARepeal.pdf.

Against:

Some additional arguments could be made against the bill's current language.

- For example, the bill only requires the parties to provide material transaction documents to the PSC, "if available." It is unclear what is meant by "if available" in this context. In what situations would documents in existence not be available?
- The PSC could only request additional documents in writing for 30 days after receiving a filing, even if the initial filing was woefully incomplete, making it difficult for the PSC to determine quickly what additional documents were needed. Broader access language in earlier versions of the bill has been removed.
- Finally, the bill makes confidential—and exempt from disclosure under the Freedom of Information Act—any non-public information labeled confidential. The bill states that the PSC "shall" issue protective orders to protect information designated by a party as confidential arguably eliminating the PSC's usual discretion to evaluate a request for a protective order. At a minimum, the bill should guarantee that the advisory comments that the PSC may provide are available to the public.

POSITIONS:

AARP Michigan supports the bill, as passed the House, but would prefer that it include review of mergers of large telecommunications firms. (10-13-06)

Michigan Alliance for Competitive Telecommunications (MiACT) supports the bill, as passed the House, but would prefer that it include review of telecommunications mergers. See written testimony provided to the committee. (10-13-06)

Michigan Consumer Federation supports the bill, as passed the House, but would prefer that it include reviews of mergers of large telecommunications firms. (10-13-06)

Communications Workers of America Council of Michigan supports the bill. (10-18-06)

The Michigan Electric and Gas Association is neutral on the bill. (10-23-06)

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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.