

## INCONSISTENT WITH THE PUBLIC INTEREST: FERC'S THREE DECADES OF DEFERENCE TO ELECTRICITY CONSOLIDATION

*Scott Hempling\**

**Synopsis:** Since the mid-1980s, mergers and acquisitions approved by the Federal Energy Regulatory Commission have cut the number of independent retail electric utilities by more than half. These transactions have taken every possible form: horizontal, vertical, convergence, and conglomerate; operationally integrated and remote; domestic and international; publicly traded and going-private; debt-financed and stock-for-stock.

Accompanying this consolidation has been complication. The conventional pre-1980s utility—local, pure play, conservatively financed—is being replaced by multistate and multinational holding company systems: corporate structures housing multiple, and sometimes conflicting, business ventures—structures that owe their financeability and viability to their utility affiliates' monthly cash flow.

Under Section 203 of the Federal Power Act, the FERC must find these consolidating and complicating transactions “consistent with the public interest.” Despite multiple policy statements, rules, and 70-plus transaction approvals, the FERC has never defined a “public interest” in terms of the industry's performance. Though the 1996 Merger Policy Statement states a purpose of “encouraging greater wholesale competition,” that purpose rarely appears in the FERC's actual merger orders. These orders require only “no harm,” and no harm only to pre-merger competition—regardless of whether that pre-merger competition is effective or ineffective. Effective competition exists when a market's structure, and its sellers' conduct, pressure all rivals to perform at their best. By requiring only “no harm,” and by applying that standard only to pre-merger competition, the FERC has invited and approved transactions whose contributions to performance are necessarily suboptimal. For 30 years, the Commission's merger decisions have disconnected the “public interest” from performance.

That disconnection has produced, and continues to produce, consolidated asset ownership and complicated business structures. Today's electricity industry resembles nothing any prior FERC intended, because no prior FERC ever stated what it intended—not only in terms of industry performance, but also in terms of the key influences on performance, such as the appropriate number of utility systems in a region, the appropriate mix of businesses and business structures within those systems, the types of owners and the financing they use, and those owners'

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\* Scott Hempling advises and testifies before regulatory bodies throughout the United States and internationally. He has authored two books: *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* (American Bar Association 2013); and *Preside or Lead? The Attributes and Actions of Effective Regulators* (2d ed. 2013). An adjunct professor at Georgetown University Law Center, Hempling received a B.A. *cum laude* from Yale University in Economics and Political Science and in Music, and a J.D. *magna cum laude* from Georgetown University Law Center.

strategies for subsequent expansion. The main influence on the FERC's merger decisions—the main force determining these industry features—is not any public interest vision, but rather the merger applicants' strategic aims.

The Commission's deference to applicants' strategies is logical, and lawful, when the relevant markets giving birth to these transactions are effectively competitive markets. But when mergers involve retail monopolies, the relevant markets are not effectively competitive. Deference to transactions undisciplined by effective competition cannot be consistent with the public interest.

This absence of a public interest vision, and the resulting deference to private interest transactions, are the big-picture errors. They lead to five main policy errors. The FERC (1) looks only at wholesale competition, ignoring retail competition; (2) views each merger in isolation from the others, ignoring their cumulative effects; (3) ignores the relationship of purchase price to real transaction value, thereby approving transactions whose benefit-cost relationship is suboptimal; (4) allows the transacting parties to allocate nearly all their transaction's value to themselves, disregarding the contributions to that value made by the target's rate-payers; and (5) assumes without inquiry that regulators will be capable and willing to handle the post-consummation complexity.

Supporters of the FERC's merger policy might make two main arguments. First, the Commission's near-universal merger approvals have produced no obvious performance backslide. Second, no studies exist to test whether today's consolidated industry performs less efficiently than had the FERC done things differently. But neither factor proves the policy correct. The mere absence of backslide is the wrong standard to apply to a multi-trillion-dollar, infrastructural industry on which lives depend; the absence of useful studies is reason to conduct them, not to continue a policy unquestioned.

The Commission should re-examine its policy's premises: that "no harm" is the correct standard; that the market structure to which no harm should apply is the pre-merger market structure regardless of its competitive defects; and that the strategies that drive merger proposals are necessarily disciplined by forces aligned with the public interest. That re-examination should take the form of a notice of inquiry, led by a task force with expertise and hierarchical prominence comparable to the Commission's offices on reliability and enforcement. Fact-gathering and analysis, instead of continuous approvals, will help us ensure that future mergers are, as section 203 requires, consistent with the public interest.

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I. OVERVIEW: 70-PLUS APPROVALS IN 30 YEARS

Section 203 of the Federal Power Act<sup>1</sup> (FPA) applies to five categories of corporate transactions, if the transaction value exceeds \$10 million:

1. sales, leases, or dispositions of electricity “facilities” by a public utility;<sup>2</sup>
2. mergers or consolidations of such facilities by a public utility;<sup>3</sup>
3. acquisitions of public utility securities by a public utility;<sup>4</sup>
4. purchases or leases of generation facilities by a public utility, if the facilities are used for interstate wholesale sales and are subject to the Commission’s ratemaking jurisdiction;<sup>5</sup> and
5. certain transactions involving holding companies that own a transmitting utility or an electric utility.<sup>6</sup>

FPA § 203(a)(4) requires the Federal Energy Regulatory Commission (FERC) to approve the transaction if it “will be consistent with the public interest.” FPA § 203(b) authorizes the Commission to condition its approvals if “necessary or appropriate to secure the maintenance of adequate service and the coordination in the public interest . . . .”<sup>7</sup>

Applying these provisions, the FERC since the mid-1980s has approved over 70 mergers or acquisitions involving retail electric monopolies.<sup>8</sup> These transactions vary in terms of market structure (horizontal, vertical, convergence, conglomerate, market extension); operational effect (integrated, non-integrated); type of acquirer (domestic, international, publicly traded, private equity); and financial structure (debt-funded cash buyout, stock-for-stock). Common to these transactions is the presence, in the corporate family of the acquirer, the target, or both, of

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1. 16 U.S.C. § 824b [hereinafter cited as Section 203].

2. FPA § 203(a)(1)(A).

3. *Id.* § 203(a)(1)(B).

4. *Id.* § 203(a)(1)(C).

5. *Id.* § 203(a)(1)(D).

6. *Id.* § 203(a)(2).

7. In the Energy Policy Act of 2005 [hereinafter EPAAct 2005], Congress added to FPA § 203 a requirement that the transaction “not result in cross-subsidization of a non-utility associate company or the pledge or encumbrance of utility assets for the benefit of an associate company, unless the Commission determines that the cross-subsidization, pledge, or encumbrance will be consistent with the public interest.” *Id.* § 203(a)(4). For a detailed summary of FPA § 203, as amended by EPAAct 2005, see generally Hugh E. Hilliard, *FERC, May I? When Is FERC Authorization Needed For Transfers Of Public Utility Assets And Equity Interests In Public Utilities?*, 34 ENERGY L.J. 151 (2013). On September 28, 2018, the President signed into law an amendment to § 203 requiring the FERC to issue a rule directing a public utility party to certain transactions under § 203 to notify the Commission, no later than 30 days after consummation, if the transaction value exceeds \$1 million but is less than \$10 million.

8. Details appear in Table 1 below.

a retail utility protected from effective competition by an exclusive, state-granted franchise.<sup>9</sup>

*Consolidation and complication.* These FERC-approved transactions have cut the number of independent retail utilities by more than half. This consolidation has been accompanied by complication. As of the early 1980s, most electric utilities were intrastate and corporately simple; most of their earnings came from retail electric sales within a single local service territory; the rest came from wholesale sales to nearby municipal systems and rural cooperatives. Today, only about 20 utilities fit that description; most are minority members of multistate systems with multiple business interests.<sup>10</sup>

Industry consolidation affects industry performance. Merger advocates assert positives: economies of scale, diversification of load and regulatory risk, and readier access to capital. Merger skeptics assert negatives: reduction in comparative benchmarks, high acquisition debt, pressures to increase earnings to pay off that debt, loss of industry diversity, concentration of economic and political power, and diseconomies of scale due to non-integrated operations.

Complication affects industry performance as well. Supporters cite positives, like diversification of risk, diversification of investor types, and a business culture aimed at expansion and innovation. Skeptics cite negatives, like the non-utility business risks brought to the corporate family. Managing those non-utility risks can divert executives' attention from the utility. Holding companies with multiple businesses can face internal conflicts of interest: They can be tempted to sell ratepayer-funded resources off-system for profit rather than reserve them for native load; or to allocate scarce capital to higher-profit opportunities instead of to the utility's service obligations. Finally, a utility holding company can distort competition in non-utility markets if its affiliates enter with unearned advantages. To address these concerns, regulators must spend scarce resources or risk higher rates, lower service quality and reduced utility innovation.

*FERC's errors: Lack of vision, non-competitive standards, and deference without competitive discipline.* A half-century and dozens of mergers ago, the Federal Power Commission (FPC) declared: "There is a legitimate public interest in the degree of concentration of economic power in American industries and, notwithstanding the safeguard of regulation, even in the electric utility industry."<sup>11</sup> The trend toward consolidation and complication does not reflect a "legitimate public interest," because the FERC has not defined the public interest; not in a way that advances the purpose of both competition and regulation—continuous improvement in performance.<sup>12</sup> In none of its many merger issuances has the Commission described either specific metrics or general principles for performance—metrics or principles by which consumers can hold the Commission accountable. Because the FERC has expressed no vision for performance, it has provided no

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9. The FERC has approved many § 203 transactions that do not involve a retail utility monopoly, because while § 203 applies to each "public utility," FPA § 201(e) defines that phrase to include entities that are not retail utilities. Transactions that do not involve retail utilities are outside this article's scope.

10. See Tables 1, 2, 3, and 4 below.

11. *Commonwealth Edison Co. & Central Ill. Elec. Gas Co.*, 36 F.P.C. 927, 941 (1966), *aff'd sub nom. Utility Users League v. FPC*, 394 F.2d 16 (7th Cir. 1968), *cert. denied*, 393 U.S. 953 (1969).

12. As discussed in Part IV.A below.

guidance on the structural features that influence performance—asset combination, ownership type, business activities, corporate form, and financial structure.

When the Commission does cite the “public interest,” it focuses only on wholesale “competition.”<sup>13</sup> Worse, its treatment of wholesale competition is deficient because it has never defined the *quality* of competition it seeks to achieve. The FERC’s merger decisions require only “no harm” to pre-merger competition—even if that pre-merger competition is ineffective competition.<sup>14</sup> By interpreting “consistent with the public interest” to mean “not harmful to the status quo,” the FERC has defined a “public interest” that is disinterested in the continuous improvement in performance.<sup>15</sup> That stance conflicts with pro-competitive outcomes that the Commission says it favors, and that regulation is supposed to replicate. Under the Commission’s policy, mergers can be zero-sum exchanges of assets for money rather than transactions that improve performance.

This lack of vision leads to deference. Instead of guiding mergers toward the public interest, the FERC defers to transactions that advance opportunistic interests. Deference to a merger is logical, and lawful, when the relevant markets producing that merger are effectively competitive. But when mergers involve retail monopolies, the relevant markets are not effectively competitive. Deference to transactions undisciplined by effective competition cannot be consistent with the public interest.<sup>16</sup>

The Commission does limit its deference. To ensure that mergers cause “no harm,” it tests for merged entity market power over wholesale electricity products. The Commission also requires compliance with its policies on transmission access and pricing, interaffiliate transactions, and cross-subsidization.<sup>17</sup> But because those policies apply to all jurisdictional actors already, imposing them on merging entities adds no risk-protection. The FERC does recognize that harm is possible, so it requires offsets in the form of temporary freezes or reductions in wholesale rates. But these temporary measures do not change the key fact: The transactions themselves emerge from a monopoly market, not an effectively competitive market, so the temporary rate freezes or reductions cannot substitute for the benefits customers would receive had the transaction emerged from an effectively competitive market. The “no harm” provisions prevent harms that are already unlawful; the rate savings are token compared to what the applicants gain. So the conclusion remains: The Commission approves transactions without verifying that they arise from, and are consistent with, the forces of effective competition.

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13. As discussed in Parts IV.A and V.A below.

14. As discussed in Part IV.B.5.b below.

15. *Id.*

16. *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1510 (D.C. Cir. 1984) (“Without empirical proof that . . . existing competition would ensure that the actual price is just and reasonable, [the Commission’s approach] retains the false illusion that a government agency is keeping watch over rates, . . . when it is in fact doing no such thing.”). *Farmers Union* dealt with rate-setting under the “just and reasonable” standard, not with mergers under the “public interest” standard. But there is no reason to assume that the public interest standard, while more general than the just and reasonable standard, is looser; that somehow ratepayers who are protected from rates undisciplined by competition should not be protected from mergers undisciplined by competition.

17. Hilliard, *supra* note 7, at 190-91.

Lack of vision and deference are the big-picture errors. They lead to five policy errors. The Commission (1) confines its competition analysis to wholesale generation markets, ignoring each merger's effects on retail competition; (2) analyzes each merger in isolation from the others, ignoring their cumulative effects; (3) downplays the financial risks associated with acquisition debt, by failing to assess the relationship of purchase price to real transaction value; (4) allows the merging parties to allocate their transaction's value nearly entirely to the merging entities, disregarding the value contributed by the target's ratepayers; and (5) pays insufficient attention to the obstacles regulators will face in attempting to align the merged entity's performance with the public interest. These omissions—producing an unbroken series of approvals across five Presidential administrations—are inconsistent with the public interest.

*FERC's possible defenses: Jurisdictional limits, competitive forces and no adverse effects.* The Commission could offer three defenses. First, as a jurisdictional matter the agency should confine its merger-related concerns to rates, because (a) in enacting simultaneously the FPA and the Public Utility Holding Company Act (PUHCA), the 1935 Congress intended to create separate substantive spheres—rate concerns in the FPA and corporate structure concerns in PUHCA; and (b) PUHCA's 2005 repeal (and replacement with a new "Public Utility Holding Company Act of 2005" that deals only with books and records and affiliated service company costs) reflected a congressional intent to exempt the industry from corporate structure oversight.<sup>18</sup> Second, the merger trend is the product of normal competitive forces, justifying deference to private actors. Third, despite dozens of multi-billion-dollar transactions, there has been no evidence of harm. As this article will discuss, each of these arguments fails on statutory language, facts, or logic.

*Recommendations:* The long-term effects of the industry's consolidation and complication are unknown, because they have not been studied. But the trend continues.<sup>19</sup> To fill this knowledge gap, the FERC should give its policies a rigorous review. Mergers are major structural events, not routine transactions to approve with generic conditions. The Commission should create a merger task force, with expertise and hierarchical prominence comparable to its offices on reliability and enforcement. The task force should open a notice of inquiry, conduct objective research, and draft a mission statement and rules that will subject future mergers to a level and type of regulatory discipline that replicates effective competition.

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18. PUHCA 1935, ch. 687, Stat. 818, *repealed by* Energy Policy Act of 2005, 109 P.L. 58, 119 Stat. 594, P.L. 58, 2005. This article will refer to the two versions of the Public Utility Holding Company Act as "PUHCA 1935" and "PUHCA 2005."

19. Cf. William S. Lamb & Michael Didriksen, *Electric and Gas Utility Mergers and Acquisitions: Trends in Deal Terms, Contract Provisions, and Regulatory Matters*, 38 ENERGY L.J. 133, 147 (2017) [hereinafter Lamb & Didriksen 2017] ("While there may be some moderation of these trends in a rising interest rate environment, structural elements of the electric and gas utility industry will continue to incentivize consolidation. As a result, the long-standing trend towards consolidation seems likely to continue."). One of that article's co-authors thus has answered a question he raised a decade earlier. Markian M.W. Melnyk & William S. Lamb, *PUHCA's Gone: What Is Next for Holding Companies?*, 27 ENERGY L.J. 1, 1 (2006) [hereinafter Melnyk & Lamb 2006] ("It remains to be seen whether PUHCA's demise will usher in a new era of consolidation for electric and gas utilities.").



*Scope of this article: Electric utilities, 1980s forward.* The utility merger topic is vast, but a journal article's size is limited. This article does not address the technical aspects of the FERC's wholesale competition analysis—a topic already treated in numerous pleadings, rulemakings and orders, and currently undergoing review in RM16-21.<sup>20</sup> It does not address the merger decisions of state commissions.<sup>21</sup> Its focus is this: How has the FERC applied the statutory standard—"consistent with public interest"—to diverse transaction forms initiated by diverse applicants, during a three-decade period in which the industry structure has consolidated and corporate form has become complicated? How has the FERC accounted for the retail electric monopoly—whose presence in each transaction distinguishes these transactions from mergers in competitive markets? That retail utilities themselves fall outside FERC regulation does not change reality: Their exclusive market position affects the public interest that the FERC is obligated to protect.

Why focus on the 1980s to the present? Plenty of mergers preceded this period.<sup>22</sup> But a combination of four features distinguishes the most recent thirty years from the prior sixty. First, the prominent merger proposals that opened this period—like PacifiCorp-Utah Power & Light, Southern California Edison-San Diego Gas & Electric, and Northeast Utilities-Public Service of New Hampshire—"dwarfed previous mergers in size."<sup>23</sup> Second, merger frequency has been higher than in preceding decades, especially as merged companies merged with other merged companies.<sup>24</sup> Third, during this period Congress amended PUHCA 1935 several times: In 1992 it exempted acquisitions of "exempt wholesale generators" from the "integrated public-utility system" requirement; in 2005 it repealed the statute. The 2005 repeal eliminated the "integrated public-utility system" require-

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20. Notice of Inquiry, *Modifications to Comm'n Requirements for Review of Transactions under Section 203 of the Fed. Power Act and Market-Based Rate Applications under Section 205 of the Fed. Power Act*, No. RM16-21, 156 F.E.R.C. ¶ 61,214 (Sept. 22, 2016) [hereinafter RM 16-21 Notice of Inquiry].

21. A detailed treatment of the combined impact of both federal and state decisions on electric utility mergers is the subject of a forthcoming book by the author.

22. In 1920 investor-owned utilities numbered around 2000, in 1957 there were 465, and in 1991 there were around 230. John Moot, *Electric Utility Mergers: Uncertainty Looms over Regulatory Approvals at the FERC*, ENERGY L.J. 1, 5 n.18 (1991) (citing *Electricity Transmission: Realities, Theory and Policy Alternatives*, FERC TRANSMISSION TASK FORCE, ELECTRICITY TRANSMISSION: REALITIES, THEORY AND POLICY ALTERNATIVES 6-7 (Oct. 1989)).

23. Moot, *supra* note 22, at 5.

24. As discussed in Part II.A.4 below. On changes in frequency, two authors note:

Mergers in the electric utility industry from 1917 through 1930 averaged in excess of 200 per year, peaking at over 300 per year in the mid-1920s. PUHCA reversed that trend. Between 1935 and 1950, more than 750 utilities were spun off from holding companies in connection with rationalization of utility systems under section 11 of PUHCA 1935. From 1936 through 1975 there were 517 mergers, occurring at an annual rate of less than fifteen a year. From 1976 through 1998, seventy-six mergers took place, about three per year on average.

Melnik & Lamb 2006, *supra* note 19, at 11-12, citing ENERGY INFO. ADMIN., U.S. DEP'T OF ENERGY, THE CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY 1999: MERGERS AND OTHER CORPORATE COMBINATIONS 1 (1999).

ment for acquisitions of retail utilities, and removed all limits on geographic remoteness, type-of-business mixing and type-of-acquirer.<sup>25</sup> These statutory changes made legal the consolidation and complication this article addresses.

Fourth, these three decades of consolidation and complication have coincided with an industry-wide debate over whether, where, for what sectors, and how to introduce competition into historically monopolistic product markets—first generation, then retail sales, then transmission construction and now distributed energy resources. This coinciding is not necessarily coincidence. When merger applicants cite their need to be “more competitive,” that intent can mean two very different things: (1) the parties want to be more efficient, thus making the market more competitive; or (2) the parties want to exploit unearned advantages or act anti-competitively, thus making the market less competitive.<sup>26</sup>

The purpose of this article is not to rehash century-long arguments over the costs and benefits of consolidation and complication, although there will be some discussion of costs and benefits to help set context.<sup>27</sup> The aim instead is to assess whether the FERC, by largely ignoring these subjects, is failing to carry out its statutory obligation to reject transactions that are inconsistent with the public interest.

*Terminology.* Unless otherwise specified, in this article “utility” and “public utility” are shorthand for companies that have an exclusive retail franchise granted by state law. (The FPA’s definition of “public utility” is broader.) “Merger,” “acquisition,” and “transaction” refer to any of the transactions subject to section 203, to the extent a transacting part is or controls a franchised retail utility. “Acquirer” and “target” refer to the corporations that, in an acquisition, are, respectively, buying a company or being bought by a company; and “the Commission” refers to either the FERC or the FPC.

## II. THE RESULTS: CONSOLIDATION AND COMPLICATION

Since the 1980s, mergers have brought two major changes to the electric industry. The first is consolidation of control of state-granted, exclusive retail franchises; and of the physical facilities of generation, transmission, and distribution. The second is complication of utility holding company systems in terms of business activity, corporate structure and financial structure.

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25. Lamb & Didriksen 2017, *supra* note 19, at 134 (describing the “current wave of consolidation [as] appear[ing] to have begun relatively slowly in the late 1980s, and gain[ing] momentum during the 1990s, driven in part by the Energy Policy Act of 1992 and electric industry restructuring initiatives that were taking place in many states”).

26. The difference between behaving anti-competitively and exploiting unearned advantages is discussed at Part IV.B.5 below.

27. For recent examples of these debates, see the author’s pre-filed testimony, and the applicants’ responding testimony, in any of these dockets: In the Matter of Exelon Corp. and PHI Holdings, Case No. 9361 (Md. Pub. Serv. Comm’n 2014); In the Matter of Hawaiian Elec. Co. and NextEra, Docket No. 2015-0022 (Hawaii Pub. Utils. Comm’n 2015); In re Joint Application of Cleco Power LLC, et al., Docket No. U-33434 (La. Pub. Serv. Comm’n 2015); In the Matter of Joint Application of Great Plains Energy Inc., Kansas City Power and Light Company and Westar, Inc., Docket No. 16-KCPE-593-ACQ (2016); and In the Matter of the Merger of AltaGas, Ltd. and WGL Holdings, Formal Case No. 1142 (D.C. Pub. Serv. Comm’n 2017); *see also* Lamb & Didrikson 2017, *supra* note 19.

A. *Consolidation: Chronological, geographical, and accelerated*

1. Consolidation defined

I define consolidation to mean a reduction in the number of independent utility corporations controlling retail monopoly electric service franchises. In this context, “independent” means not owned by, not commonly owned with, and not affiliated with another utility corporation. Consolidation occurs when two or more of these utility corporations, previously owned separately, become owned in common—when one utility corporation (or its holding company owner) acquires or merges with another utility corporation (or its retail franchise and associated assets). Consolidation reduces the number of separate corporate entities ultimately controlling retail monopoly franchises.

Looking at the past three decades, one can view the consolidation trend chronologically and geographically, as discussed next.

2. Chronological view

Since 1986, the FERC has approved retail utility mergers continuously. *See Table 1. (Italics identify transactions that were withdrawn at some point after the FERC’s approval.)* Some of these transactions were mergers, some were acquisitions, some involved independent utilities, and some involved holding companies of utilities.

**Table 1: FERC Merger Approvals<sup>28</sup>**

1986	Toledo Edison and Cleveland Electric Illuminating (forming holding company Centerior)
1988	Georgia Power (owned by Southern Company) and Savannah Electric
1988	Duke Power and Nantahala Power & Light
1988	Utah Power & Light and PacifiCorp
1990	Central Vermont Public Service and Allied Power & Light
1991	Northeast Utilities (holding company for Connecticut Light and Power, Western Massachusetts Electric and Holyoke Water Power) and Public Service of New Hampshire
1991	Kansas Power & Light and Kansas Gas & Electric
1992	Iowa Public Service and Iowa Power & Light (forming holding company Midwest Power Systems)
1993	Cincinnati Gas & Electric and Public Service of Indiana (forming holding company Cinergy)
1993	Entergy (holding company owner of Arkansas Power & Light, Louisiana Power & Light, Mississippi Power & Light, New Orleans Public Service) and Gulf States
1994	<i>El Paso Electric Company and Central &amp; South West</i>

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28. Dates are dates of the FERC’s approvals, not of consummations. The parenthetical lists of holding company subsidiaries include only electric utilities.

- 1995 Midwest Power Systems (consisting of Iowa Public Service and Iowa Power & Light) and Iowa-Illinois Gas & Electric (forming holding company MidAmerican)
- 1997 Public Service of Colorado and Southwestern Public Service (forming holding company New Century Energies)
- 1997 Union Electric and Central Illinois Public Service (forming holding company Ameren)
- 1997 *Baltimore Gas & Electric and Potomac Electric Power*
- 1997 Duke Power and PanEnergy
- 1997 IES Utilities, Interstate Power, Wisconsin Power & Light, South Beloit Water, Gas & Electric (forming holding company Alliant)
- 1997 Enron and Portland General
- 1997 Centerior (holding company owner of Toledo Edison and Cleveland Electric Illuminating), Ohio Edison Company, Pennsylvania Power Company (forming holding company FirstEnergy)
- 1997 Atlantic City Electric and Delmarva Power & Light (becoming Connecticut Power Delivery)
- 1998 Louisville Gas & Electric and Kentucky Utilities
- 1998 Scottish Power and PacifiCorp (which owns Utah Power & Light)
- 1999 New England Electric System (holding company for New England Electric Power, Massachusetts Electric, Narragansett Electric) and National Grid
- 1999 Eastern Utility Associates (holding company for Montaup Electric, Blackstone Valley Electric, Eastern Edison, Newport Electric) and New England Electric System and National Grid
- 1999 MidAmerican Energy (holding company for Iowa Public Service, Iowa Power & Light and Iowa-Illinois Gas & Electric) and Berkshire Hathaway
- 1999 Boston Edison and Commonwealth Energy
- 1999 AES and Central Illinois Light
- 1999 Consolidated Edison of New York and Orange & Rockland
- 1999 Sierra Pacific Power and Nevada Power
- 1999 Dynegy and Illinois Power
- 2000 American Electric Power and Central & South West
- 2000 *Sierra Pacific Power, Nevada Power, Portland General Electric*
- 2000 New Century Energies (holding company for Southwestern Public Service and Public Service of Colorado), Northern States Power (Minnesota) and Northern States Power (Wisconsin) (forming Xcel Energy)
- 2000 New York State Electric & Gas and Central Maine Power
- 2000 Commonwealth Edison and PECO Energy (forming Exelon)
- 2000 PowerGen (UK) acquires Louisville Gas & Electric and Kentucky Utilities
- 2000 Carolina Power & Light and Florida Progress (holding company for Florida Power Corp.).
- 2000 UtiliCorp United, St. Joseph Light & Power, and Empire District Electric

- 2000 *Consolidated Edison and Northeast Utilities*
- 2001 AES and Indianapolis Power and Light
- 2001 E.ON (Germany) acquires Louisville Gas & Electric and Kentucky Utilities from PowerGen (UK)
- 2001 FirstEnergy (holding company for Toledo Edison, Cleveland Electric Illuminating, Ohio Edison Company and Pennsylvania Power Company) and General Public Utilities (holding company for Metropolitan Edison, Jersey Central Power & Light, and Pennsylvania Electric)
- 2001 Energy East (holding company for New York State Electric & Gas and Central Maine Power) and RGS Energy Group (holding company for Rochester Gas & Electric)
- 2001 Potomac Electric Power and Conectiv Power Delivery (the result of the Atlantic City Electric-Delmarva merger) (forming Pepco Holdings)
- 2002 Ameren (holding company for Union Electric and Central Illinois Public Service) and Central Illinois Light
- 2004 Ameren (holding company for Union Electric, Central Illinois Public Service and Central Illinois Light) and Illinois Power
- 2005 Cinergy (holding company for Cincinnati Gas & Electric and PSI Energy) and Duke Energy
- 2005 MidAmerican Energy Holdings acquires PacifiCorp from Scottish Power
- 2007 Texas Holdings Limited Partnership acquires Oncor Electric Delivery
- 2007 Great Plains Energy (holding company for Kansas City Power & Light) acquires Aquila's Missouri operations
- 2007 Black Hills acquires Aquila's Colorado electric operations
- 2007 Iberdrola (Spain) acquires Energy East (holding company for New York State Electric & Gas, Central Maine Power and Rochester Gas & Electric)
- 2010 PPL Electric (holding company for Pennsylvania Power & Light) acquires Louisville Gas & Electric and Kentucky Utilities from E.ON
- 2010 FirstEnergy Corp. (holding company for Pennsylvania Power, Ohio Edison, Cleveland Electric Illuminating, Toledo Edison, Pennsylvania Electric, Metropolitan Edison, and Jersey Central Power & Light) and Allegheny Energy (holding company for Monongahela Power, Potomac Edison, and West Penn Power)
- 2011 Northeast Utilities (holding company for Connecticut Light & Power, Western Massachusetts Electric, and Public Service of New Hampshire—it had sold off Holyoke) and NSTAR Electric (consisting of what were Cambridge Electric Light, Commonwealth Electric, Canal Electric, and Boston Edison)
- 2011 Duke Energy (holding company for Duke Energy Carolinas, Duke Energy Indiana, Duke Energy Ohio, and Duke Energy Kentucky) and Progress Energy (holding company for Carolina Power & Light and Florida Power Corp)
- 2011 AES (owner of Indianapolis Power & Light) and Dayton Power & Light

- 2012 Exelon Corporation (holding company for Commonwealth Edison and PECO Energy) and Constellation Energy Group (holding company for Baltimore Gas & Electric)
- 2012 Fortis (Canada) acquires Central Hudson Gas & Electric
- 2013 MidAmerican (holding company for Iowa Public Service, Iowa Power & Light, Iowa-Illinois Gas & Electric, and PacifiCorp) and Nevada Power and Sierra Pacific
- 2014 Fortis (Canada) acquires UNS Energy (holding company for Tucson Electric and UNS Electric)
- 2015 Wisconsin Energy (holding company for Wisconsin Electric Power) merges with Integrys Energy Group (holding company for Wisconsin Public Service and Upper Peninsula Power)
- 2015 Macquarie *et al.* acquires Central Louisiana Electric
- 2015 Exelon (holding company for Commonwealth Edison, PECO Energy, and Baltimore Gas & Electric) acquires Pepco Holdings (holding company for Potomac Electric Power, Delmarva and Atlantic City Electric)
- 2015 *NextEra and Hawaiian Electric*
- 2015 Iberdrola (Spain, renamed Avangrid) (holding company for New York State Electric & Gas, Rochester Gas & Electric, and Central Maine Power) acquires United Illuminating
- 2016 Emera (Canada) and Tampa Electric
- 2016 Empire District Electric and Liberty Utilities
- 2017 *Oncor and NextEra (holding company for Florida Power & Light)*
- 2017 Oncor and Sempra (holding company for San Diego Gas & Electric)
- 2018 Hydro One (Canada) and Avista
- 2018 Great Plains Energy (holding company for Kansas City Power & Light) and Westar (holding company for Kansas Gas & Electric and Kansas Power & Light)

### 3. Geographic view

This period's early mergers were intra-regional, usually involving adjacent utilities or ones within the same organized power pool. The reason: PUHCA 1935 prohibited acquisitions of utilities unless they "serve[d] the public interest by tending toward the economical and efficient development of an integrated public-utility system."<sup>29</sup> This integration requirement reflected Congress's view that consolidation "serve[d] the public interest" only if it produced a more economical,

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29. PUHCA 1935 § 10(c)(2). An integrated public-utility system, for an electric company, was: a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.

PUHCA 1935 § 2(a)(29)(A). Technically, the restriction of § 10(c)(2) was triggered when a person already owning one utility subsidiary sought to acquire a second. PUHCA 1935 § 9(a)(2).

efficient company.<sup>30</sup> Adjacency or proximity (along with transmission interconnection) thus characterized the period's early mergers, including Toledo Edison and Cleveland Electric Illuminating; Kansas Power & Light and Kansas Gas & Electric; Northeast Utilities and Public Service of New Hampshire; Iowa Public Service Company, Iowa Power Inc., and Midwest Power Systems (a three-way merger); Entergy and Gulf States; and Cincinnati Gas & Electric Company and Public Service of Indiana. (A distinct category of mergers fell outside of PUHCA 1935 because they did not involve the holding company form, such as where utilities in dispersed geographic areas were divisions of a single corporation rather than affiliates of a holding company. Examples were Citizens Utilities, which had utility divisions in Arizona, Hawaii, Vermont, and other states; and PacifiCorp, which had divisions in seven Western states.)

More recent transactions have been inter-regional and international. Toward the end of the 1990s, the Securities and Exchange Commission applied PUHCA 1935's integration requirement less literally than previously. This looser application allowed long-distance transactions like those involving American Electric Power Company and Central and South West Corp.; Florida Progress (the holding company for Florida Power Corp.) and Carolina Power & Light; and National Grid (UK) and New England Electric System.<sup>31</sup>

PUHCA 1935's repeal brought couplings of utilities whose remoteness precluded physical integration. Tables 2 and 3 display examples, inter-regional and international.

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30. See, e.g., *Wisconsin's Envtl. Decade v. SEC*, 882 F.2d 523 (D.C. Cir. 1989) (reversing SEC approval of an acquisition that made no improvement in utility operations); see also *National Rural Elec. Coop. Ass'n v. SEC*, 276 F.3d 609 (D.C. Cir. 2002). In both cases, the author was appellate counsel for the petitioners. In the second case, the court remanded the SEC's approval of the AEP-CSW merger because the agency failed to determine whether, post-merger, the inter-company electrical flow would be bidirectional—a feature the court viewed as essential to integration. The court also held that the SEC cannot “interpret the phrase ‘single area or region’ [in the definition of ‘integrated public-utility system’] so flexibly as to read it out of the Act.” *Id.* at 618. For three years after the 2002 remand, the SEC took no action against the newly formed holding company. The transaction's lawfulness became a non-issue with PUHCA 1935's repeal in 2005.

31. The wisdom of those SEC decisions (some of which this author contested—such as *Wisconsin's Envtl. Decade v. SEC*, 882 F.2d 523 (D.C. Cir. 1989); *National Rural Elec. Coop. Ass'n v. SEC*, 276 F.3d 609 (D.C. Cir. 2002); and *Envtl. Action v. SEC*, 895 F.2d 1255 (9th Cir. 1009)) is outside this article's scope. The historically inclined can consult LEONARD S. HYMAN, *AMERICA'S ELECTRIC UTILITIES: PAST, PRESENT AND FUTURE* 102 (1994) (asserting that the SEC “seems to have lost interest in enforcing the letter of the law . . . and now approves the formation of holding companies that comply with the law in the most far-fetched ways”); and Richard D. Cudahy & William D. Henderson, *From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons*, 26 *ENERGY L.J.* 35, 103-104 (2005) [hereinafter Cudahy & Henderson 2005] (stating that before 2002, “it had become commonplace for the SEC to approve merger activity with virtually no regard for the Act's geographic strictures”).

**Table 2: Inter-Regional Holding Company Systems**

<u>Holding company</u>	<u>Locations of utility subsidiaries</u>
Berkshire Hathaway	Washington State, Nevada, Oregon, California, Utah, Wyoming, and Iowa
Exelon	Illinois, Maryland, District of Columbia, Delaware, and New Jersey
American Electric Power	Ohio, Indiana, Michigan, Kentucky, West Virginia, Virginia, Texas, Louisiana, Arkansas and Oklahoma
Duke	Florida, North Carolina, Ohio, Indiana, and Kentucky
Xcel	Minnesota, Colorado, New Mexico, and Texas

**Table 3: International Holding Company Systems**

At least 20 electric utilities are now owned by five foreign companies:

<u>Holding company</u>	<u>Utilities</u>
Fortis (Canada)	Tucson Electric, Unisource Energy, and Central Hudson Electric & Gas
Emera (Canada)	Bangor-Hydro and Tampa Electric
Iberdrola (Spain)	United Illuminating, New York State Electric & Gas, Rochester Gas & Electric, and Central Maine Power
National Grid (UK)	New England Electric System (consisting, before the 1980s, of New England Power Company, Massachusetts Electric Company, and Narragansett Electric Company); EUA (consisting, before the 1980s, of Montaup Electric Company, Blackstone Valley Electric Company, Eastern Edison Company, and Newport Electric Corporation); Niagara Mohawk
Gaz Metro (Canada)	Green Mountain Power and Central Vermont Public Service

#### 4. Acceleration: Mergers of the previously merged

The pace of consolidation increases as previously merged utilities merge with each other. Here are three prominent examples—displayed as equations, the parentheses and brackets signaling prior mergers:

2001	FirstEnergy + GPU = [(Cleveland Electric + Toledo Edison) + Ohio Edison + Pennsylvania Power] + [(Jersey Central Power & Light Company, Metropolitan Edison Company, and Pennsylvania Electric Company)]
2011	Duke Energy + Florida Progress = [Duke + (Cincinnati Gas & Electric + Public Service of Indiana)] + [(Florida Power Corp. + Carolina Power & Light)]



2015 Exelon + PHI = [(Commonwealth Edison+ PECO) + BG&E] + [(Delmarva + Atlantic City Electric) + Pepco].

With mergers of the previously merged, the 10 most active acquirers now own what used to be 62 independent utilities—more than half the United States total:

National Grid owns eight:	New England Electric System (consisting, before the 1980s, of New England Power Company, Massachusetts Electric Company, Narragansett Electric Company); EUA (consisting, before the 1980s, of Montaup Electric Company, Blackstone Valley Electric Company, Eastern Edison Company, and Newport Electric Corporation); Niagara Mohawk.
Great Plains Energy owns eight:	UtiliCorp United, St. Joseph Light & Power, Empire District Electric, Kansas City Power & Light, Aquila, Black Hills, Kansas Power & Light, and Kansas Gas & Electric.
Duke Power Company owns seven:	Duke Power, Nantahala Power & Light, Cincinnati Gas & Electric, Public Service of Indiana, PanEnergy, Florida Power & Light, and Carolina Power & Light.
Berkshire Hathaway owns seven:	Iowa Public Service, Iowa Power & Light, Iowa-Illinois Gas & Electric, PacifiCorp, Utah Power & Light, Nevada Power, and Sierra Pacific Power.
Northeast Utilities (now called Ever-source) owns seven:	Connecticut Light & Power, Western Massachusetts Electric Power (those two already owned by NU before the 1980s), Public Service of New Hampshire, Boston Edison, Commonwealth Energy, Cambridge Electric Light Company, and Canal Electric Company.
FirstEnergy owns seven:	Cleveland Electric Illuminating, Toledo Edison Company, Ohio Edison, Pennsylvania Power, Monongahela Power Company, Potomac Edison Company, and West Penn Power Company.
Exelon owns six:	Commonwealth Edison, Philadelphia Electric, Baltimore Gas & Electric, Potomac Electric Power, Delmarva Power & Light, and Atlantic City Electric.

Ameren owns four	Union Electric, Central Illinois Public Service, Central Illinois Light Company (acquired from AES in 2003), and Illinois Power (acquired from Dynegy in 2004).
Xcel Energy owns four	Northern States Power Company-Minnesota, Northern States Power Company-Wisconsin, Public Service Company of Colorado, and Southwestern Public Service Company.
Iberdrola (now called Avangrid) owns four	New York State Electric & Gas, Central Maine Power, United Illuminating, and Rochester Gas & Electric.

For National Grid and Eversource, some of the utilities listed were already in a holding company prior to the 1980s. If we add to the above list of ten holding companies those multi-utility holding company systems (to the extent not listed above) that pre-dated the post-1980s merger trend, the concentration is more marked:

American Electric Power owns ten	Appalachian Power, Kingsport Power, Indiana Michigan Power, Kentucky Power, Ohio Power, and Columbus and Southern (all from the prior AEP family that pre-dated the 1980s-forward merger trend and some of which have merged into a single company); Central Power & Light, West Texas Utilities, Public Service Company of Oklahoma, and Southwestern Electric Power Company (all from the prior Central and Southwest family that pre-dated the post-1985 merger trend, and some of which have merged into a single utility).
Southern Company owns four	Alabama Power, Georgia Power, Gulf Power, and Mississippi Power.
Entergy owns five	Entergy Arkansas, Entergy Mississippi, Entergy Louisiana, New Orleans Public Service, and Entergy Texas (formerly Gulf States).

And when we add those three systems to our totals, we see that 81 formerly independent utilities are owned by 13 holding companies.<sup>32</sup>

One last way to see the national picture is to count the unmerged. Of several hundred investor-owned utilities that existed independently in the early 1980s, only the 18 listed in Table 4 remain uncoupled with some other utility. *See* Table 4. (Some of the listed companies might be a subsidiary of a holding company, and/or have a gas affiliate, but none has merged with another electric utility.)<sup>33</sup>

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32. Various sources have recorded the merger trend as it has moved through the years. While these sources cite different numbers—because of different definitions of utilities, different definitions of “merger” and different time periods—they all support the existence of a trend. Consider these six sources:

In 2000, the U.S. Energy Information Agency reported that “[b]y the end of 2000, the 10 largest IOUs (investor-owned electric utilities) will own approximately 51 percent of all IOU-owned power production capacity (up from percent in 1992) and the 20 largest IOUs will own approximately 73 percent (up from about 36 percent in 1992).” Stephen Paul Mahinka & Theodore A. Gebhard, *Preclosing Cooperation in Energy Mergers: Antitrust Issues and Practical Concerns*, THE ELEC. J. (Nov. 2000) (quoting U.S. Energy Information Agency and other sources).

In 2000, the FERC referred to “the more than 50 merger cases filed” since its 1996 Merger Policy Statement. Order No. 642, *Revised Filing Requirements under Part 33 of the Commission’s Regulations*, 65 Fed. Reg. 70983 (Nov. 28, 2000) at text adjacent to n.10, F.E.R.C. STATS. & REGS. ¶ 31,111 (2000), *order on reh’g*, Order No. 642-A, 94 F.E.R.C. ¶ 61,289 (2001).

A 2011 presentation stated that from 1993 to 2010, the members of the EEI Utilities Stock Index declined from 100 to 58. Duke Energy and Progress Energy, *Transforming Our Future*, Presentation to 46th EEI Financial Conference Presentation (Nov. 8, 2011).

A 2012 survey found that from 1995 to 2012, “the number of shareholder-owned electric utility holding companies has declined by 48 percent.” Jack Azagury et al., *The Race to Consolidate*, PUB. UTIL. FORTNIGHTLY (Sept. 2012), <https://www.fortnightly.com/fortnightly/2012/09/race-consolidate>.

In a 2015-16 merger case before the Hawaii Public Utilities Commission, where NextEra (the holding company for Florida Power & Light) sought to acquire HEI (the holding company for Hawaiian Electric Company and two affiliates), an HEI witness testified that the number of electric investor-owned utilities had declined by 50%, from 98 companies in December 1995 to 49 companies as of December 2013. Docket No. 2015-0022, Applicants’ Exh. 33, Direct Testimony of John J. Reed at 10.

According to the Edison Electric Institute there were, at the end of 2016, 50 remaining utility systems: 44 publicly traded on U.S. stock exchanges and 6 either owned by independent power producers or foreign companies. Edison Electric Institute, 2016 FINANCIAL REVIEW: ANNUAL REPORT OF THE U.S. INVESTOR-OWNED ELECTRIC UTILITY INDUSTRY 101, [http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/finreview/Documents/FinancialReview\\_2016.pdf](http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/finreview/Documents/FinancialReview_2016.pdf) (last visited July 6, 2018) [hereinafter EEI Financial Review].

33. This list was developed by identifying, from the Edison Electric Institute’s Financial Review’s 2016 list of all utilities, those that are not part of a multi-utility holding company system. *See* EEI Financial Review, *supra* note 32.

**Table 4: Electric Utilities Remaining Unmerged**

Arizona Public Service (owned by Pinnacle West)  
 Black Hills Corporation  
 CenterPoint Energy  
 Detroit Edison  
 El Paso Electric  
 Idaho Power  
 Madison Gas & Electric  
 Minnesota Power (owned by Allete)  
 Montana Dakota Utilities  
 NiSource  
 NorthWestern Energy. (formerly Montana Power)  
 Oklahoma Gas & Electric  
 Otter Tail  
 Pacific Gas & Electric  
 Portland General Electric  
 Public Service Electric and Gas (New Jersey)  
 South Carolina Electric & Gas  
 Southern California Edison

Some of these utilities are subsidiaries of holding companies, but those holding companies, unlike the ones in the preceding lists, own no other electric utilities, and usually no other major businesses. These are relatively simple companies.

Mergers of the previously merged means larger transaction sizes:

In addition to the absolute number of utilities decreasing, there has been a significant increase in the concentration of the largest utilities. For most of the past 12 years, major M&A activities were very limited among the top 10 largest utilities with virtually no mergers among them until recently. In 2011 and 2012, we saw departure from this trend, driven primarily by the Exelon-Constellation and Duke-Progress mergers. These changes in concentration within the industry, particularly among the larger players, support the hypothesis that a new pattern of more active mergers and acquisitions is emerging.<sup>34</sup>

*B. Complication: Business activities, corporate structure, and financial structure*

1. *Complication defined*

The typical 1980s electric utility was a single corporation, vertically integrated, owning generation, transmission, and distribution. It earned most of its revenues from a single retail monopoly franchise subject to a single state's jurisdiction, the rest from wholesale sales subject to FERC jurisdiction. Some of these companies also earned minor, incidental revenues from non-utility businesses. The industry also had 13 so-called "registered holding companies," each owning

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34. Azagury et al., *supra* note 32.

multiple utilities in adjacent states.<sup>35</sup> Section 11(b)(1) of PUHCA 1935 prohibited these registered holding companies from owning non-utility businesses unrelated to their utility subsidiaries.

This operating integration and corporate simplicity was mandated by PUHCA 1935, which required that each utility holding company satisfy the “integrated public-utility system” test.<sup>36</sup> Section 11(b)(1) of PUHCA 1935 limited “registered” holding companies (a category consisting mostly of multi-state systems) to “a single integrated public-utility system” plus “such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system.” Each “exempt” holding company (a category consisting mostly of intrastate systems, and exempt from most of PUHCA 1935, including section 11(b)(1)) was limited to a single integrated system, but under section 3(a) could own unrelated non-utility businesses unless doing so became “detrimental to the public interest or the interest of investors or consumers.” Sections 6 and 7 of PUHCA 1935 required conservatism in financial structure, and section 11(b)(2) required simplification of corporate structure.

“Complication,” as I use the term, refers to how a utility’s post-merger corporate family differs from this 1980s-era picture, in terms of business activities, corporate structure, and financial structure. Compare, for example, Madison Gas & Electric (MGE) with Baltimore Gas & Electric (BGE). In the early 1980s, BGE looked like MGE. Each was a local utility company serving a single territory. Today they look very different in terms of their family’s geographic dispersion, business activities, hierarchical organization, corporate governance, internal and external financing, interaffiliate transactions, and shareholder goals.

MGE serves the Madison, Wisconsin area. It is the sole utility subsidiary of the publicly traded holding company MGE Energy. The utility’s business represents most of the holding company’s assets, liabilities, revenues, expenses and operations. The holding company’s unregulated activities are nearly all energy regulated, and all of them are conducted in the Madison area.<sup>37</sup> BGE serves the Baltimore, Maryland area. It is one of six utilities owned by the publicly traded holding company Exelon Corporation; the other utilities serve in Illinois, Pennsylvania, New Jersey, Delaware and the District of Columbia. The holding company owns numerous other subsidiaries. In the corporate hierarchy, BGE is several corporate layers down; it is owned by a company that is owned by a company that is owned by Exelon Corporation. Exelon’s other affiliates do one or more of the following: invest in fossil, nuclear, solar and wind generation; sell in wholesale

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35. U.S. Government Accountability Office, GAO-05-617, <https://www.gao.gov/assets/250/247000.html>. By 2004, mergers and acquisitions had increased this number to 29. *Holding Companies Registered Under the Public Utility Holding Company Act of 1935*, <https://www.sec.gov/divisions/investment/regpuaccompanies.htm>.

36. PUHCA 1935 § 11(a); *see also supra* note 29 and accompanying text.

37. MGE ENERGY, INC. 2017 ANNUAL REPORT (Form 10-K for year ending Dec. 31, 2017) (describing, at 7, the nonregulated energy operations as “owning and leasing electric generating capacity that assists MGE through MGE Energy’s wholly owned subsidiaries MGE Power Elm Road and MGE Power West Campus”; and describing all activities other than those unregulated activities and the regulated activities as “investing in companies and property that relate to the regulated operations and financing the regulated operations,” all of which activities are conducted by wholly owned subsidiaries).

and retail competitive markets in some or all of the Mid-Atlantic, Midwest, South and West; or conduct commodities trading.<sup>38</sup>

In terms of complication, MGE is largely unchanged since the 1980s, while BGE reflects the complication trend.

Holding company complication affects utility performance, as well as regulatory efforts to induce performance. As this article uses the term, complication has three main dimensions: business activities, corporate structure, and financial structure, each discussed next.

## 2. Business activities

A utility's corporate family becomes more complicated as it engages in business activities other than providing franchised retail electric service within a single state-defined service territory. Complication can occur across two dimensions: geographic and type-of-business.

### a. Geographic complication

Geographic expansion has four stages, described here in order of increasing complexity. The first stage involves a utility merging with an adjacent utility. This action does not cause regulatory complication, if the purpose and result are to re-set decades-old corporate boundaries to reflect modern economies of scale. Economies of scale exist when, for a particular product or service, long-run average cost per unit declines as output increases.<sup>39</sup>

The second stage comprises mergers of non-adjacent utilities that can be physically integrated. Integration can happen if both utilities serve within a region or sub-region whose transmission capacity, and whose planning and dispatch procedures for generation and transmission, allow the merging companies to plan and operate as a single physical entity. An example was the 1991 acquisition of Public Service of New Hampshire by Northeast Utilities (now called Eversource). The merging companies all resided with New England Power Pool (NEPOOL), at the time a tight pool conducting integrated transmission planning and operations within its six-state footprint.<sup>40</sup>

The third stage comprises mergers of non-adjacent utilities that are not in the same integrated region or sub-region, but whose service territories are sufficiently close, and the transmission capacity between them sufficiently available, to make the generation capacity owned by one available to support the customer demands of the other. These companies are interconnected indirectly; but they are not integrated in the sense of single-system operations. Examples are the merger of Pepco, Atlantic City Electric, and Delmarva (creating Conectiv and now part of Exelon), and the merger of Commonwealth Edison and Philadelphia Electric (also now part of Exelon).

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38. EXELON CORP, 2017 ANNUAL REPORT (Form 10-K for year ending Dec. 31, 2017), <http://www.exeloncorp.com/company/Documents/Exelon%202017%20Annual%20Report.pdf>.

39. Paul Krugman & Robin Wells, *Microeconomics* 348 (4th ed. 2015) [hereinafter Krugman & Wells].

40. It is now possible for non-adjacent utilities not part of a tight power pool to integrate if they lie within the footprint of a regional transmission organization (RTO). Consequently, mergers of companies within an RTO footprint are less likely to have power supply integration as their real purpose and effect.

The fourth stage in geographic complication includes the mergers of utilities for which resource-sharing of generation or transmission is not physically feasible. The earliest examples were the merger of Florida Progress and Carolina Power & Light, and the merger of MidAmerican (which owned utilities in the Midwest) and PacifiCorp (which owned utilities in the West). NextEra (the holding company for Florida Power & Light) tried to acquire Hawaiian Electric and Oncor. Both examples fell into this category; each was rejected by the Hawai'i and Texas Commissions, respectively. Of course, any of the acquisitions by non-North American companies, such as Scottish Power's acquisition of PacifiCorp or National Grid's (U.K.) acquisition of New England Electric System are examples as well.

b. Type-of-business complication

Type-of-business complication refers to the presence in the utility's corporate family of non-core activities—activities other than the sale of retail electric service to residents of the utility's state-franchised service territory, and activities other than wholesale electric service to customers within or near that territory. Described here are two types of non-core businesses—electric and non-electric—in ascending order of business-type distance from the original utility business.

*Electric businesses:* This business complication type involves wholesale and retail electricity businesses other than the state-franchised retail monopoly businesses. Wholesale businesses, run by affiliates, come in three forms: (a) owning generating units physically near the original retail utility, they sell output back to the retail utility; (b) owning generating units physically near the original retail utility, they sell power to unaffiliated retail utilities in the same region (a company could do both (a) and (b)); and (c) owning generating units in regions remote from the original retail utility, they sell the output at wholesale to other retail utilities in that remote region. When some states authorized retail competition in the late 1990s and early 2000s, some retail utilities created affiliates to sell competitive retail electricity—in and outside their home territories.

*Non-electric businesses:* Business complication involving non-electric businesses can include the following eight activities:

1. selling services to the affiliated utility, such as (a) inputs specific to utility operations (*e.g.*, a coal-mining company or gas pipeline selling coal or gas to a utility affiliate that owns coal-fired or gas-fired power plants) or (b) general overhead services (*e.g.*, accounting, legal, and real estate services);
2. having created the affiliates in Activity #1 above, then expanding the customer base by selling the same services to non-affiliated utilities (*e.g.*, a coal-mining affiliate selling coal to other utilities);
3. using the affiliated utility's service territory knowledge, name recognition, and customer loyalty to sell energy-related services to the utility's customer base (*e.g.* energy efficiency services, home energy audits, and heating, ventilation, and air conditioning services);
4. expanding that energy-related business (from Activity #3 above) to other service territories;

5. using the affiliated utility's service territory knowledge, name recognition, and customer loyalty to sell non-energy products to the utility's customer base, and then to others (*e.g.*, home energy alarm systems);
6. expanding the non-energy products businesses (from Activity #5 above) to other geographic areas;
7. engaging in unrelated non-utility businesses, such as banking, real estate development, or furniture sales within the affiliated utility's service territory; and
8. engaging in those unrelated non-utility businesses (from Activity #7 above) outside the affiliated utility's service territory.

*Paths to business-mixing:* Unrelated businesses become part of the same corporate family by three main paths:

1. An existing utility or utility holding company becomes a new entrant in a non-utility market. In the 1990s, Constellation Energy (then the holding company for BGE) entered the global commodities trading business.
2. An existing utility or utility holding company acquires a non-utility business. Western Resources (then the holding company for Kansas Power & Light and Kansas Gas & Electric—later renamed Westar—and recently acquired by Great Plains Energy (the holding company for KCP&L and other utilities)) acquired companies selling home alarm systems. In 1988, Hawaiian Electric's holding company bought a bank.
3. A non-utility business (or holding company already owning such a business) acquires a utility or a utility holding company. Berkshire Hathaway, a conglomerate, has bought three utilities or utility holding companies: MidAmerica Energy Holding Company (the holding company for MidAmerican Energy Company, which provides electric and gas utility service in Iowa, Illinois, South Dakota and Nebraska), PacifiCorp, and Nevada Power (the product of a merger of Sierra Pacific Resources and Nevada Power). KKR and other private hedge funds bought Oncor (a retail utility in Texas—now owned by Sempra, the holding company for San Diego Gas & Electric).

### 3. Corporate structure

Corporate structure involves the ownership relationships within a utility's corporate family: Which affiliates own which assets, conduct which businesses with whom, and control whose decisions? Which executives plan, finance, and operate the utility businesses, and how? When electric utilities were independent companies, they, like typical corporations, issued millions of shares to diverse entities: individual people, trust funds, philanthropic funds, pension funds, mutual funds, and hedge funds. The utility merger trend has changed this model. Most electric utilities are now owned wholly by a holding company, which in turn might be owned by a holding company owning other companies. At the end of this chain are still the ultimate owners—individuals, philanthropic funds, pension funds, mutual funds, and hedge funds. But the mix of those ultimate owners, along with the strategies of the utility's more direct owners, affects utility performance.



The variations on corporate structure can be described and understood through two different frames: the utility's relationship to its various shareholders, and the types of ultimate shareholders.

a. Utility's relationship to its shareholders

The utility-shareholder relationship can take one of the following forms:

1. the utility is owned directly by the ultimate shareholders (*e.g.*, individuals, mutual funds, and pension funds);
2. the utility is owned by a holding company, which in turn is owned by the ultimate shareholders;
3. the utility is owned by a holding company that itself is owned by another holding company, creating multiple layers in the corporate family between the core utility and the ultimate shareholders; or
4. the utility itself resides within the top-level holding company, as a division rather than a subsidiary. That top-level holding company will own one or more subsidiaries.

b. Types of ultimate shareholders

To complicate the corporate family's business mix is to complicate its shareholder mix. Consider a standalone utility (sometimes called "pure play"), providing only electric service within a single state. It will attract (and historically did attract) conservative investors seeking to buy and hold shares for stable dividends and slow-but-steady value growth. Compare that model with a holding company that makes multiple acquisitions unrelated to core utility service. That holding company will attract a different category of shareholders: those willing to take higher risks, for higher returns and faster value growth.

These differences in shareholder goals produce differences in corporate leadership. That leadership then determines business priorities—such as whether to build new generation or instead to buy output from others; whether to expand trading boundaries and trading partners (such as by forming or joining a regional transmission organization) or instead to create barriers to trade, so as to maintain control over the utility's historic service region; whether to make acquisitions, be acquired, or remain pure play; whether to pay dividends or instead to save cash for future acquisitions; or whether to encourage the state to introduce retail competition vs. maintain the historic monopoly. The mix of holding company activities affects the mix of shareholders, which in turn affects the mix of holding company activities.

How shareholder mix affects utility performance is subject to debate. Some assert that diverse ownership "provide[s] adequate capital at the lowest cost," makes the utility system "more robust (less susceptible to systemic risk)," and thus more able to "withstand the financial collapse"; and "should bring more diversity of management and technologies. . . ." <sup>41</sup> Others raise concerns, as did intervenors in the Washington State Commission's review of an Australian holding company's

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41. Melnyk & Lamb 2006, *supra* note 19, at 21.

(Macquarie) proposal to acquire Puget Sound Energy.<sup>42</sup> The Commission majority did not see a problem:

[The] source of the equity behind the Investor Consortium, including the Macquarie investors, is overwhelmingly government and private pension funds and endowments. It is not hedge funds, venture capital, “corporate raiders” and other sources of capital often thought of in the context of “highly leveraged private equity buyouts.” The Investor Consortium represents very large pools of “patient capital” that invest in utility companies like Puget Energy expecting relatively stable long-term returns that are a good fit with the relatively long-term liabilities of pension funds and endowments. There is no evidence in our record that the Consortium intends or desires to “flip” its investment in Puget Energy in the near term or at any particular point in time.<sup>43</sup>

Shareholder type was also an issue when the Australian holding company Babcock and Brown sought to buy NorthWestern Energy, the company providing retail electric service in Montana, South Dakota, and Nebraska. NorthWestern Energy had recently emerged from a bankruptcy caused by its failed non-core investments.<sup>44</sup> That drama led the Montana Commission to declare a preference for a standalone utility, and for acquirers that demonstrated “commitment to long-term ownership of the utility.”<sup>45</sup> Recognizing that its proposal conflicted with the Commission’s preference, Babcock and Brown tried to change the Commission’s mind. As recounted by the Commission, its witness warned that if the Commission rejected Babcock and Brown’s bid, short-term investors would find another buyer. If the merger is denied, he testified, the “hedge funds or ‘merger arbitragers’ who bought stock after the sale announcement in anticipation of a short-term return . . . will pressure NorthWestern to find a way to recover their investments.”<sup>46</sup> Unimpressed, the Commission rejected the acquisition; the possibility of short-term owners did not “have any bearing one way or the other on the merits of the proposed acquisition at issue in this proceeding.”<sup>47</sup> NorthWestern remains unacquired.

#### 4. Financial structure

Financial structure (also called “capital structure”) refers to the types and sources of a corporate family’s financing, within each family member and for the family as a whole. The types of financing are equity, debt, and equity-debt hybrids such as preferred stock. The sources of financing are internal and external (to an individual affiliate and to the consolidated system).

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42. Puget Holdings LLC and Puget Sound Energy, Inc., No. U-072375, 2008 Wash. UTC LEXIS 1023, at \*15-16 (Wash. Utils. and Transp. Comm’n Dec. 30, 2008).

43. *Id.* at 8.

44. Jan Falstad, *NorthWestern emerges from bankruptcy*, MISSOULIAN (Nov. 2, 2004), [https://missoulian.com/news/state-and-regional/northwestern-emerges-from-bankruptcy/article\\_49105b39-77f5-58ac-b97b-beaf6e93db1e.html](https://missoulian.com/news/state-and-regional/northwestern-emerges-from-bankruptcy/article_49105b39-77f5-58ac-b97b-beaf6e93db1e.html).

45. Statement of Factors for Evaluating Proposals to Acquire NorthWestern Energy, Docket No. N2004.10.166, at 2 (Mont. Pub. Serv. Comm’n Oct. 14, 2004), <http://psc2.mt.gov/Docs/ElectronicDocuments/pdfFiles/N2004-10-166INSaleEvaluation.pdf>.

46. Order No. 6754e, NorthWestern Corp. and Babcock & Brown Infrastructure Ltd., No. D2006.6.82, 2007 Mont. PUC LEXIS 54, at \*116 (Mont. Pub. Serv. Comm’n July 31, 2007) (Commission paraphrasing of witness testimony), [http://psc2.mt.gov/Docs/ElectronicDocuments/pdfFiles/D2006-6-82\\_6754e.pdf](http://psc2.mt.gov/Docs/ElectronicDocuments/pdfFiles/D2006-6-82_6754e.pdf).

47. *Id.*

The post-acquisition holding company system's capital structure has the following dimensions: (a) the debt-equity ratio for the holding company and each affiliate, along with the types of debt (*e.g.*, short, medium, and long) and the maturity dates; (b) which affiliates have obligations to pay dividends to which companies, under what terms and at whose direction; (c) which companies are responsible for issuing debt or equity to which companies, under what terms and at whose direction; (d) which affiliates, if any, are legally responsible for the debts of other affiliates; and (e) which affiliates, if any, have had their stock or assets pledged as collateral, or otherwise encumbered, for loans made to other affiliates.

In assessing and guiding financial structure, the utility regulator aims to ensure the utility's access to capital at reasonable cost. The equity share must be large enough to make lenders confident of repayment (and therefore willing to accept relatively low interest rates), but small enough so that the higher cost of equity (relative to the cost of debt) does not raise the price of electricity unnecessarily. Mergers and acquisitions can change the debt-equity mix of the corporate family in which the utility resides. If the merger financing is more debt-heavy than the utility's pre-acquisition mix, the utility's new family will have more financial risk than the utility did. The same result occurs if the corporate family which the utility joins has affiliates that are more debt-heavy than the utility.

Capital structure affects utility performance. There are two distinct concerns, one for each direction of the fund flow. First, funds need to flow into the utility. A pure play utility, owned by the ultimate shareholders, has direct access to the equity markets. But with an acquisition (if the acquiring holding company buys 100%, as is typical), the holding company becomes the utility's sole source of equity—a problem for the utility if the holding company has priorities, like pursuing more acquisitions, that compete with the utility's equity needs. Second, funds flow out of the utility to pay dividends. Since the utility's retail monopoly franchise produces income more predictably than the holding company's other ventures, the holding company has incentive and opportunity to extract from the utility the funds it wants, or to pledge utility assets or stock as collateral to support non-utility debt.

These examples assume that pressure on the utility comes from the holding company that directly owns the utility. But influence can come from indirect ownership. An affiliate of Electricité de France (EDF) sought to buy a 49.99% share in a nuclear subsidiary owned by Constellation Energy Group (CEG), the top-level holding company for Baltimore Gas & Electric.<sup>48</sup> The Commission held that EDF, by controlling the flow of dividends from the nuclear affiliate to CEG, could influence CEG's decisions about when, and at what cost, to support the capital needs of BGE.<sup>49</sup>

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48. See generally *In re Current & Future Financial Condition of Baltimore Gas & Elec. Co.*, Case No. 9173, Order No. 82719, 100 Md.P.S.C. 133, 2009 WL 2195934 (2009).

49. A Maryland statute prohibits any transaction by which a company "acquire[s], directly or indirectly, the power to exercise . . . substantial influence over the policies and actions [of a utility]," unless the transaction receives Commission approval. MD. CODE ANN., PUB. UTIL. COS. § 6-105(e)(1). Although EDF was not technically the acquirer, and although the acquirer was acquiring stock in a nuclear affiliate of BGE rather than in BGE itself, the Maryland Commission found that EDF would have the power to control the flow of dividends from the nuclear affiliate to CEG. That power, in turn, "could affect substantially the decisions CEG and BG&E

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This subsection has described three forms of complication: business activities, corporate structure, and financial structure. These forms interact. Adding higher-risk, non-utility businesses can cause a holding company to acquire more lower-risk utility businesses. Doing so can lower the consolidated holding company system's cost of capital by reducing its overall risk, but this action increases the industry's consolidation. And the new income produced from the acquired utility businesses can support more borrowing for purposes of starting or acquiring non-utility businesses, thus continuing the cycle. These are the regulatory concerns that industry complication brings.

### III. HISTORY OF FERC'S MERGER POLICIES

This Part III summarizes each major FERC policy issuance on mergers, from the 1980s to the present. The purpose is solely to provide the legal context; analysis and critique appear in Parts IV and V. Readers familiar with this history can skip to Part IV. Readers seeking more detail on these FERC issuances can consult the footnoted sources.

#### A. *The Commonwealth factors*

From 1968 to 1996, the Commission addressed mergers by applying the so-called *Commonwealth* factors:

1. the effect of the proposed merger on competition;
2. the effect of the proposed merger on the applicants' operating costs and rate levels;
3. the reasonableness of the purchase price;
4. whether the acquiring utility has coerced the target utility into acceptance of the merger;
5. the impact of the merger on the effectiveness of state and federal regulation; and
6. the contemplated accounting treatment.<sup>50</sup>

During this period, the Commission issued its landmark order conditionally approving the merger of PacifiCorp and Utah Power & Light.<sup>51</sup> The landmark was a condition requiring the merged company to provide nondiscriminatory transmission of wholesale power over its combined system. Without that condition, the merged company could have used UP&L's bottleneck transmission system to control the sale of low-cost hydroelectric power produced in the northwest to high-

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make as to the financing and financial structure of the utility." The transaction thus would allow EDF to exercise "substantial influence over the policies and actions" of BG&E. *In re Current & Future Financial Condition of Baltimore Gas & Elec. Co.*, Case No. 9173, Order No. 82719, 100 Md.P.S.C. at 2.

50. *Commonwealth Edison*, *supra* note 11, at 927, 936-42.

51. *Utah Power & Light, PacifiCorp and PC/UPL Merging Corp.*, 45 F.E.R.C. ¶ 61,095 (1988), *order on reh'g*, 47 F.E.R.C. ¶ 61,209 (1989), *remanded*, *Env'tl. Action v. FERC*, 939 F.2d 1057 (D.C. Cir. 1991) (holding that Commission's exclusion of PURPA qualifying facilities from eligibility for nondiscriminatory transmission service under the approval conditions was unlawful). The author participated in the FERC and appellate proceedings.

cost markets in the southwest.<sup>52</sup> Until 1996, the Commission's merger approvals contained similar transmission conditions.<sup>53</sup> Then in 1996, Order No. 888 made transmission service obligatory for all investor-owned utilities.<sup>54</sup>

On the relationship of benefits to costs, the *PacifiCorp-UP&L* decision held that section 203 did not require a "rate-case type inquiry," but only a "more generalized inquiry and cross examination regarding the types of savings and efficiencies that might be achieved through merger."<sup>55</sup> Until 1996, the Commission's merger orders repeated that treatment.<sup>56</sup>

### B. Merger Policy Statement (1996)

In 1996 the FERC replaced the *Commonwealth* factors with its Merger Policy Statement.<sup>57</sup> Declaring the statutory language neutral, the Commission said it would neither apply a "presumption against mergers" nor presume that "all mergers are beneficial." A merger can be a mixed bag. "[E]ven if certain aspects of a proposed merger are detrimental, the merger can still be consistent with the public interest if there are countervailing benefits that derive from the merger."<sup>58</sup>

The Commission emphasized "protect[ing] the public interest in the development of . . . highly competitive markets." Focusing on wholesale generation, the Commission would strive not merely to preserve status quo competition, but also to improve the quality of competition, using transmission as a lever: "[W]hile in the past we had focused only on [preventing] increases in market power, we no longer believed that we could find any merger to be consistent with the public interest, whether or not the merger created increased market power, unless the merging utilities provided open access." This "revised view of the public interest,"

52. In the evidentiary hearing before ALJ George Lewnes, merger opponents produced Salt Lake City newspaper editorials praising UP&L for purchasing low-cost hydropower from the northwest, marking up the price and reselling it in the southwest, then sharing the profits with its retail ratepayers—a anti-competitive tactic sustainable in the market only because UP&L foreclosed competing generation sellers in the northwest from using its transmission system to sell to the southwest themselves.

53. See, e.g., *Kansas Power & Light Co. and Kansas Gas & Elec. Co.*, 56 F.E.R.C. ¶ 61,356 (1991); *Northeast Utilities Service Company (Re Public Service Company of New Hampshire)*, 56 F.E.R.C. ¶ 61,269 (1991).

54. Order No. 888, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, F.E.R.C. STATS. & REGS. ¶ 31,036 (1996), *order on reh'g*, Order No. 888-A, F.E.R.C. STATS. & REGS. ¶ 31,048, *order on reh'g*, Order No.888-B, 81 F.E.R.C. ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 F.E.R.C. ¶ 61,046 (1998), *aff'd in relevant part sub nom.*; *Transmission Access Policy Study Grp. v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom.* *New York v. FERC*, 535 U.S. 1 (2002).

55. 45 F.E.R.C. ¶ 61,095, at p. 61,298.

56. See, e.g., *Entergy Services, Inc. & Gulf States Utilities Co.*, 64 F.E.R.C. ¶ 61,001, at n.7 (1993).

57. Order No. 592, *Inquiry Concerning the Commission's Merger Policy under the Federal Power Act: Policy Statement*, 61 Fed. Reg. 68,595 (Dec. 30, 1996) [hereinafter Order No. 592 or Merger Policy Statement], F.E.R.C. STATS. & REGS. ¶ 31,044 (1996), *reconsideration denied*, Order No. 592-A, 79 F.E.R.C. ¶ 61,321 (1997).

58. *Id.* at text accompanying n.21.

from discrimination-prevention to competition-improvement, responded to Congress's 1992 goal of (in the Commission's words) "encouraging greater wholesale competition and the significant increase in actual competition."<sup>59</sup>

The new policy also sought to assist companies "seeking to reposition themselves in response to the emerging competitive business landscape." These "market participants require greater regulatory certainty and expedition of regulatory action," to respond quickly to "rapidly changing market conditions."<sup>60</sup>

Moving from purpose to practice, the Policy Statement replaced the six *Commonwealth* factors with a three-part inquiry, addressing a merger's effects on competition, rates and regulation, as discussed next.

### 1. Effect on Competition

To address a proposed merger's effects on wholesale generation competition, the Commission established a screen for horizontal market power. Based on the Department of Justice/Federal Trade Commission Horizontal Merger Guidelines (1992), the screen required applicants to define geographic and product markets. Applicants had to use a "delivered price test" to identify potential suppliers to those markets, then use the Herfindahl-Hirschman Index to measure supplier concentration.<sup>61</sup> The current version of these steps appears in what is now known as "Appendix A."

Passing the screen creates a rebuttable presumption that the merger will not give the merged entity market power. This presumption obviates a trial-type hearing unless contrary evidence arises. If the applicants fail the screen, the FERC staff will conduct "a more detailed analysis, which may include a trial-type hearing" at which applicants must produce evidence showing their transaction is consistent with the public interest. If the FERC finds "an adverse effect" on competition, and if other factors don't "mitigate or counterbalance" those effects, the FERC may impose mitigation remedies. Options include "the formation of an Independent System Operator (ISO), divestiture of assets, elimination of transmission constraints, efficient regional transmission pricing, and offering an open season to allow the merging utilities' customers to escape from their contracts."<sup>62</sup> On timing of mitigation: If requiring a remedy to be in place pre-consummation could "jeopardize the ability of parties to merge" or delay customer benefits, the Commission will consider interim measures like "sell[ing][Applicants'] transmission rights on congested transmission paths to third parties or not trad[ing] in markets where it has market power."<sup>63</sup>

Screen-failing applicants can avoid mitigation if they show the transaction's consistency with the public interest. Consistency involves four factors:

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59. *Id.* at text adjacent to n.26 (citing the Energy Policy Act of 1992 [hereinafter EPAct 1992]); and *El Paso Electric Co. and Central & Southwest Services Inc.*, 68 F.E.R.C. ¶ 61,181, 61,914-15 (1994), *dismissed*, 72 F.E.R.C. ¶ 61,292 (1995).

60. *Id.* at text accompanying n.3.

61. *Id.* at Part III.B.2.c.

62. *Id.* at Part III.B.2.e.

63. *Id.* at n.38.

(1) the potential adverse competitive effects of the merger; (2) whether entry by competitors can deter anti-competitive behavior or counteract adverse competitive effects; (3) the effects of efficiencies that could not be realized absent the merger; and (4) whether one or both of the merging firms is failing and, absent the merger, the failing firm's assets would exit the market.<sup>64</sup>

The Appendix A assessment would address wholesale markets. The Commission would look at retail markets only "if a state lacks authority under state law and asks us to do so."<sup>65</sup>

## 2. Effect on rates

A merger's mix of benefits and costs can affect rates. Recall that the FERC's *Utah Power & Light-PacifiCorp* decision required only a "generalized inquiry" into "types of savings and efficiencies."<sup>66</sup> That practice, the Merger Policy Statement acknowledged, had not worked well. It had produced "estimates of somewhat amorphous net merger benefits," leading to disputes over whether the applicants had "adequately substantiated those benefits." Still, some type of protection was necessary, because of several risks: The projected benefits might not materialize; "the elimination of the independence of the companies and resulting combination of the facilities . . . would be likely to lead to unnecessary rate increases or inhibit rate reductions"; and the merged companies might not be "able to operate economically and efficiently as a single entity." The Commission therefore replaced its "generalized inquiry" with a requirement of "ratepayer protection mechanisms."<sup>67</sup>

Applicants needed to offer these "ratepayer protection mechanisms," the FERC said, to satisfy a merger standard of "no harm." In the prior era of "generalized inquiries," the Commission had applied the no-harm standard by determining "whether the [merger] costs are likely to exceed the [merger's] benefits."<sup>68</sup> Instead of having to compare costs and benefits, merger applicants now would need to make "hold-harmless" commitments like temporary wholesale rate

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64. Order No. 642, *supra* note 32, at text accompanying note 24.

65. *Id.* at Part III.F. As stated in Part I above, this article focuses on topics other than wholesale competition. For detailed discussion of the FERC's wholesale competition assessment techniques see Mark J. Niefer, *Explaining the Divide Between DOJ and FERC on Electric Power Merger Policy*, 32 ENERGY L.J. 505 (2012); Harvey L. Reiter, *Implications of Mergers and Acquisitions in Gas and Electric Markets: The Role of Yardstick Competition in Merger Analysis*, NRRI Quarterly Bulletin (Summer June, 1999); Darren Bush, *Electricity Merger Analysis: Market Screens, Market Definition, and Other Lemmings*, REV. INDUS. ORG. 263, 286 (2008); Richard Gilbert & David Newbery, *Analytical Screens for Electricity Mergers*, REV. INDUS. ORG. 217, 223 (2008); and Diana L. Moss, *Antitrust Versus Regulatory Merger Review: The Case of Electricity*, 32 REV. INDUS. ORG. 241, 244-57 (2008).

66. See discussion of the PacifiCorp-UP&L merger in Part III.A above.

67. Order No. 592, *supra* note 57 at text accompanying nn.39 and 40.

68. See, e.g., *Wisconsin Elec. Power Co., Northern States Power Co., et al.*, 79 F.E.R.C. ¶ 61,158 (1997) (holding ratepayer protection adequate if there was no wholesale rate increase for four years); *Public Service Co. of Colorado*, 75 F.E.R.C. ¶ 61,325 at 62,043-44 (1996) (setting for hearing whether applicants' proposed hold-harmless commitment was adequate); *Cincinnati Gas & Electric Company and PSI Energy, Inc.*, 64 F.E.R.C. ¶ 61,237 at 62,714 (1993) (requiring showing that "any rate increase was not related to the merger"); *Union Electric*, 77 F.E.R.C. ¶ 61,026 at 61,107-08 (1996) (expressing concern that Applicants' open season commitment might be inadequate).

freezes or reductions, preferably negotiated with the wholesale customer intervenors. Hold-harmless commitments were necessary, the Commission said, because “even in an open access environment, markets may not work perfectly or even well. This is particularly the case during the transition from a monopoly cost-of-service market structure to a competitive market-based industry.”<sup>69</sup>

The no-harm standard, and the requirement of rate freezes or rate reductions, would apply to wholesale customers only; the Policy Statement proposed no inquiry into the rate effects on retail customers.

### 3. Effect on regulation

The FERC’s concern with a merger’s effects on regulation grew out of the *Ohio Power* litigation. The D.C. Circuit there interpreted FPA § 318 to prevent the FERC from disallowing from a utility’s wholesale rates costs imprudently incurred when purchasing from an affiliate, if the SEC under PUHCA 1935 had approved the purchase (the SEC was applying an “at-cost” standard; while the FERC wanted to apply a “market” standard on the premise that market prices for the non-power goods and services would be lower than the selling affiliate’s cost).<sup>70</sup> To protect against such preclusion, the 1996 Policy Statement gave applicants two options: Agree to heed the FERC’s policies on interaffiliate transactions, or face a hearing addressing the merger’s effect on regulation.<sup>71</sup> Either way, the FERC would protect its authority.

As for state authority, the Policy Statement echoed its treatment of competitive effects: “If the state lacks . . . authority and raises concerns about the effect on regulation, we may set the issue for hearing; we will address these circumstances on a case-by-case basis.”<sup>72</sup>

#### C. Order No. 642 (2000)

Order No. 642 revised data requirements for the Appendix A horizontal market analysis.<sup>73</sup> It also added guidelines for vertical merger analysis. The vertical concern was “regulatory evasion”—the upstream affiliate overcharging the downstream affiliate for inputs, hoping the FERC will include the excess cost in the downstream affiliate’s rates. As with the 1996 Policy Statement, the FERC said it will not address regulatory evasion in the retail context “unless a state lacks adequate authority to consider such matters and requests us to do so.”<sup>74</sup>

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69. Order No. 592, *supra* note 57, at text accompanying n.50.

70. *Ohio Power Co. v. FERC*, 954 F.2d 779, 782-86 (D.C. Cir. 1992) (holding that the FERC is precluded from declaring an SEC-approved interaffiliate price unreasonable), *cert. denied*, 498 U.S. 73 (1992).

71. Order No. 592, *supra* note 57, at text accompanying notes 57 and 58. The FERC tests the reasonableness of intra-system transactions by applying a market test: What would be the terms of the utility’s purchase or sale had it transacted with a non-affiliate subject to effective competition?

72. *Id.*

73. Order No. 642, *supra* note 32. Additional required information included “joint ventures, strategic alliances, tolling arrangements or other business arrangements”; as well as “business activities, corporate affiliations, officers in common with other parties associated with the transactions either directly or indirectly, jurisdictional transactions”; and “all parent companies and all energy affiliates and subsidiaries (those companies which provide electric products or inputs to electric products).”

74. *Id.* at text accompanying n.94.



#### D. EPAct 2005

The Energy Policy Act of 2005 (EPAct 2005) amended Federal Power Act section 203, producing the version described in Part I of this article. The major changes were to raise the jurisdictional trigger from \$50,000 to \$10 million (except for mergers or consolidations of jurisdictional facilities, for which the trigger remained at \$50,000 until September 2018, when the President signed into law an amendment raising those transactions' trigger to \$10 million as well); and to add to FPA jurisdiction several categories of transactions, including certain holding company transactions and the acquisition of generation or utility securities.<sup>75</sup>

EPAct 2005 also repealed PUHCA 1935, replacing it with PUHCA 2005, the latter dealing with books-and-records access and intra-holding company allocation of service company charges.<sup>76</sup>

#### E. Order No. 667 (2005)

Order No. 667 implemented the FERC's EPAct 2005 obligations.<sup>77</sup> The Commission there explained that "PUHCA 2005 is primarily a 'books and records access' statute and does not give the Commission any new substantive authorities"; nor does it "affect the Commission's independent ability to obtain access to books and records under the FPA and NGA." The FERC rejected requests to "reimpose particular requirements in PUHCA 1935 that Congress chose not to include in PUHCA 2005."<sup>78</sup>

On interaffiliate pricing, recall the *Ohio Power* discussed in Part III.B.3. The Commission had argued to the D.C. Circuit, unsuccessfully, that its disallowances based on a "market" standard should not be precluded by the SEC's approvals based on an "at cost" standard. Since the basis for the preclusion was PUHCA 1935, that statute's repeal eliminated the problem. But in Order No. 667, the Commission said it would not require holding company systems to switch to the FERC's "market standard" automatically, where centralized service companies sold services to utility affiliates priced at the SEC's old "at cost" standard.<sup>79</sup> These

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75. For detail on EPAct 2005's effect on mergers and holding company structure, *see generally* Melnyk & Lamb 2006, *supra* note 19, at 15-20.

76. Section 1264(a) and (b) of the Energy Policy Act of 2005 requires holding companies and their associate and affiliate companies to provide the FERC with the information the Commission deems necessary "for the protection of customers with respect to jurisdictional rates." Section 1264(c) authorizes the FERC to examine the books and records of any member of a holding company system if "necessary or appropriate for the protection of utility customers with respect to jurisdictional rates." Section 1266 exempts from this federal records provision any holding company that has that status merely because it owns a PURPA qualifying facility, a "foreign utility company," or an "exempt wholesale generator." Section 1275(b) directs the FERC, on request of a state commission or a holding company system, to "review and authorize" the allocation of costs of goods and services provided by a holding company's service affiliate to its utility subsidiaries. Section 1267 preserves the Commission's authority, in setting rates, to disallow costs arising from interaffiliate transactions.

77. Order No. 667, *Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005*, 113 F.E.R.C. ¶ 61,248 (2005) [hereinafter Order No. 667], *order on reh'g*, Order No. 667-A, 71 Fed. Reg. 28,446 (May 16, 2006), F.E.R.C. STATS. & REGS. ¶ 31,213, *order on reh'g*, Order No. 667-B, 71 Fed. Reg. 42,750 (July 28, 2006), F.E.R.C. STATS. & REGS. ¶ 31,224 (2006), *order on reh'g*, Order No. 667-C, 72 Fed. Reg. 8,277 (Feb. 26, 2007), 118 F.E.R.C. ¶ 61,133 (2007).

78. Order No. 667, *supra* note 77, at PP 4, 6.

79. *Id.* at P 14.

transactions would enjoy a rebuttable presumption of reasonableness, subject to complaints that the at-cost price exceeded the market price. For non-power goods or services transactions from special purpose subsidiaries to their utility affiliates, however, the FERC would require pricing at market. Holding company systems would not have to file their cost allocation agreements for non-power goods and services since, technically, those sales are not FPA-jurisdictional.

#### F. Order No. 669 (2006)

Order No. 669 implemented the 2005 amendments to Federal Power Act section 203.<sup>80</sup> It defined statutory terms, including “value” for purposes of the \$10 million trigger.<sup>81</sup> It also clarified the evidentiary support necessary to demonstrate that a proposed transaction will not violate either section 203(a)(4)’s prohibition against harmful cross-subsidization by a utility of a non-utility associate, or its prohibition against harmful pledges or encumbrances of utility assets for the benefit of an associate company.<sup>82</sup> Order No. 669 also granted blanket authorizations for several categories of transactions.<sup>83</sup> These blanket authorizations were permissible because, the FERC explained, (a) they don’t affect wholesale competition or captive wholesale customers; and (b) the intrastate transactions, and their effects on retail competition, are more appropriately addressed by state commissions.<sup>84</sup>

#### G. Supplemental Policy Statement (2007)

In 2007, the FERC issued a “Supplemental Policy Statement.”<sup>85</sup> It provided clarifications and guidance about:

- (1) The information that must be filed as part of section 203 applications for transactions that do not raise cross-subsidization concerns;
- (2) the types of applicant commitments and ring-fencing measures that, if offered, might address cross-subsidization concerns;
- (3) the scope of blanket authorizations under sections 203(a)(1) and 203(a)(2);
- (4) what constitutes a disposition of control of jurisdictional facilities for purposes of section 203; and
- (5) the Commission’s Appendix A analysis.<sup>86</sup>

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80. Order No. 669, *Transactions Subject to FPA Section 203*, 71 Fed. Reg. 1348 (Jan. 6, 2006), F.E.R.C. STATS. & REGS. ¶ 31,200 (2005) [hereinafter Order No. 669], *order on reh’g*, Order No. 669-A, 71 Fed. Reg. 28,422 (May 16, 2006), F.E.R.C. STATS. & REGS. ¶ 31,214, *order on reh’g*, Order No. 669-B, 71 Fed. Reg. 42,579 (July 27, 2006), F.E.R.C. STATS. & REGS. ¶ 31,225 (2006).

81. Order No. 669, *supra* note 80, at PP 94-98.

82. *Id.* at P 6.

83. *Id.* These transactions included: U.S. holding company acquisitions of foreign utilities; certain intra-holding company system financings and reorganizations; holding company investments in transmitting utilities and electric utility companies; “[s]ection 203(a)(2) purchases or acquisitions by holding companies of companies that own, operate, or control facilities used solely for transmission or sales of electric energy in intrastate commerce”; and “[s]ection 203(a)(2) purchases or acquisitions by holding companies of facilities used solely for local distribution and/or sales at retail regulated by a state commission.”

84. *Id.* at P 57.

85. *FPA Section 203 Supplemental Policy Statement*, 72 Fed. Reg. 42,277 (Aug. 2, 2007), F.E.R.C. STATS. & REGS. ¶ 31,253 (2007).

86. *Id.* at P 9.

#### H. Policy Statement on Hold Harmless Commitments (2016)

The 1996 Policy Statement required merger applicants to hold customers harmless from merger costs, including so-called transaction costs and transition costs. In a 2016 Policy Statement, the Commission defined and gave examples of those costs, while establishing controls and procedures for recording them.<sup>87</sup> The Commission also withdrew its proposal to reject hold-harmless commitments that were time-limited, largely because “there is less of a nexus between activities that are identified as transition costs and the transaction as time passes.”<sup>88</sup> For the period in which an applicant could not recover merger-related costs without a showing of comparable benefit, five-year limits were “standard.”<sup>89</sup> Finally, the Commission clarified that no hold-harmless commitment would be necessary in two situations: customers taking service at market-based rates, and customers whose prices were set by a contract that prevents the pass-through of these costs.<sup>90</sup>

#### I. Notice of Inquiry RM16-21 (2016)

In September 2016, the FERC began an investigation on whether to revise its market power analyses for mergers under section 203 and for market-based rate applications under section 205.<sup>91</sup> The Commission asked commenters to consider whether its analyses “are effective at identifying the potential for the exercise of market power, and if not, what improvements can be made.”<sup>92</sup> Besides seeking to “harmonize” its approaches under sections 203 and 205, the Commission asked whether it should—

- (1) establish a simplified analysis for certain section 203 transactions that are unlikely to raise market power concerns;
- (2) add a supply curve analysis to section 203 evaluations;
- (3) improve the Commission’s single pivotal supplier analysis in reviewing market-based rate applications, and add a similar pivotal supplier analysis to section 203 evaluations;
- (4) add a market share analysis to review of section 203 transactions;
- (5) modify how capacity associated with long-term power purchase agreements (PPAs) should be attributed in section 203 transactions; and
- (6) require submission of applicant merger-related documents.<sup>93</sup>

The Commission also sought comments on the scope of the blanket authorizations granted in Order No. 669. The Commission has received comments but has not acted.

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87. Policy Statement on Hold Harmless Commitments, 155 F.E.R.C. ¶ 61,189 (2016) [hereinafter 2016 Policy Statement].

88. *Id.* at PP 82-83 (stating that “as time passes, it becomes more difficult to distinguish actions taken, and related expenditures, to integrate the operations and assets of newly-merged companies from the conduct of an applicant’s normal business activities”).

89. *Id.* at P 85.

90. *Id.* at P 7.

91. RM16-21 Notice of Inquiry, *supra* note 20.

92. *Id.* at P 11.

93. *Id.* at P 1.

#### IV. BIG-PICTURE ERRORS: INADEQUATE DEFINITION OF “PUBLIC INTEREST,” NO-HARM STANDARD, DEFERENCE WITHOUT COMPETITIVE DISCIPLINE

Parts II and III have described, respectively, the factual context (over 70 mergers in 30 years, the consolidation and complication trend continuing) and the legal context (the Commission’s major merger issuances from the 1980s to the present). This Part IV assesses the Commission’s goals and associated reasoning. It describes the big-picture errors. Lacking an adequate definition of “public interest,” the Commission defers to transacting parties who pursue private interests. This deference takes the form of a no-harm standard—a standard inconsistent with the continuous performance improvements induced by effective competition, the quality of competition that regulators are duty-bound to replicate. Part V then explains how this combination of lack of vision, incorrect standard and deference leads to five specific policy errors.

##### A. FERC’s “public interest”: No vision for industry performance

###### 1. Inadequate definition of “public interest”

To ensure that a transaction is “consistent with the public interest,” the Commission needs an adequate definition of the public interest. That definition must flow from the statute’s purpose.<sup>94</sup> The Federal Power Act is an economic regulatory statute. Economic regulation’s purpose is to induce industry performance: performance for the consumer, performance comparable to what effective competition would produce.<sup>95</sup> To be “consistent with the public interest,” FERC-approved mergers must emerge from, and reflect the discipline of, effective competition.

In none of the FERC’s merger issuances—the 1996 Policy Statement, Order Nos. 642, 667 and 669, or the 70-plus approval orders—is there a clear definition of public interest, let alone a definition requiring that mergers come from, and reflect, the discipline of effective competition. The 1996 Policy Statement’s stated purpose is to make mergers “consistent with the competitive goals” of EPAct 1992. But that stated purpose is only aspirational; it states no specific industry outcomes by which consumers can hold the Commission accountable.

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94. *NAACP v. FPC*, 425 U.S. 662 (1976) (“[T]he use of the words ‘public interest’ in a regulatory statute is not a broad license to promote the general public welfare. Rather, the words take meaning from the purposes of the regulatory legislation.”).

95. *See, e.g., Delmarva Power & Light Co. v. Public Service Comm’n of Md.*, 370 Md. 1, 6 (2002) (holding that a commission “takes the place of competition and furnishes the regulation which competition cannot give”) (quoting OSCAR L. POND, *A TREATISE ON THE LAW OF PUBLIC UTILITIES*, 29-31 § 901 (3d ed.1925)); *see also* Alfred Kahn, *The Economics of Regulation: Principles and Institutions*, Vol. 2 at 112 (1971, 1988) (stressing the “importance of making regulation more intelligent and more effective in those circumstances in which competition is simply infeasible”); JAMES BONBRIGHT, *PRINCIPLES OF PUBLIC UTILITY RATES* 25 (1961) (asserting that the objective of utility regulation is “to serve as a substitute for competition”).

Effective competition produces results that are economically efficient. Economic efficiency means biggest bang for the buck, no waste, no economic opportunity foregone.<sup>96</sup> To achieve that result, regulators must set standards that allocate benefits to the benefit-creators and costs to the cost-causers. Under those economic conditions, the legitimate interests of shareholders and customers are aligned: Customers receive appropriate value for the price they pay (relative to all feasible alternatives); shareholders receive an appropriate return for the risk they take (relative to all feasible alternatives).

Because the Commission has never addressed these principles, it has not defined the public interest adequately. The necessary inference—one that will become clearer in the ensuing assessment of the no-harm standard—is that the FERC defines the “public interest” as not harming the pre-merger status quo, whatever that status quo is.

## 2. No positive standards for structure, conduct, or performance

Because the FPA’s purpose is economic performance, the FERC must define the public interest in terms of economic performance. And if industry performance is the necessary output, then industry structure and conduct are the necessary inputs. But on those three subjects—structure, conduct, performance—the FERC’s merger orders are nearly silent.

Consider the standards proposed by Scherer and Ross in their landmark text.<sup>97</sup> On industry performance, Scherer and Ross identify six criteria:

1. “Firms’ production and distribution operations should be efficient and not wasteful of resources.”
2. “Output levels and product quality (*i.e.*, variety, durability, safety, reliability, and so forth) should be responsive to consumer demands.”
3. “Profits should be at levels just sufficient to reward investment, efficiency, and innovation.”
4. “Prices should encourage rational choice, guide markets toward equilibrium, and not intensify cyclical instability.”
5. “Opportunities for introducing technically superior new products and processes should be exploited.”
6. “Success should accrue to sellers who best serve consumer wants.”<sup>98</sup>

Industry performance results from seller and buyer conduct. In efficient, effectively competitive markets, say Scherer and Ross, conduct looks like this:

1. “Some uncertainty should exist in the minds of rivals as to whether one rival’s price moves will be followed by the others.”
2. “Firms should strive to attain their goals independently, without collusion.”

96. See Krugman & Wells, *supra* note 39, at 29 (explaining that “an economy is efficient if there are no missed opportunities—there is no way to make some people better off without making other people worse off”).

97. F. M. Scherer & D. Ross, *Industrial Market Structure and Economic Performance* (1990) [hereinafter Scherer & Ross].

98. *Id.* at 53-54.

3. "There should be no unfair, exclusionary, predatory, or coercive tactics."
4. "Inefficient suppliers and customers should not be shielded from competition."
5. "Sales promotion should be informative, or at least not be misleading."
6. "There should be no persistent, harmful price discrimination."<sup>99</sup>

Finally, conduct is influenced by industry structure. In effectively competitive markets, industry structure has these features:

1. "The number of traders should be at least as large as scale economies permit."
2. "There should be no artificial inhibitions on mobility and entry."
3. "There should be moderate and price-sensitive quality differentials in the products offered."<sup>100</sup>

The FERC is no stranger to structure, conduct, and performance or to the need for performance to achieve economic efficiency. All three concepts are captured, verbally, in this passage from the 1996 Policy Statement: "[C]ompetition needed to protect the public interest will not be efficient and deliver lower prices in poorly structured markets."<sup>101</sup> The Commission also recognizes that these concepts must permeate its merger decisions: "[A]s customer protection is increasingly dependent upon vibrant competition, it is critically important that mergers be evaluated on the basis of their effect on market structure and performance."<sup>102</sup>

But beyond these words, the FERC has articulated no required outcomes in any of these three areas. Lacking any vision for success, the FERC does not test whether a merger will achieve success. The FERC has made itself unaccountable for industry performance. Thirty years of continuous approvals, yet the FERC has produced no study of how its policies affect industry performance. The Commission has made improvements. On drawing geographic boundaries, it has substituted Appendix A's "delivered price test" for the discredited "hub-and-spoke" method.<sup>103</sup> And in RM16-21 it asks important questions about measuring market power. But on the concepts of structure, conduct, and performance—concepts the Commission recognized verbally in its 1996 Policy Statement—the FERC has no track record.

### 3. Approval of acquirers with conflicts of interest

In any industry structure, performance and conduct are affected by the types of companies that make up that structure. Lacking standards for structure, conduct, and performance, the FERC's policy ignores that point. The result is indif-

99. *Id.*

100. *Id.*

101. Order No. 592, *supra* note 57, at Part III.A.2.b.

102. *Id.*

103. The "hub-and-spoke" method is discussed in Order No. 592, *supra* note 57, at Part III.B.2.b.

ference—to whether a merger participant's internal conflicts will undermine structure, conduct, and performance. Market structures will more likely produce conduct that aligns shareholder and customer interests if the market participants have organized themselves to align those interests. Intra-family conflict, between non-utility business priorities and utility customer welfare, risks producing suboptimal utility performance. The FERC's merger policy does not prevent intra-family conflict because it pays insufficient attention to the three family features that can lead to conflict: business activities, governance structure, and financial structure.

*Business activities:* A pure play utility—one affiliated with no other business, while serving a single local territory—experiences no inter-business conflict. The potential for conflict grows as the holding company's business activities expand. Geographic expansion (acquiring other utilities in other locations) can benefit customers if there are economies of scale (*i.e.*, decreases in per-unit cost over the relevant segment of demand); it can hurt customers if operations are impaired by managerial remoteness or diseconomies of scale. Type-of-business expansion (acquiring companies that sell other services, to third parties or to the utility itself) is a double-edged sword: Non-utility affiliates can help support a utility (as might a subsidiary skilled in acquiring land or buying fuel), but they can also add to its risks (as when affiliates invest in nuclear power, merchant generation, or hedge funds).

Weighing these positives and negatives is challenging, because both sides of the equation are hard to quantify.<sup>104</sup> But the difficulty of weighing does not erase the regulator's obligation.<sup>105</sup> On whether companies with conflicting business activities should receive extra attention, the FERC has no policy.

*Governance structure:* Among all its executives and boards, a utility's corporate family should have an uncompromised priority: performance for the utility customer. There should be no incentive for executives to learn their job on ratepayer funds, then receive promotions to competitive affiliates; no distraction from an executive's utility service functions due to other holding company priorities. When presented with a proposed acquisition, the FERC should ask: Will ultimate control or influence be exercised by individuals whose full focus and professional priority is on service to utility customers? Or instead will control be exercised by

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104. We do know that utilities' non-utility investments in the 1980s were "not particularly successful." Melnyk & Lamb 2006, *supra* note 19, at 10 (citing Leonard S. Hyman, *Investing in the "Plain Vanilla" Utility*, 24 ENERGY L.J. 1, 10 (2003)). Hyman asserted that—

[i]n the past, utility managers failed their investors when they bet the company on a technology they did not understand (nuclear power), when they entered businesses far afield from their experience (diversification), and when they plunged into seemingly related businesses without adjusting their finances to the new risk levels (merchant generation, power marketing, and foreign investment).

105. See, e.g., Joint Report and Application of Oncor Electric Delivery Company LLC. and NextEra Energy, Inc. for Regulatory Approvals Pursuant to PURA §§ 14.101, 39.262, and 39.915, P.U.C. Docket No. 46238, at text accompanying nn.8, 14, 2017 WL 2536473 1, 3-4 (Texas Pub. Utils. Comm'n Apr. 13, 2017) (finding that "the expansive and diversified structure of NextEra Energy and its affiliates would subject Oncor to new and potentially substantial risks," including, but not limited to, "potential changes in renewable demand resulting from changes in climate or tax policy, commodity risks, retail electric provider risks, as well as power and nuclear generation risks, . . . [which] in conjunction with the high amount of leverage at NextEra Energy, increase the likelihood that unforeseen events could jeopardize Oncor's financial stability").

companies and executives having objectives that distract from or conflict with the public interest? The Commission does not ask these questions.

*Financial structure:* The mix of equity and debt, for the utility and for the consolidated system, affects the utility's costs. Also mattering is who provides the equity and who holds the debt—and which business activities have priority when financial capital is scarce. Holding company executives will have hierarchical power over the flow of funds, to and from the utility. They should have no corporate reason to take risks that endanger the flow to the utility or require inappropriate flow from the utility—the latter flow including not only dollars but also collateral.

With the exception of the *Westar* requirements,<sup>106</sup> the Commission's merger policy, and its many approvals, are silent on these finance topics. That silence signals, again, indifference to types of merger participants. Whether the transaction involves pure play utilities (*e.g.*, PEPCO-BGE), foreign infrastructure acquirers (*e.g.*, National Grid, Iberdrola), hedge funds (*e.g.*, KKR), or conglomerates (*e.g.*, Berkshire Hathaway, Enron), these complexities have given the Commission no pause.

Do the Commission's policies on rates and cross-subsidies solve the problem? The Commission's "ratepayer protection mechanism" is only a short-term freeze or reduction; it provides no protection when the short term ends. And the prohibition against cross-subsidies is only a prohibition. As with speeding and jaywalking, a prohibition is only as good as the enforcement. Enforcement depends on auditing. Auditing is not like a trip to the dentist, who checks every tooth; auditing is sampling. It cannot promise 100% coverage—especially where the agency's standards lack rigor to begin with. Enforcement also depends on consequences. What are the consequences if the merged company's executives commit cross-subsidization? Is it unscrambling the merger, penalizing innocent shareholders, ordering the wayward executives fired or demoted? Each of these options has its problems. But the Commission has given no clear answer. Seeing no clear hierarchy of penalties for violating merger conditions, a wrongdoer could challenge any penalty as arbitrary or as lacking notice.

One more problem: the FERC's merger decisions have never defined "cross-subsidization." Given the political content of the term, and even its confusion by experts,<sup>107</sup> a definition by the agency charged with prohibiting it would help everyone.

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106. See Order Conditionally Granting Authorization to Issue Long-Term Unsecured Debt and Announcing New Policy on Conditioning Securities Authorizations, 102 F.E.R.C. ¶ 61,186 (Feb. 21, 2003); Order Rescinding Authorization to Issue Long-Term Unsecured Debt and Clarifying Policy on Securities Authorizations, 104 F.E.R.C. ¶ 61,018 (July 2, 2003).

107. As I was taught by economists, technically a cross-subsidization occurs when the purchasers of Product X pay a price exceeding the standalone (fully distributed) cost of Product X, so that purchasers of Product X (or some other product) can pay a price below the incremental cost of Product X (or some other product). But many people, experts and non-experts, use the term when referring to an allocation of sunk costs disproportionate to load responsibility. In the political realm, "cross-subsidy" is the term Person X uses when paying for something that benefits Person Y but not Person X.



*B. No harm: A standard in conflict with competition*

The FERC allows mergers if they cause no “harm”—meaning only that costs cannot exceed benefits.<sup>108</sup> This standard is inconsistent with effective competition, for an obvious reason: Competitors that promise only that costs won’t exceed benefits lose out to those who promise the best benefit-cost ratio. Furthermore, when the FERC compares benefits to costs (only to ensure that costs do not exceed benefits), it counts the wrong benefits and does not count all the costs. The Commission also allows the merged entity to discriminate inter-generationally because the benefits are short-term while the costs are long-term. Finally, the FERC’s view of harm—which includes only harm to status quo wholesale competition—excludes multiple other harms.

1. “No harm” requires only benefit-cost equality; effective competition requires the best benefit-cost ratio

Under the 1996 Merger Policy Statement, merger applicants must offer “ratepayer protection mechanisms,” in the form of short-term rate freezes or reductions. While some call these measures “benefits,” their required purpose is only to offset harm.<sup>109</sup> A merger standard that merely prohibits harm but does not require benefits conflicts with elementary principles of both regulation and competition.

Utility regulation is built on the prudence standard.<sup>110</sup> Just and reasonable rates must reflect only prudent costs. When ratemaking is cost-based, regulators apply the prudence standard by testing costs for reasonableness. In the market-based rate context, the prudence standard is implicit in the FERC’s presumption that if no seller has market power, competitive forces will cause rates to reflect only reasonable costs (including a fair return). Merely avoiding harm does not make costs prudent; costs are prudent only if they are the most economical means of producing the necessary benefits.<sup>111</sup> Suppose a utility needs to replace a widget whose operating cost is \$10 an hour. It buys a new \$10/hour widget when an \$8/hour widget is available (assume comparable price and quality). The regulator doesn’t find the utility prudent because costs didn’t rise; she finds the utility imprudent because it failed to choose the lower-cost solution. Prudence is not “no harm”; prudence is behavior that is economically efficient. Applied to mergers, the prudence standard requires merger applicants to prove not merely that cost

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108. *Entergy & Gulf States, Inc.*, 121 F.E.R.C. ¶ 61,182 at P 71 (2007) (explaining Commission’s policy of imposing conditions “only when needed to address specific, transaction-related harm”).

109. Merger Policy Statement, *supra* note 57, at text accompanying nn.39 and 40 (describing the “ratepayer protection mechanisms” as protection against rate increases, given the risk that the “elimination of the independence of the companies and resulting combination of . . . facilities . . . [could] lead to unnecessary rate increases or inhibit rate reductions,” or the risk that the merged entity will fail to “operate economically and efficiently”).

110. *See, e.g., Midwestern Gas Transmission Co. v. E. Tenn. Nat. Gas Co.*, 36 F.P.C. 61, 70 (1966), *aff’d sub nom.* *Midwestern Gas Transmission Co. v. FPC*, 388 F.2d 444 (7th Cir. 1968) (“Managements of unregulated business subject to the free interplay of competitive forces have no alternative to efficiency. If they are to remain competitive, they must constantly be on the lookout for cost economies and cost savings. . . . Public utility management, on the other hand, does not have quite the same incentive.”). The Commission later rescinded its decision on unrelated grounds. *Knoxville Utilities Bd. v. Eastern Tenn. Nat. Gas Co.*, 40 F.P.C. 172 (1968).

111. *See, e.g., El Paso Nat. Gas Co. v. FPC*, 281 F.2d 567, 573 (5th Cir. 1960) (utilities must “operate with all reasonable economies”); *Midwestern Gas Transmission Co.*, *supra* note 110, 36 F.P.C. at 70 (utilities must use “all available cost savings opportunities . . . as well as general economies of management”).

does not exceed benefit, but that the merger's cost is the least-cost means of achieving the benefit.

Like the prudence standard in regulation, effective competition demands the best benefit-cost ratio. Investment analysts don't recommend deals that cause no harm; they insist on deals that produce biggest bang for buck. They ask: Will this investment yield a return (*i.e.*, a benefit-cost ratio) at least as large as alternative investments with comparable risks? The same reasoning applies to corporate acquisitions. "A firm which acquires another company . . . does so ideally for exactly the same reason that it purchases a new piece of machinery."<sup>112</sup> No investor, no acquirer of utilities, no target shareholder assesses a transaction using a no-harm standard.

The key difference between the Commission's no-harm standard and the prudence/investment advisor/effective competition standard lies in what is being compared. The no-harm standard looks only at the transaction itself, asking: "Do the costs not exceed the benefits?" The prudence/investment advisor/effective competition standard compares the action's benefit-cost ratio to the ratio of all feasible alternative actions, asking: "Do the costs produce the biggest bang for the buck?" That standard is the one that regulation must emulate.

Indifferent to economic efficiency, the Commission's no-harm standard denies customers the benefits of effective competition. If merger applicants had to demonstrate that their chosen transaction produced the highest possible benefit-cost ratio for the customers relative to other feasible transactions, target companies who wanted their transactions approved would have to select acquirers based on performance. (Today, targets select acquirers based on offer price—a distinct problem addressed in Part IV.C below.) Competing acquirers would bid based on benefits offered to customers, up to the point where their investment in the transaction was no longer attractive relative to other investments of comparable risks. (Today, competing acquirers bid based on the price offered, then incur new debt to cover the price—as discussed in Part V.C below.) Imposing the correct standard would require from the transacting parties no more than what effective competition requires of prospective merger partners: to act cost-effectively, obtaining for their customers the most benefits relative to the costs. Mergers designed for maximum benefit to customers would replace mergers designed for maximum strategic benefit to acquirers and maximum gain to target shareholders.

My criticism of the no-harm standard admittedly conflicts with opinions by the Commission and the Ninth Circuit, all of which say merger applicants need not show any positive benefit.<sup>113</sup> These opinions ignore the central principle: the

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112. Victor Brudney & William W. Bratton, *Cases and Materials on Corporate Finance* 651 (4th ed. 1993).

113. See, e.g., *Northeast Utilities-Public Service of New Hampshire*, 56 F.E.R.C. ¶ 61,269, at p. 61,994 (1991) (holding that "merger applicants need not show that a positive benefit will result from a proposed merger . . . . It is sufficient if the probable merger benefits . . . add up to substantially more than the costs of the merger"), *upheld on other grounds*, *Northeast Utilities Serv. Co. v. FERC*, 993 F.2d 937 (1st Cir. 1993); *PacificCorp-UP&L, Order on Rehearing, Utah Power & Light Co., PacificCorp and PC/UP&L Merging Co.*, 47 F.E.R.C. ¶ 61,209, at p. 61,750, and n. 93 (1989) (holding that applicants "need not show a positive benefit of the merger. Rather, they need only show that the merger is compatible with the public interest"); *Pacific Power & Light Co. v. FPC.*, 111 F.2d 1014, 1016 (9th Cir. 1940) (reversing Commission decision that the phrase "consistent with the public interest" required "benefit to the public," not merely "no serious harm"; the phrase "does

public interest served by regulation is the interest in protecting consumers from suppliers who face no competition. That protection can have meaning only if it produces results that emulate competition. Competition requires constant improvement—a positive benefit.

The Ninth Circuit's decision makes a distinct error. In interpreting the phrase "consistent with the public interest" to require no improvement, the court focuses on the term "consistent" while ignoring the phrase "public interest." True, "consistent" can mean "no better than"—as when a baseball pitcher's ERA of 3.85 this year is "consistent" with his 3.85 last year.<sup>114</sup> But section 203 pairs the adjectival phrase "consistent with" with the noun phrase "public interest."<sup>115</sup> In the context of utility regulation, the term "public interest" does not mean "no worse than last year," or "no worse than everyone else." Were that the case, a utility in 2018 could use the technology of 1980 and still be deemed prudent.<sup>116</sup> Because the purpose of regulation is to emulate effective competition, "public interest" cannot mean "no harm"; it must mean "all cost-effective improvement over the status quo." The Commission has statutory discretion to determine what cost-effective improvements prudence requires. But it does not have statutory discretion to say that "public interest" requires no improvement.<sup>117</sup>

2. To offset negatives, FERC incorrectly counts "benefits" unrelated to or achievable without the transaction

The Commission says that even a transaction with adverse effects can win approval, if there are "countervailing benefits that derive from the merger."<sup>118</sup> This phrase contains the key limitation: The benefits must "derive from the merger." This limitation is rooted in section 203, because what must be "consistent with the public interest" is the "merger or consolidation," *i.e.*, the specific transaction triggering FERC jurisdiction.

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not connote a public benefit to be derived or suggest the idea of a promotion of the public interest. The thought conveyed is merely one of compatibility.").

114. Non-baseball fans: ERA is earned run average—the average number of runs a pitcher allows per nine innings. MAJOR LEAGUE BASEBALL, <http://m.mlb.com/glossary/standard-stats/earned-run-average>.

115. RM16-21 Notice of Inquiry, *supra* note 20, at P 2.

116. Readers of a certain age will recall the Kaypro "luggables" and their 5-1/4 inch floppy disks.

117. The Commission need not be "forever bound" by *Pacific Power & Light*, if it declares and explains a new interpretation that the statute can support, and takes into account legitimate reliance interests of affected parties. *Verizon v. FCC*, 740 F.3d 623, 636 (D.C. Cir. 2014) (holding that FCC "need not remain forever bound by" its prior statutory interpretation) (emphasis in original); *Chevron, U.S.A. v. NRDC*, 467 U.S. 837 (1984) (requiring judicial deference to reasonable agency interpretations of statutes susceptible of multiple interpretations); *National Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005) (holding that an agency interpretation valid under *Chevron* may not be invalidated by the court of appeals based on *stare decisis*). The Commission can also practice nonacquiescence, at least outside the Ninth Circuit. *See, e.g.*, Samuel Estreicher & Richard L. Revesz, *Nonacquiescence by Federal Administrative Agencies*, 98 YALE L.J. 679 (1989) ("[E]ven if an agency must conform its administrative proceedings to the case law of the court of appeals to which review would lie, where this case law is inconsistent with the agency's policy, the agency can continue to press that policy in other circuits if it chooses to do so.").

118. Merger Policy Statement, *supra* note 57, at text accompanying n.21 (providing that "even if certain aspects of a proposed merger are detrimental, the merger can still be consistent with the public interest if there are countervailing benefits that derive from the merger").

In the FERC's decisions, this limitation is dishonored. The money to fund a temporary rate freeze or reduction can come from any source; the applicants need not prove the money's connection to merger-caused savings. But if the freeze or reduction is not derived from merger savings, it is not "derived from the merger." It is not part of the transaction's efficiency value; it is a payoff made to win support. Besides disregarding the statutory language and the Commission's own Merger Policy Statement, allowing pure cash to win approval favors acquirers with extra funds over acquirers whose proposals will produce real savings. The result is industry consolidation unsupported by operational efficiencies.

One might argue that the acquirer offering the highest price is necessarily the most efficient company—either because its prior efficiencies created an unbeatable cash reserve or because its proven ability to create prospective savings attracted the debt and equity financing that supported its winning price bid. This argument is worth considering conceptually, but the FERC has never required it be proven factually. And there can be non-efficiency factors that readily explain an acquirer's highest-price offer. The acquirer could have cash reserves from its non-utility businesses—businesses which enjoy an unearned advantage due to their affiliation with a retail monopoly. Or its high price offer could be based on an expectation of earning supranormal profits from double-leveraging—because the retail commission allows it to earn an equity-level return on the portion of acquired equity funded with acquisition debt—with that debt available at lower-than-normal interest due to the acquirer's ownership of other retail monopolies.<sup>119</sup> These factors have no necessary connection to the efficient provision of electricity service.

Benefits unrelated to the merger are, by definition, achievable without the merger. Yet the Commission routinely accepts these benefits as offsets to harm. An early example was the *PacifiCorp-UP&L* proceeding. The applicants there projected capacity savings from combining the two companies' winter and summer peaks. Intervenors argued that since these savings could be achieved contractually, they should not be attributed to the merger. The FERC disagreed: "The possibility of achieving a particular benefit through a contractual arrangement [achievable without the merger] does not diminish the cost savings associated with that benefit."<sup>120</sup> The Commission's reasons—that the FPA does not treat mergers as "presumptively hostile" and that its statutory mission differs from Justice's<sup>121</sup>—do not respond to the point made here: that the "public interest" compels results

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119. For more detail on double-leveraging, see Part V.D.2 below.

120. 45 F.E.R.C. ¶ 61,095 at text between nn.191 and 192 (1989). The FERC's decision was reversed in part on other grounds; specifically, its exclusion of PURPA qualifying facilities from eligibility under the transmission conditions. *Environmental Action v. FERC*, 939 F.2d 1057 (D.C. Cir. 1991). The author represented petitioner *Environmental Action*. See also *Entergy Servs. Inc. & Gulf States Utilities, Co.*, 67 F.E.R.C. ¶ 61,192 at text accompanying nn.18 and 19, p. 61,583-84 (1994) (holding that merger applicants need not prove that "the benefits achieved from the merger could have been achieved from a less costly alternative. . . . [They] do not have to demonstrate whether the merger is the only means by which the companies could accomplish the overall objectives of the FPA."), upheld on other grounds, *Arkansas Elect. Energy Consumers v. FERC*, 290 F.3d 362 (D.C. Cir. 2002).

121. *Northeast Utilities Service Company* (Re Public Service Company of New Hampshire), 56 F.E.R.C. ¶ 61,269, p. 61,995 at text accompanying nn.80-85 (1991).

consistent with effective competition, and that under effective competition mergers must produce benefits—benefits that are “derived from” the merger. Benefits “derived from” the merger are benefits dependent on the merger, thus unachievable without the merger.

Other examples of “benefits” that don’t derive from the transaction are transferring transmission assets to a standalone transmission company;<sup>122</sup> joining an RTO;<sup>123</sup> and increasing an RTO’s footprint.<sup>124</sup> None of these actions derives from the transaction, *i.e.*, the meshing of two companies; all of them are achievable without the merger. Plenty of companies have taken these actions without a merger. These actions derive not from the merger but from strategy—offering to do something a prudent utility could have done without the merger, and should have done anyway had it been acting consistently with the public interest. Note the irony: Had these entities done the right thing before the merger opportunity arose, they now would have no “countervailing benefit” to offer. The FERC’s policy thus encourages to-be-merging companies to refrain from taking public-interest actions, so they will have something in the tank to offer as “countervailing benefits.”

The Commission has approved as countervailing benefits actions that do actually derive from the transaction. Examples are where the coordination of the two companies’ operations reduces energy costs, thus compensating for increasing capacity charges;<sup>125</sup> or where the merger attracts more competitors whose market entry might moderate a merger-caused increase in locational marginal prices.<sup>126</sup> But these examples are not as numerous as the ones where the Commission counted benefits that were achievable without the merger. Counting such benefits as offsets to harm lowers overall economic value. For that reason, the Department of Justice’s *Horizontal Merger Guidelines* “credit only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anti-competitive effects.”<sup>127</sup>

The no-harm standard also conflicts with the FPA’s purpose. That purpose, like economic regulation generally, is to improve economic performance—to replicate competitive outcomes, so that consumers are protected from “exorbitant prices and unfair business practices.”<sup>128</sup> Whereas effective competition requires rivals to produce savings continuously, the FERC’s merger applicants need make no such showing—not even a “generalized showing.”<sup>129</sup> By requiring a benefits

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122. *ITC Midwest LLC*, 133 F.E.R.C. ¶ 61,169 at P 23 (2010).

123. *ALLETE*, 129 F.E.R.C. ¶ 61,174, at ¶ 20 (2009).

124. *Ameren Servs. Co.*, 103 F.E.R.C. ¶ 61,121 at P 23 (2003).

125. *Bluegrass Generation Co.*, 139 F.E.R.C. ¶ 61,094 at ¶ 41 (2012).

126. *See, e.g., id.* at P 41 (2012); *Rockland Elec. Co.*, 97 F.E.R.C. ¶ 61,357, at p. 62,651 (2001).

127. U.S. DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION, HORIZONTAL MERGER GUIDELINES, 30 (Aug. 19, 2010), <https://www.justice.gov/sites/default/files/atr/legacy/2007/08/14/hmg.pdf>.

128. *Public Sys. v. FERC*, 606 F.2d 973, 979 n.27 (D.C. Cir. 1979).

129. Order No. 592, *supra* note 57, at text accompanying n.21, (relieving applicants of the “generalized showing” requirement).

level unrelated to—in fact lower than—competitive outcomes, the FERC acts inconsistently with the statute.<sup>130</sup>

On this issue, the First Circuit agreed with the FERC. It held that the prohibition against counting benefits achievable by other means is a product of antitrust law, which the FERC is not obligated to enforce.<sup>131</sup> But the FERC and the First Circuit framed the “benefits” issue as a response to *competitive* harm: If there is no competitive harm, there is no need to require real benefits (*i.e.*, benefits unachievable without the merger) to offset the harm. Neither the FERC nor the court addressed whether, competitive harm aside, the “public interest” requires a merger to demonstrate that it produces efficiencies “consistent with” what effective competition would produce.<sup>132</sup> The Commission’s and First Circuit’s error was to treat benefits as relevant only as offsets to anticompetitive harm. If regulation’s purpose is to produce performance comparable to what effective competition would produce, the analysis of benefits cannot be so limited.

### 3. Discrimination by mismatch: Benefit recipients differ from risk bearers

Besides undermining economic efficiency, the FERC’s benefits policy produces intergenerational discrimination. The typical “ratepayer protection mechanism”—a temporary rate freeze or reduction—protects only current ratepayers. But the risk that compels the protection—the risk of the merged entity failing to “operate economically and efficiently”—falls also on future ratepayers.

### 4. FERC miscounts costs

The no-harm standard says costs cannot exceed benefits. Even if this standard were correct, the FERC’s counting of costs is incorrect. An acquisition involves three types of cost: acquisition cost (the purchase price), transaction cost (the cost incurred by the merging parties to assess and negotiate the transaction),<sup>133</sup>

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130. Contrast PUHCA 1935, which required acquisition applicants to show a specific type of benefit that satisfied a specific statutory purpose: the acquisition had to “serve the public interest by tending towards the economical and efficient development of an integrated public-utility system.” PUHCA 1935 § 10(c)(2), 15 U.S.C. § 79j(c)(2) (repealed 2005); *see also* Wisconsin’s *Env’tl. Decade v. SEC*, 882 F.2d 523 (D.C. Cir. 1989) (invalidating SEC’s approval of a proposal to place a new holding company above existing utilities; the transaction would produce “no substantive changes in the operations or the functioning” of an already integrated system). In that appellate proceeding the author represented the petitioner. On remand, the SEC found benefits in the form of financing efficiencies.

131. *Northeast Util. Serv. Co. v. FERC*, 993 F.2d 937, 946-47 (1st Cir. 1993) (upholding the FERC’s approval of Northeast Utilities’ acquisition of Public Service of New Hampshire, and holding that “[a]lthough the Commission must include antitrust considerations in its public interest calculus under the FPA, it is not bound to use antitrust principles when they may be inconsistent with the Commission’s regulatory goals”).

132. As a separate matter, a merger that itself produced no competitive harm could, in combination with prior and subsequent mergers, create consolidation that does cause harm. This problem of “incipiency,” addressed by § 7 of the Clayton Act, was recognized by the FPC in *Central Maine Power Co. and Rangeley Power Co.*, 55 F.P.C. 2477, 2480-81 (1976). For more analysis of this point, see Part V.B below.

133. The FERC has described “transaction costs” as including the costs of—

securing an appraisal, formal written evaluation, or fairness opinions related to the transaction; structuring the transaction, negotiating the structure of the transaction, and obtaining tax advice on the structure of the transaction; preparing and reviewing the documents effectuating the transaction (*e.g.*, the costs to transfer legal title of an asset, building permits, valuation fees, the merger agreement or purchase agreement and any related financing documents); the internal labor costs of employees and the

and transition cost (the costs incurred to mesh the managements and operations of the merging companies).<sup>134</sup> All three categories must be counted. Especially the acquisition cost: One does not buy a rental property if the expected rent revenue just equals the sum of rehabilitation and maintenance costs. If the expected revenue does not also recover the acquisition cost and the transaction cost, the purchase makes no economic sense. Even this elementary concept is missing from the FERC's merger policy. Presumably the Commission ignores purchase price because applicants do not seek to recover the acquisition premium (purchase price less book value) in rates. But a promise not to recover the premium in rates does not mean the acquisition itself—as judged by the relationship of total costs to total benefits—is economical.

The Commission also ignores non-quantifiable costs that are no less important than quantifiable costs. Acquisitions of distant businesses can diminish executive attention to the local business. As the corporate family acquires non-utility businesses whose financial risk exceeds a typical utility's risk, conservative investors are replaced by higher-risk-taking investors—ones who demand higher returns, leading to more pressure on executives to divert more attention from the utility business and take more risk. Bond rating agencies can no longer give the utility consistently stable ratings based on the utility's own operational performance and regulatory treatment, because the holding company system's financial health is no longer based solely on those relatively predictable variables. These pressures on utility earnings cause the utility's leadership to be less tolerant of the Commission's pro-competitive efforts, more ready to create or maintain entry barriers, and thus more likely to weaken the competitive forces that the Commission says it wants. Each of these factors causes costs that the Commission disregards.

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costs of external, third-party, consultants and advisors to evaluate potential merger transactions, and once a merger candidate has been identified, to negotiate merger terms, to execute financing and legal contracts, and to secure regulatory approvals; obtaining shareholder approval (*e.g.*, the costs of proxy solicitation and special meetings of shareholders); professional service fees incurred in the transaction (*e.g.*, fees for accountants, surveyors, engineers, and legal consultants); and installation, integration, testing, and set up costs related to ensuring the operability of facilities subject to the transaction.

2016 Policy Statement at ¶ 21.

134. FERC has described “transition costs” as including costs—

incurred after the transaction is consummated, often over a period of several years. These costs include both the internal costs of employees spending time working on transition issues, and external costs paid to consultants and advisers to reorganize and consolidate functions of the merging entities to achieve merger synergies. These costs may also include both capital items (*e.g.*, a new computer system or software, or costs incurred to carry out mitigation commitments accepted by the Commission in approving the transaction to address competition issues, such as the cost of constructing new transmission lines) and expense items (*e.g.*, costs to eliminate redundancies, combine departments, or maximize contracting efficiencies).

*Id.* at P 23.

5. FERC's definition of "harm" ignores multiple public interest harms

a. Wholesale competition and rates assessed; retail competition and rates ignored

In assessing competitive harm, the FERC looks only at wholesale competition and wholesale ratepayers. The Commission will consider (though not commit to) addressing a merger's effects on retail competition and retail customers only if the relevant state commission lacks jurisdiction to conduct that assessment and asks the FERC to do it.<sup>135</sup>

This practice has no legal basis, because section 203 makes no wholesale-retail distinction. The FPA does not authorize the FERC to cede its obligatory public interest jurisdiction to state legislatures and state commissions.

Leaving the retail competition review to the states also leaves consumers unprotected. A merger adversely affecting retail competition or retail ratepayers would get a pass from the FERC if either (a) a state commission with jurisdiction fails to exercise it, or (b) a state commission without jurisdiction fails to seek the FERC's involvement. Some state commissions with jurisdiction have said, for example, that because their state does not authorize retail competition, concerns about a merger's effect on that competition is "speculative."<sup>136</sup> But the current absence of competition does not make the possibility of future competition—and harms to that competition—"speculative." If (a) there is some product customers want; (b) price and quality differentials among prospective suppliers are sufficiently large to justify customers' shopping effort; (c) the product's cost function does not signal a natural monopoly (which would make competition inefficient); and (d) there are no impossible-to-remove entry barriers, then future competition is possible and plausible; it has a probability above zero. This list of factors, which is not exhaustive, lends itself to factual investigation and factual analysis. The matter is "speculative" only if one avoids the investigation and analysis.

There could also be state commissions that lack jurisdiction but fail to seek the FERC's involvement. The reasons could be lack of attention, lack of merger expertise (because of the absence of jurisdiction), or pressure from the local utility to back off. The Commission regulates in a real world. These are real world possibilities. They do not justify the Commission's avoidance of real questions. They do not convert a merger with adverse effects into one without adverse effects.

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135. Merger Policy Statement, *supra* note 57, at Part III.F.

136. In its opinion approving the proposed Pepco-BG&E merger, the Maryland Commission said that "the retail competition picture is too undefined to weigh the impact of the merger on it now." The Commission added, however, that retail competition "is sufficiently possible to cause us to take steps adequate to assure that the merger does not disadvantage the public interest should retail competition materialize." The Commission retained its "full jurisdiction to mitigate" the merger's effects on any future retail competition." *In the Matter of the Joint Application of the Baltimore Gas and Electric Company, Potomac Electric Power Company and Constellation Energy Corporation for Authorization and Approval of a Merger and Associated Transactions*, 1997 Md. PSC Lexis 205, 176 P.U.R. 4th 316 at text accompanying n.11 (Apr. 16, 1997). That 1997 version of Pepco-BG&E merger did not go forward. The two companies were joined 20 years later, when Exelon, then the owner of BG&E, bought PHI Holdings, the owner of Pepco. See also *In the Matter of: Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for Approval of Merger*, 1997 Ky. P.U.C. LEXIS 274 (declining to consider merger's effect on retail competition).



An anonymous reviewer suggested that the FERC's practice honors the FPA's Declaration of Policy, specifically that such "Federal regulation . . . extend[s] only to those matters which are not subject to regulation by the States."<sup>137</sup> This suggestion has two problems. First, the quoted provision is only preamble; the actual jurisdictional provision, section 201(b), establishes certain limits on the FERC's authority but does not address merger transactions. Second, the phrase "such Federal regulation" refers to the objects of regulation cited previously in the Declaration: "matters relating to generation to the extent provided in this subchapter and subchapter III of this chapter and of that part of such business which consists of the transmission of electric energy in interstate commerce and the sale of such energy at wholesale in interstate commerce."<sup>138</sup> Again, mergers are not mentioned.

b. Status quo competition is sufficient; improvements are unnecessary

Although the FERC wants competition unharmed, it has not defined the competition that should not be harmed. The 1996 Policy Statement refers to EPart 1992's "competitive goals"; specifically, "competitive bulk power markets."<sup>139</sup> If this statutory goal means *effectively* competitive bulk power markets, it leads us to Scherer and Ross's structure-conduct-performance logic presented in Part IV.A.2 above.<sup>140</sup> But as that Part explained, the FERC's merger decisions nowhere establish accountable metrics for structure, conduct, or performance. I do not suggest that the structure-conduct-performance paradigm is the only way to assess competitiveness; the Commission has discretion to design its own analytical path. But the Scherer-Ross focus—indeed the necessary focus of any effort to define the vague term "competition" in practical terms—is on the end result: performance. The Commission does not assess a merger's effect on performance—of either the merged entity or the industry as a whole (the latter being a distinct error discussed at Part V.B below). On conduct, the FERC looks only for anti-competitive conduct—ignoring how a merger undisciplined by competition can displace more efficient transactions and absorb resources better used in other ways. The Commission thus denies consumers the benefits of the pro-competitive conduct that would result if the approved merger was a transaction produced by effective competition. On structure, the FERC addresses only the control of bottleneck transmission and strategic generation—again omitting Scherer and Ross's positive structural elements.

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137. 16 U.S.C. § 824(a). The full passage is as follows:

It is hereby declared that the business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest, and that Federal regulation of matters relating to generation to the extent provided in this subchapter and subchapter III of this chapter and of that part of such business which consists of the transmission of electric energy in interstate commerce and the sale of such energy at wholesale in interstate commerce is necessary in the public interest, such Federal regulation, however, to extend only to those matters which are not subject to regulation by the States.

138. *Id.*

139. Merger Policy Statement, *supra* note 57, at text accompanying n.1.

140. Scherer & Ross, *supra* note 97.

The FERC's real focus, then, is preventing harm to pre-merger competition. Appendix A requires applicants to define only status quo markets, then calculate the merger-caused changes to those markets. Whether a merger will preclude *improvements* to competition (such as by giving the merged company unearned advantages over future competitors in future markets, or by displacing a more cost-effective acquirer who could not offer as high a purchase price) is ignored. Also ignored is any competitive ineffectiveness in the pre-merger market. The Commission ignores such suboptimality as long as the proposed merger doesn't make things worse.<sup>141</sup>

By asking only whether the proposed merger reduces the competitiveness of the pre-merger market, the Commission fails to satisfy its own 1996 purpose: advancing "the competitive goals" of EPAct 1992. The goal of EPAct 1992 was not "don't harm the status quo"; the goal was "make markets competitive," meaning, necessarily effectively competitive. Any doubt is readily resolved by returning to the Federal Power Act itself, whose "history . . . indicates an overriding policy of maintaining competition to the *maximum extent possible* consistent with the public interest."<sup>142</sup> The FERC's merger policy doesn't insist on competition "to the maximum extent possible consistent with the public interest" because it has defined "public interest" incorrectly to mean something less than what is possible—merely no harm to the status quo. In a competitively weak market, even a merger that does not enable anti-competitive conduct can give the merged entity unearned advantages (unearned because they derive from the pre-merger market weaknesses), thereby making future competition suboptimal.

One might argue that "consistent with the public interest" necessitates a no-harm standard because "consistent with" does not mean "promoting."<sup>143</sup> That argument is circular—it assumes away the question because it ignores the meaning of "public interest." If the public interest is an interest in effective competition, and if effective competition means continuous improvement, then "consistent with the public interest" requires continuous improvement.

Contrast the Commission's 30-year indifference to improving competition through its merger decisions with its 20-year campaign to improve competition through its wholesale sales and transmission decisions. In Order No. 888 the FERC imposed nondiscriminatory transmission tariffs on all jurisdictional transmission.<sup>144</sup> The Commission acted then because, it found, new section 211 (added by EPAct 1992 to provide a complaint-only path for comparable transmission service) failed to improve status quo competition sufficiently.<sup>145</sup> Then in Order No. 2000, the Commission found that its Order No. 888 tariffs were not sufficient to ensure effective competition, so it created a path for transmission owners to form

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141. Readers wishing more complexity can consider whether the harm that the FERC does address is harm to consumer surplus, producer surplus, or total surplus. *See generally* the sources cited in Niefer, *supra* note 65, at 509 n.19 (2012).

142. *Otter Tail Power Co. v. United States*, 410 U.S. 366, 374 (1973) (emphasis added).

143. *See, e.g., Pacific Power & Light Co.*, 111 F.2d. 1014.

144. Order No. 888, *supra* note 54.

145. *Id.* at text accompanying nn.66 and 67 (finding that "section 211 alone is not enough to eliminate undue discrimination"; it is "an inadequate procedural substitute for readily available service under a filed non-discriminatory open access tariff").

regional transmission organization—and then required subsequent merger applicants to join RTOs.<sup>146</sup> Still seeking improvements to competition, the FERC issued Order No. 890, because even with the Order No. 888 tariffs, and even with regional transmission organizations, “opportunities for undue discrimination continue to exist,” requiring yet more adjustments to improve competition.<sup>147</sup> And there’s more. In Order No. 1000, the Commission again found that wholesale competition needed improvement, so it required transmission owners to create regional planning processes everywhere—not just in RTO regions.<sup>148</sup> Finally, in Order Nos. 719 and 745, the FERC required yet more improvements to RTO-organized markets, finding that those markets would not be sufficiently competitive without the participation of demand aggregators who were compensated comparably to generators.<sup>149</sup> The FERC has initiated similar improvements with a major order on storage.<sup>150</sup> Wholesale sales—continuous improvement; mergers—the status quo is sufficient. It is almost as if two policies are being run out of two separate agencies.

### c. Opportunity cost harm ignored

The Commission ignores the distinction between status quo harm and opportunity cost harm. Status quo harm occurs when the merger diminishes benefits available from the pre-merger status quo. But a merger also can divert resources from more productive uses, and it can displace benefits that would have arisen

146. Order No. 2000, *Regional Transmission Organizations*, 65 Fed. Reg. 809 (Jan. 6, 2000), F.E.R.C. STATS. & REGS. ¶ 31,089 (1999), *order on reh’g*, Order No. 2000-A, 65 Fed. Reg. 12,088 (Mar. 8, 2000), F.E.R.C. STATS. & REGS. ¶ 31,092 (2000) (finding that the “nature of the emerging markets and the remaining impediments to full competition that became apparent in the nearly four years since the issuance of Order Nos. 888 and 889 . . . have made clear that the Commission must take further action if we are to achieve the *fully competitive* power markets envisioned by those orders”) (emphasis added), *aff’d sub nom.* Public Utility District No. 1 of Snohomish County, Washington v. FERC, 272 F.3d 607 (D.C. Cir. 2001); *see also* Wabash Valley Power Ass’n v. FERC, 268 F.3d 1105, 1109 (D.C. Cir. 2001) (describing how the FERC issued Order Nos. 888, 889 and 2000 to improve wholesale competition).

147. Order No. 890, *Preventing Undue Discrimination and Preference in Transmission Service*, 72 Fed. Reg. 12,266 at P 26 (Mar. 15, 2007), F.E.R.C. STATS. & REGS. ¶ 31,241, *order on reh’g*, Order No. 890-A, 73 Fed. Reg. 2,984 (Jan. 16, 2008), F.E.R.C. STATS. & REGS. ¶ 31,261 (2007), *order on reh’g and clarification*, Order No. 890-B, 73 Fed. Reg. 39,092 (July 8, 2008), 123 F.E.R.C. ¶ 61,299 (2008), *order on reh’g*, Order No. 890-C, 74 Fed. Reg. 12,540 (Mar. 25, 2009), 126 F.E.R.C. ¶ 61,228 (2009), *order on clarification*, Order No. 890-D, 74 Fed. Reg. 61,511 (Nov. 25, 2009), 129 F.E.R.C. ¶ 61,126 (2009).

148. Order No. 1000, *Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities*, 136 F.E.R.C. ¶ 61,051 at PP 30-31 (2011 [hereinafter Order No. 1000]) (finding that the reforms adopted in Order No. 890 “provide an inadequate foundation for public utility transmission providers to address the challenges they are currently facing or will face in the near future”; “additional reforms . . .” are necessary . . . “to address remaining deficiencies in transmission planning and cost allocation processes so that the transmission grid can better support [competitive] wholesale power markets”; the new requirements will “enhance the ability of the transmission grid to support wholesale power markets.”) *aff’d*, South Carolina Pub. Serv. Auth. v. FERC, 762 F.3d 41 (D.C. Cir. 2014).

149. Order No. 719, *Wholesale Competition in Regions with Organized Electric Markets*, 73 Fed. Reg. 64100 (Oct. 28, 2008), F.E.R.C. STATS. & REGS. ¶ 31,281 (2008); Order No. 745, *Demand Response Competition in Organized Wholesale Energy Markets*, 134 F.E.R.C. ¶ 61,187, 76 Fed. Reg. 16,658 (2011).

150. Order No. 841, *Electric Storage Participation in Regions with Organized Wholesale Electric Markets*, 162 F.E.R.C. ¶ 61,127 (Feb. 15, 2018) (finding that existing market rules create barriers to entry by storage, “thereby reducing competition and failing to ensure just and reasonable rates”).

without the transaction. In doing so, the merger causes opportunity cost. As a leading economist has written, the “opportunity cost of an item—what you must give up in order to get it—is its true cost.”<sup>151</sup>

Here are two plausible examples. First, consider an acquirer selected by the utility target based on the purchase price offered rather than customer performance promised. If the merger displaced a transaction that would have produced better customer performance, it has caused opportunity cost harm—a real loss to customers.<sup>152</sup> Second, when an acquirer incurs acquisition debt, the resulting principal and interest payments preclude other expenditures. The loss of benefits from those expenditures is opportunity cost. In effectively competitive markets, transactions that involve opportunity cost have less success than transactions that do not, all else equal. By ignoring opportunity cost, the Commission violates the principle that regulation should produce results comparable to effective competition.

### *C. Regulatory deference without competitive discipline*

If the proposed transaction will cause no harm (as the Commission defines harm), and if the applicants offer a short-term rate benefit (which need not be “derived from” the transaction<sup>153</sup> and need not replicate the benefits that effective competition would provide), the Commission defers to the transaction. The Commission does not explore whether another transaction, or an alternative use of the merging parties’ resources, would be more cost-effective. This deference would make sense, and would be lawful, if the deferred-to transactions were disciplined by effective competition. But the Commission’s merger approvals fail this test, because mergers of retail monopolies are, by definition, not disciplined by effective competition.

#### 1. Competitive conditions create corporate strategy discipline

To understand this error of deference, consider mergers in the competitive context. In an effectively competitive market, the customers of a prospective target are free to shop among suppliers. So a prospective acquirer of that target is not buying a secure revenue stream; it is buying only an opportunity to compete for a revenue stream—a stream that can run dry if the customers choose a better performer. The risk of losing that stream disciplines the prospective acquirer’s offer price. That offer price will reflect the net present value of the expected post-merger earnings—with the expectation disciplined by competition for the customers’ favor. The competition among retailers for the target’s consumers disciplines the competition among acquirers for the target’s shareholders.

Where the acquisition price is disciplined by competition for the target’s consumers, the highest offer will come from the acquirer that can either create the most savings (enabling the merged entity to generate more profit while charging

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151. Krugman & Wells, *supra* note 39, at 7.

152. The public interest violation caused by this practice, long accepted by the FERC, is the subject of Part IV.B.5.c. below.

153. Contrary to the 1996 Merger Policy Statement, which says (at text accompanying n.21) that there must be “countervailing benefits that derive from the merger.”

the pre-merger product price) or provide the best performance (allowing the merged entity to raise the product price without losing customers). Either way, the winning bid should come from the combined company that will operate most cost-effectively. Competition thus aligns all interests: the acquirer's, the target's, and the consumers'. There are no foregone opportunities, no economic waste, no opportunity cost. The public interest has been served.

This scenario—effective competition in the target's retail market—brings one additional positive: The economic gain produced by this cost-effective transaction is shared among the acquirer, the target and the target's customers objectively—by market forces. As we will see in Part V.D below, the FERC's no-harm standard means that any merger-produced gain is allocated not by objective market forces but by negotiations among the merging companies, each of which has at its core a franchised utility not subject to objective market forces.

## 2. Retail monopoly mergers lack competitive discipline

Now consider an acquisition where the target is a utility with a franchised retail monopoly. Two things have not changed: The target shareholders still want the highest price, and the acquirer's bid price still will be constrained by the net present value of expected post-merger earnings. But two other things have changed. Because the retail market has no competition to discipline prices, the merging companies' interests diverge from the consumers' interest. Also changed is the size of the expected stream of earnings. Absent regulatory action, the profit-maximizing price charged by the target—a monopolist—will exceed that charged by a target that faces competition. So the target still holds out for the highest price, but without retail competition the acquirer offering the highest price will not necessarily be the best performer, since where there is no competition suboptimal performance faces no competitive penalty. The transaction will produce fewer competitive benefits than in the competition context. And those benefit levels will be determined by the regulator. The Commission's benefit level is a minor, temporary benefit aimed at harm prevention, a benefit that need not even be "derived from the merger." All remaining transaction value stays with the merging companies, divided between them as they wish. The merger results from pecuniary, opportunistic strategy rather than objective competitive forces, the allocation of benefits is skewed toward the merging entities, and resulting merged entity is not necessarily the best market performer. That is not a public interest outcome.

We should expect acquirers and targets to act self-interestedly; that is what profit-maximizers do. In markets subject to effective competition, pursuing self-interests can increase efficiency and thereby produce societal gains. But in the context of monopoly utilities, pursuing self-interests decreases efficiency and therefore produces societal losses. So regulatory standards must replicate competitive forces. As explained next, the FERC's standards do not.

## 3. The insufficiency of regulatory discipline

Utility merger negotiators will set a purchase price reflecting their expectation of regulated earnings (as well as their expectation for unregulated earnings). In mergers of retail utilities, the regulated earnings are dominated by state com-

mission decisions. Because the Commission does not consider whether state commissions test proposed mergers against a competitive standard, the Commission cannot know whether the acquisition prices of mergers it reviews were disciplined by regulatory treatment comparable to competitive pressures. The Commission said it intends its merger policy to assist the development of competition,<sup>154</sup> but its policy nowhere substitutes for the discipline of competition.

That wholesale customers typically reach settlements does not make merger terms consistent with competitive pressures. These settlements necessarily reflect wholesale customer expectations bounded by the Commission's no-harm, no-improvement policy. To cite these settlements as proof of the policy's competitiveness is therefore to argue in a circle. A rational wholesale customer will not likely forego a rate freeze or rate cut, even a temporary one, for the privilege of litigating a full merger case based on the unlikely prospect that the FERC will change its precedent. That parties settle these cases does not make the FERC's merger policy economically efficient—or lawful.

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Over these 30 years of merger rules and transaction approvals, the FERC has never described a desired outcome, in terms of ownership concentration, types of owners, corporate structure complexity, family business activities, or financial structure. Its only stated purpose has been to assist EPA's 1992's goal of encouraging wholesale, bulk power competition. The Commission aims only to prevent harm to status quo competition; it does not require merger applicants to show their transactions' consistency with future effective competition. The Commission's policy is indifferent not only to the corporate structure, financial structure, and business mix of any particular merged company; the policy is indifferent also to the economic efficiency of the industry as whole. In this context, indifference means deference—deference to merging companies' private interest strategies.

Deference is logical, and lawful, when competition is effective. In a merger involving retail utility monopolies, competition is not effective. The Commission's casualness with mergers resembles its prior casualness over oil pipeline pricing, about which the D.C. Circuit declared: "Without empirical proof that . . . existing competition would ensure that the actual price is just and reasonable, [the Commission's approach] retains the false illusion that a government agency is keeping watch over rates, . . . when it is in fact doing no such thing."<sup>155</sup>

#### V. SPECIFIC ANALYTICAL ERRORS: COMPETITION, RATES, AND REGULATION

The 1996 Policy Statement addresses competition, rates, and regulation. In addressing these subjects, the Commission makes five analytical errors. First, it gives insufficient treatment to retail competition—including head-to-head, yardstick, and franchise competition. Second, the FERC assesses each merger in isolation, ignoring the cumulative effects and offering no indication of necessary end points to the consolidation and complication that its policies have allowed. Third,

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154. Merger Policy Statement, *supra* note 57, at text adjacent to n.26 (expressing intent to "protect the public interest in the development of . . . highly competitive markets").

155. *Farmers Union Cent. Exch., Inc.*, 734 F.2d at 1510.

the Commission pays no attention to the financial risks associated with the premiums acquirers pay for targets. Fourth, the FERC disregards efficiency losses that result from targets choosing acquirers based on price bids rather than performance ability. Fifth, when assessing “effect on regulation” the FERC focuses only on preserving regulatory jurisdiction, when the larger concern is regulatory effectiveness.

A. *Competition analysis: Insufficient treatment of retail markets*

1. Effects on retail head-to-head competition: Left to state commissions

The Federal Power Act assigns to the Commission “consumer protection responsibility.”<sup>156</sup> The Commission acknowledges that this responsibility includes reviewing mergers’ effects on retail competition.<sup>157</sup> But the Commission will exercise that responsibility only if a state commission lacks authority and asks for help. So under the following plausible scenarios, the Commission would do nothing:

1. The state commission has state statutory authority to address the merger’s effects on retail competition but never addresses the subject.
2. The state commission lacks state statutory authority but does not understand the potential for adverse effects, or is not curious about them, so does not contact the FERC.
3. The state commission lacks state statutory authority, the state commission understands the adverse effects, but because the merging utilities have offered a temporary rate freeze or short-term rate credit at retail, the state commission decides that pleasing current ratepayers is more important than preserving retail competition for future ratepayers. So it approves the transaction without contacting the FERC.
4. The state commission has state statutory authority, but dismisses concerns as “speculative” without investigating the facts.<sup>158</sup>

The FERC cannot delegate its merger review powers to state commissions, because section 203 has no delegation provision and because state commissions have only the authority their state legislatures or constitutions grant them. In the context of retail competition, therefore, the FERC is not delegating authority; it is avoiding its responsibility to exercise authority. It is doing so for reasons unrelated to market facts, because the FERC’s decisions not to address retail competition are not based on market facts. The Commission is not deferring to a state commission analysis, because in the four situations above there is no state commission

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156. *New York Independent System Operator, Inc.*, 135 F.E.R.C. ¶ 61,170 at P 15 (2011).

157. Merger Policy Statement, *supra* note 57, at Part III.F.

158. *See, e.g.*, the Kentucky Commission’s rejection of retail market power concerns arising from the proposed merger of Louisville Gas & Electric and Kentucky Utilities. The Kentucky Commission viewed concerns about market power in retail markets as “highly conjectural and theoretical. . . . The total absence of direct competition in Kentucky’s existing retail electric market makes implausible any attempt to prove market power and obviates the need, at this time, to consider this issue.” Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for Approval of Merger, 1997 Ky. P.U.C. LEXIS 274.

analysis.<sup>159</sup> Under section 203, the Commission is not like a prosecutor, with legal discretion to choose the conduct it will address; its public interest responsibility does not depend on what states do.

Even if the FERC's § 203 responsibility were limited to a merger's effects on wholesale competition, retail competition affects wholesale competition. When multiple retail sellers vie for customers, they seek to distinguish themselves by their prices. For retail sellers lacking their own generation, the main input to their retail prices is wholesale purchase costs. Retail marketers facing strong retail competition will bargain more aggressively for low wholesale prices. So the quality of retail competition affects the quality of wholesale competition. Addressing this problem is not invading states' authority; it is taking into account state-level facts in assessing a FERC-jurisdictional transaction.<sup>160</sup> The Commission's indifference to retail competition disserves its own goals for wholesale competition.

## 2. Yardstick competition and franchise competition: Ignored

Yardstick competition is comparison competition. When regulators or customers are familiar with two or more companies, they can compare the prices and service quality, then make decisions—regulators, about cost disallowances and service quality penalties; customers (especially large industrial customers), about location decisions.<sup>161</sup>

A close cousin to yardstick competition is across-the-fence rivalry: adjacent companies vying to attract each other's existing loads or new loads. As the California Commission explained:

Existing customers who are facing other pressures to relocate, such as plant modernization or expansion, may select a site within the area served by the preferred utility. New customers, without an existing location in either service area, will make the same election. These will include residents who may be accommodated by housing or commercial development in areas of the service territory which admit such expansion. Finally, existing consumers with neither the opportunity nor means to relocate

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159. The situation therefore differs from FERC's logical and permissible reliance on a state commission's finding of retail cost imprudence as a basis for eliminating the utility's rebuttable presumption of wholesale cost prudence. *Southern California Edison Co.*, 8 F.E.R.C. ¶ 61,198, at ¶ 61,680 (1980) (shifting burden of going forward to the utility on prudence of nuclear construction costs, due to state commission's finding of imprudence; utility had offered the FERC only "vague generalizations about the problems inherent in all building projects"), *aff'd sub nom.*, *Anaheim v. FERC*, 669 F.2d 799 (D.C. Cir. 1981).

160. As the Supreme Court said FERC must do in the context of price squeeze. *Federal Power Commission v. Conway Corp.*, 426 U.S. 271 (1976) (holding that if wholesale price squeeze is alleged, Commission must consider retail rate levels when determining lawfulness of a wholesale rate).

161. See, e.g., *Florida Power & Light Co.*, Opinion No. 57, 8 F.E.R.C. ¶ 61,121 (1979) (describing the importance of "significant" yardstick competition and franchise competition between FP&L and its municipal wholesale customers, and noting that such competition is vulnerable should utility use its "wholesale monopoly power . . . to maintain or enhance [its] retail market position"); see also Reiter, *supra* note 65 (citing Alfred Kahn's statement that regulators "are essentially incapable of assuring that performance will be positively good," as reason why regulators should use yardstick competition to supplement regulation). The current author, who has advised and appeared before many state commissions, does not agree fully with Professor Kahn's statement about regulators' incapability, but does agree on the usefulness of yardstick competition. For the author's eulogy of the legendary Dr. Kahn, see <http://www.scotthemplinglaw.com/essays/alfred-kahn>.



will take their complaints to the management of the utility deemed to charge excessive rates or deliver inferior service.<sup>162</sup>

The loss of this inter-utility rivalry was one reason why the California Commission rejected the merger of Southern California Edison and San Diego Gas & Electric. With rivalry, the public was “advantaged by the presence of proximate comparative data,” data that actually spurred SDG&E to study the reasons for its higher rates. “[T]he loss of SDG&E as a regulatory comparison is an adverse unmitigable impact of the proposed merger,” diminishing the Commission’s “ability to regulate the merged utility effectively.”<sup>163</sup>

Despite dozens of adjacent-utility mergers, the FERC has never discussed the harm from diminished yardstick competition or across-the-fence rivalry.

The FERC also disregards mergers’ effects on franchise competition. While economies of scale can justify a monopoly franchise, consumers can benefit from competition for that franchise: The “public has an obvious interest in competition, ‘even though that competition be an elimination bout.’”<sup>164</sup> Any company with electricity experience, access to financing, service reputation and knowledge of the region is a potential franchise competitor.<sup>165</sup> But as with benchmark competition, the FERC has approved dozens of mergers, including adjacent-utility mergers, without questioning their effects on franchise competition.

#### *B. Analysis-in-isolation: Missing mergers’ cumulative effect*

Assessing each transaction isolated from the others, the FERC does not address their cumulative effects. Mergers of remote companies, made possible by the repeal of PUHCA 1935,<sup>166</sup> avoid the Appendix A screen because the merging companies serve distant, distinct markets; neither company’s output can substitute for the other’s. Opponents to the Duke-Cinergy merger argued that while individual remote-company mergers might pass the screen, the FERC should consider whether their cumulative effect will undermine competition. The Commission disagreed, saying it had no obligation to assess a merger “not only on its own

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162. *SCEcorp, S. Cal. Edison Co. and San Diego Gas & Elec. Co.*, Decision No. 91-05-028, 40 CPUC 2d 159, 122 P.U.R. 4<sup>th</sup> 225, PUC LEXIS 253, at \*236-37 and n.68, \* 238, \*262. (Cal. P.U.C. 1991); see also *AT&T, Inc. & BellSouth Corp.*, 22 F.C.C. Rcd 5,662, at 5,755 ¶ 188 (expressing concern that mergers reduce benchmarks, especially concerning “new technologies and services”).

163. *Id.* at 262, 360.

164. *Hecht v. Pro-Football, Inc.*, 570 F.2d 982, 991 (D.C. Cir. 1977) (quoting *Union Leader Corp. v. Newspapers of New England, Inc.*, 284 F.2d 582, 584, at n.4 (1st Cir. 1960)). The rarity of active franchise competition is due more to the lack of clear legal procedures than the lack of economic benefits. See Scott Hempling, *Competition for the Monopoly: Why So Rare* (January 2013), <http://www.scotthemplinglaw.com/essays/competition-for-monopoly>; Harvey Reiter, *Competition Between Public and Private Distributors in a Restructured Power Industry*, 19 ENERGY L.J. 333 (1998) (distinguishing competition in the market from competition for the market, and describing the benefits of allowing “public and private ownership structures to be pitted against each other”).

165. *Borough of Ellwood City v. Pa. Power Co.*, 462 F. Supp. 1343, 1346 (W.D. Pa. 1979) (“If plaintiffs [municipalities] were to become unable to serve their customers profitably, Penn Power [the investor-owned utility serving that area] would logically be in the best position to assume plaintiffs’ present service.”).

166. As explained in Part I above.

specific terms but [also] as a harbinger of change.”<sup>167</sup> Section 203 requires the FERC to “approve a transaction if *it* is consistent with the public interest,” so the Commission “cannot deny or condition a proposed merger based on speculation about general trends that may or may not occur in the future.” While “as markets evolve, product market and geographic market definitions can change,” the Commission “will not speculate on what general trends might emerge; rather, we will evaluate the effect of the merger on competition based on the record in this case.”<sup>168</sup>

What a difference 30 years makes. What the FERC in 2005 called speculation, the FPC in 1976 saw as cause for concern. Addressing a merger of two electric utilities in Maine, the Commission cited as a “guideline” the Clayton Act’s concern with “incipiency.” The Clayton Act, said the FPC,

looks not merely to the present effect of a merger but to impact upon future competition between many small entities by “arresting a trend toward concentration in its incipency before that trend developed to the point that a market was left in the grip of a few big companies . . . Thus, where concentration is gaining momentum in a market, we must be alert to carry out Congress’ intent to protect competition against ever increasing concentration through mergers.”<sup>169</sup>

The FPC then cited the “national trend toward concentration” as reason to consider incipency. (The Commission did cite several public interest rationales for mergers, including “optimal scale generating facilities, the scarcity of EHV transmission for long range transmission of electric power and the existence of exclusive franchise areas.”<sup>170</sup>) Today as in 1976, we have a “national trend toward concentration.” Given the Commission’s obligation to apply antitrust principles,<sup>171</sup> its merger decisions must consider the Clayton Act’s concern with incipency.

The Commission declines to “speculate.” If “speculate” means “guessing without evidentiary or logical basis,” the Commission is correct. But a refusal to speculate does not excuse a refusal to extrapolate. Using facts and logic to identify transactional purposes, and to assigning probabilities to possible outcomes, is extrapolating, not speculating. For it is not “speculative,” *i.e.*, lacking evidentiary or logical basis, to say that (a) if two companies find it privately beneficial to merge and the FERC allows it, then (b) other companies will do the same, and then (c) still others will also. This extrapolation is especially non-speculative if history tracks that very sequence. Perhaps in 1985, when Toledo Edison and Cleveland Electric Illuminating merged, one might not have predicted that 70-plus industry mergers would follow, and that Toledo Edison and Cleveland Electric would now

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167. *Duke Energy Corp. & Cinergy Corp.*, 113 F.E.R.C. ¶ 61,297 at P 39 (2005); 2005 FERC LEXIS 3051 (2003) (paraphrasing arguments of American Public Power Association and National Rural Electric Cooperative Association).

168. *Id.* at P 78.

169. *Central Maine Power Co. & Rangeley Power Co.*, 55 F.P.C. 2477 (1976) (quoting *United States v. Von’s Grocery Co.*, 384 U.S. 270 (1966) (interpreting Clayton Act § 7)).

170. *Id.*

171. *Gulf States Util. Co. v. FPC*, 411 U.S. 747 (1973) (interpreting the “public interest” under FPA § 204 to require the Commission to consider “the fundamental national economic policy expressed in the antitrust laws”).

be minor members of the multi-company, multi-state FirstEnergy. But by 2005, with over 45 transactions approved and consummated, there were factual and logical bases for assuming that each merger would generate more mergers. No speculation was necessary.

It is reasonable to expect that if Companies A and B find it profitable to merge, so will Companies C and D—and that C and D will do so not only because they find it profitable but also *because A and B have merged*. It is also reasonable to assume that as mergers proceed, the unmerged will wonder whether remaining standalone is becoming a disadvantage—not because of any diseconomy but because now a larger size is preferred by “the financial community,” creating better access to lower-cost capital.<sup>172</sup> Or because target CEOs feel pressured to get for their shareholders the same gains other targets CEOs have gotten for their shareholders. As for the “more competitive” point, the public interest effects are ambiguous. Merger applicants do not necessarily mean “more competitive” in the sense of improving on cost and quality—actions that make *the market* more competitive as rivals try to match those improvements. To merger applicants, “more competitive” can instead mean instead that larger size means larger market share, more dominance and more ability to exclude competitors. These possibilities are not speculative, because they have factual and logical support. Mergers cause other mergers, creating cumulative effects. Whether those cumulative effects are positive or negative is not necessarily clear—but it is not speculating to raise the question.

Only in utility regulation is the term “speculate” considered a pejorative. John Snow speculated that London’s 1854 cholera epidemic might be related to a water pump—and was right.<sup>173</sup> Astronomers speculated about black holes—and then discovered them. Nikola Tesla and Thomas Edison speculated about ways to move electric current over long distances—and found solutions.<sup>174</sup> To predict the cumulative effects of electricity mergers, we have historical facts.

The Commission’s legal error is to view the “public interest” as comprising only the customers of the merging companies. Their interest is but a part of the full public interest, which includes all customers whose future options are plausibly affected by a predictable chain of events—each merger leading to others. The Commission cannot serve that public interest by approving transactions in isolation.

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172. See, e.g., Rebuttal Testimony of Vincent L. Ammann, *In the Matter of the Merger of AltaGas Ltd and WGL Holdings, Inc.*, Md. Pub. Serv. Comm’n Case No. 9449 (Sept. 11, 2017) (asserting that the acquisition of Washington Gas Light by AltaGas will improve the former’s access to capital).

173. This landmark event in the history of data analysis is beautifully rendered by Edward Tufte in his *Visual Explanations* 27–37 (1997). A photograph of London’s John Snow Pub, located at the site of the deadly pump, appears at [https://www.edwardtufte.com/bboard/q-and-a-fetch-msg?msg\\_id=0002Je](https://www.edwardtufte.com/bboard/q-and-a-fetch-msg?msg_id=0002Je).

174. For a fine fictional account, see GRAHAM MOORE, *THE LAST DAYS OF NIGHT: A NOVEL* (2017). Washington D.C.’s baseball fans speculate about the Nationals’ World Series chances—but that speculation is only hope, because the historical facts give no support.

*C. Financial risk relative to transaction value: No standards, no inquiry*

To buy a target's stock for cash, the acquirer needs financing. (A stock-for-stock exchange requires upfront cash only for transaction costs (advisory fees, filing fees and regulatory costs), and for transition costs (the costs of meshing the two companies' operations).) The acquirer's financing can come from four sources: retained earnings, new debt, new equity, and sale of the acquirer's or target's assets.<sup>175</sup> Acquisition financing involves risks to the merged entity. The type and magnitude of those risks depends on, among other things, the mix of debt and equity.

*Risks of debt financing:* Acquisition debt adds debt to the merged entity's consolidated capital structure, affecting its bond ratings and thus the cost of future debt. The rational acquirer makes a private calculation: How will the increase in interest cost caused by a possible ratings decline compare to the benefits gained from issuing the debt, relative to other means of financing the acquisition?

The public interest perspective is different. If the merged entity's earnings fall behind lenders' expectations, the possible results include higher interest costs and even default.<sup>176</sup> Increasing the merged entity's debt reduces its ability to absorb regulatory actions that protect consumers. These regulatory actions include not only cost disallowances (either for imprudent actions or for prudent but not-used-and-useful investments<sup>177</sup>), but also competition-injecting actions like substituting third-party supply for the utility's traditional rate-based expenditures.<sup>178</sup> State regulators can use these tools to improve industry performance—but not if doing so could weaken the utility's debt-burdened parent. This consequence of acquisition debt receives no FERC attention.

*Risks of equity financing:* Where the acquirer issues equity to buy the target at a premium, the acquirer's existing shareholders can suffer dilution. The market

175. Here are two examples. In Exelon's acquisition of PHI, the total transaction cost was \$7.3 billion: \$6.826 billion for the cash purchase price and \$0.514 billion for transaction costs. The sources of financing for the \$7.3 billion were \$3.5 billion in new debt, \$1.841 billion in new equity, \$1.0 billion in mandatory convertible debt, and \$1.0 billion from the sale of Exelon generating assets. Exelon would also assume \$6.197 billion in PHI's consolidated outstanding debt. Direct Testimony of John W. Wilson in D.C. PSC Formal Case No. 1119 at 8 (Nov. 2014) (citing discovery submissions).

In Great Plains Energy's original proposal to acquire Westar's stock for cash, GPE would have paid \$8.6 billion for all of Westar's equity. Of that \$8.6 billion, \$4.4 billion would have come from new debt, and \$4.2 billion from new equity and preferred convertible stock. Proxy Statement, Form DEFM14A (Aug. 25, 2016) at 8-9; Joint Application in KCC Docket No. 16-KCPE-593-ACQ at ¶ 8 (June 28, 2016).

176. "[L]everage is almost always a factor in a company's spectacular success and even more leverage often plays a part in a subsequent failure. For leverage occupies the same multiplier role in the expanding growth of earnings in a period of corporate success as it may later play on the downside when earnings shrink and ultimately turn into mounting losses." Cudahy & Henderson 2005, *supra* note 31, at 93.

177. See, e.g., *New England Power Co.*, 8 F.E.R.C. ¶ 61,054 (1979), *aff'd sub nom.* NEPCO Mun. Rate Comm'n v. FERC, 668 F.2d 1327 (D.C. Cir. 1981) (upholding FERC's decision to disallow rate-basing of prudent unamortized expenditures on cancelled plant while allowing their recovery over five years; treatment was a reasonable balance of policy objectives).

178. Two examples: Some states are requiring utilities to use competitive bidding for new generation, rather than automatically granting this profit opportunity to the utility. And the FERC's Order No. 1000 eliminated from transmission arrangements incumbents' "right of first refusal" to build regional transmission facilities, thus creating opportunities for new entrants to displace incumbent utilities in providing that service. Order No. 1000, *supra* note 48.

value of what they receive (stock of the target) is less than the price their company pays (because of the premium above the target's market price). The rational acquirer will compare that current dilution penalty to the future value (discounted to the present) the acquirer hopes the acquisition will create. As with debt financing, this private calculation differs from the public interest calculation. When NextEra sought to acquire Oncor, its acquisition financing emphasized debt to avoid equity dilution. But to obtain debt financing on acceptable terms, NextEra insisted on having control of Oncor's Board and its cash flow. That insistence, among other factors, caused the Texas Commission to reject the transaction.<sup>179</sup>

The effects of these debt and equity risks vary with competitive conditions. If the merged utilities' products are subject to effective competition, their customers can move to other suppliers if finance risk affects price or quality adversely. That risk of customer loss would induce the merging parties to choose a purchase price and finance mix consistent with their customers' interests. When retail electric monopolies merge, however, we lose that competitive discipline; we must replace it with regulatory discipline. But the Commission has no standards for acquisition financing. Indeed, many Commission merger decisions do not even describe the transaction financing, let alone assess its consistency with the public interest.

Nor are the rate protection mechanisms<sup>180</sup> sufficient to protect against inappropriate financing. They cover only the first few years, whereas financing risks can affect later years. And they are not calibrated to financial risk; they are generic freezes and reductions, usually obtained in settlements designed solely to satisfy the 1996 Policy Statement.

*D. Allocating transaction value between customers and shareholders: No standards, no inquiry*

Most mergers involve an acquisition premium: the excess of purchase price over the target's unaffected market price.<sup>181</sup> In cash buyouts, the premium is paid, naturally, in cash—target shareholders sell their stock to the acquirer for a price exceeding its market value. In stock-for-stock exchanges with a premium, the

179. Joint Report and Application of Oncor Electric Delivery Company LLC and NextEra Energy, Inc. for Regulatory Approvals Pursuant to PURA §§ 14.101, 39.262, & 39.915, P.U.C. DOCKET NO. 46238, at text accompanying nn.9 and 10 (Texas Pub. Utils. Comm'n Apr. 13, 2017) (expressing concern that Oncor's revenues would be needed to support about 15% of the acquiring holding company's consolidated debt, "increasing financial risk to Oncor, particularly if Oncor's existing ring fence is to be weakened substantially as requested by NextEra Energy").

180. Explained in Part III.B.2 above.

181. Two clarifications. First, in finance parlance "unaffected" means "unaffected by the merger." The unaffected market price is the published market price for the target's stock before news of the likely acquisition leaked. Financial analysts sometimes differ over the correct date to use for the "unaffected" price. Second, regulatory analysts often use the term "acquisition premium" to refer not to the excess of purchase price over the target's market value, but rather the excess of purchase price over the target's book value. That latter number—a larger number—consists of two layers. The lower layer is the excess of unaffected market value over book value; the upper layer is the excess of purchase price over unaffected market value. This Part of the article focuses only on the upper layer—the excess of purchase price over unaffected market price. For reasons explained shortly, I refer to this amount as the "control premium."

value of acquirer stock received by the target shareholders exceeds the value of the target stock they give up.<sup>182</sup>

While a cash premium is a real cost to the acquirer, the FERC does not usually allow its recovery in rates.<sup>183</sup> Otherwise, the acquirer and target could agree on any premium, then make customers pay for it, limited only by the customers' elasticity of demand—low, for captive customers buying an essential service.

Distinct from premium cost recovery is a question the FERC has never addressed: Who gets to keep the gain produced by the premium, and how does the allocation of that gain affect the public's interest in efficient corporate couplings? That is the subject of this subsection.

Consider the difference between the competitive context and the utility monopoly context. In the competitive context, an acquisition premium is not inherently problematic. Where the merged entity faces competition in its retail product market, the acquirer will offer a premium no greater than what that competition will allow it to recover; the target shareholders transfer their stock to the acquirer, and whatever gain results is the target shareholders' to keep. The regulated utility setting is different because of the nature of what is being sold. As explained in the next subsection, the target shareholders are selling not only their stock; they are selling control of a government-created, government-protected monopoly franchise. The value of that franchise control is attributable, at least in part, to regulators' actions and captive ratepayers' financial support. To allow target shareholders to keep the entire gain, as if they had created that value, is to treat the franchise as a shareholder-owned asset. But the franchise is not a shareholder-owned asset; it is a government-created privilege. This misallocation of gain, long tolerated by regulators (including the FERC), distorts the merger market by favoring acquirers who can win based on acquisition price, over acquirers who should win based on promised performance.

#### 1. Control premium allocation: 100 percent to target shareholders

An ordinary stock purchaser buys but a sliver—an entitlement to a small share of the company's future earnings. For that sliver she pays the market price and only the market price, because she is purchasing stock and only stock. She owns passively. The corporate acquirer, in contrast, buys not just stock; it also buys control.<sup>184</sup> It will own actively, using its control to increase earnings in ways

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182. While merger premiums are typical, a recent exception was the 2018 merger of Great Plains Energy and Westar, a stock-for-stock exchange in which the merging entities set the exchange rate such that neither company's shareholders received a premium. Order Approving Merger at PP 34, 40, Docket No. 18-KCPE-095-MER (May 24, 2018).

183. See 1996 Merger Policy Statement, *supra* note 57, at text adjacent to n.65 (stating that "the Commission historically has not permitted rate recovery of acquisition premiums," but preserving applicant's opportunity to seek recovery in a post-merger rate application); *Ameren Corp.*, 140 F.E.R.C. ¶ 61,034 at P 30 (2012) (holding that "rate recovery of an existing facility is generally limited to the original cost of the facility and recovery of acquisition premiums including goodwill in cost-based rates is allowed only if the acquisition is prudent and provides measurable, demonstrable benefits to ratepayers").

184. An acquirer can buy control with much less than 100 percent of the target's stock. But the typical acquisition in the electric utility space is an acquisition of 100 percent of the target's stock.

ordinary investors cannot: by installing directors and executives, aligning the target's assets and practices with the acquirer's objectives.

This difference, between ordinary shareholder and corporate acquirer, explains the acquisition premium. Since the ordinary shareholder can own only passively, she pays no more than the market price because she can do nothing to increase the company's value. The corporate acquirer pays a premium because it can use its control to increase the company's value. Finance experts call this premium the control premium because it is the extra amount paid to gain control.<sup>185</sup>

In the typical utility acquisition, 100% of the control premium—the value the acquirer places on control—goes to the target company's shareholders. The target's customers receive something much smaller—the temporary rate freeze or rate decrease required by the Merger Policy Statement, and the counterpart benefits offered by the applicants in state commission proceedings. The control premium, however, is normally multiples of these customer benefits.<sup>186</sup> One can quarrel with specific calculations but there can be no reasonable disagreement on two points. First, that target shareholder gain and promised customer benefits are quantities of different magnitudes; second, that the promised customer benefit is based on what the applicants believe is needed to gain regulatory approval, whereas the shareholder gain is determined by what is necessary to win the bidding contest for shareholder approval. As discussed next, this disproportionality violates the core regulatory principle that benefits go to benefit-creators.

## 2. Control premium allocation: Disproportionate to the target's merits

If the control premium represents the acquirer's valuation of control, on what factors is that valuation based? And if the target shareholders get to keep the entire gain, what did they do to deserve it? Of four likely sources of value, three of them lack connection to the target's performance—a fact inconsistent with the regulatory practice of allowing target shareholders to keep 100% of the premium.

### a. The value of owning an exclusive retail franchise

A utility franchise's revenue stream is substantially determined, and protected, by the statutory just and reasonable standard and the Constitution's assurance of just compensation.<sup>187</sup> Had the utility paid cash for its franchise, like a McDonald's franchisee or New York City taxi driver (when buying the required

185. If the target has non-utility businesses, some portion of the control premium will be attributable to the projected earnings of those businesses. That portion of the control premium is outside regulation's concern.

186. In the Exelon-PHI case and in the proposed acquisition of HEI (the holding company for Hawaiian Electric Company and affiliates) by NextEra, the author testified that the control premium was, respectively, 12 times and 9 times the size of the promised ratepayer benefits. The Exelon acquisition of PHI (the holding company for Pepco) gave ratepayers, under the Maryland Commission's decision, \$100 per customer, along with other benefits. See *In the Matter of the Merger of Exelon Corp. and Pepco Holdings*, Case No. 9361, Order No. 86990 at Part IV (Md. Pub. Serv. Comm'n, May 15, 2015). Other merger decisions have included long lists of items deemed by state commissions to be public interest benefits. But those items' dollar values have been small compared to what target shareholders receive.

187. *Farmers Union Cent. Exch., Inc.*, 734 F.2d at 1504-5 (quoting legislative history of the Interstate Commerce Act—the first U.S. statute using the “just and reasonable” phrase—as demonstrating congressional intent that seller earn a “fair profit”); U.S. Const. amend. V (“nor shall private property be taken for public use, without just compensation”).

medallion), one could attribute at least part of the franchise's current value to that original investment. But electric utilities do not buy their franchises; they receive them for free. (They do pay franchise fees, but then include those fees in the revenue requirement.) They accept an obligation to serve and spend money to satisfy that obligation. In return they receive the right to charge government-set rates designed to give them a reasonable opportunity to earn a fair return on capital invested to honor their obligation. Since an acquisition target does not pay for its franchises, and since its prudent investments receive lawful returns,<sup>188</sup> the target's shareholders cannot say that the acquirer's perceived value in controlling a government-granted franchise is attributable to the target's performance.

b. The value of making decisions that increase the utility's actual earnings above the level regulators normally authorize

The 100% acquirer has purchased control over key decisions, including—

1. personnel for the Board and executive ranks;
2. rate case strategy—*e.g.*, the size and timing of rate requests and the persuasion techniques to deploy;
3. whether and when to withhold merger savings from ratepayers;
4. whether and when to share cost information with regulators;
5. whether, when, and how to influence government policy on matters affecting current and future growth and profitability, such as market structure changes (*e.g.*, encouraging or discouraging alternative suppliers of retail service and distributed resources), rate-basing opportunities (*e.g.*, buy vs. build decisions), and allocation of risks and benefits between shareholders and ratepayers;
6. the nature and timing of infrastructure spending;
7. the mix of debt and equity, including when to inject equity into the utility and draw dividends from the utility, when to issue debt and whether to issue it at the utility level or the holding company level, and finance acquisitions with double-leveraging (explained at paragraph (c) below);
8. whether and when to use the acquired utility franchise to create more business opportunities (such as home energy auditing, heating, ventilation, and air conditioning); and
9. whether and when to use the acquired utility franchise as an asset to support the acquisition of other businesses, including more utility franchises.

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188. Under the filed rate doctrine, whatever return actually earned under rates set lawfully is, technically, a lawful return. If the actual return is lower than the authorized return, or if the authorized return no longer reflects the true cost of equity, the utility can seek a prospective rate increase. But the existing rate, until changed prospectively, is the lawful rate. See SCOTT HEMPLING, REGULATING PUBLIC UTILITY PERFORMANCE: THE LAW OF MARKET STRUCTURE, PRICING AND JURISDICTION at ch.9 and sources cited there (American Bar Assoc. 2013).



Two examples come from AltaGas's efforts to acquire Washington Gas Light Holdings, the holding company for Washington Gas Light.<sup>189</sup> AltaGas's CEO testified that "[t]he combined company will harness the strength of the platform that WGL has built in Maryland, Virginia and Washington, D.C. to continue to grow our presence in each of these jurisdictions, and to further invest in the region."<sup>190</sup> He also described the transaction as a "'vote of confidence' in Maryland, Virginia, and the District as good places to do business." He said the merging companies are "excited to pursue growth opportunities in the region."<sup>191</sup>

The three jurisdictions are "good places to do business" in part because the utility's franchises ensure stable, profitable revenue streams from captive ratepayers. Those revenue streams also assist the target holding company's entry into non-utility businesses. WGL Energy Services, the similarly named affiliate of the government-approved gas distribution company, has a large share of the competitive retail gas market, likely because of its name recognition and utility-assisted access to lower-cost capital.

c. The acquirer's expectation that post-merger, the target utility can charge rates producing a return exceeding the authorized return

The control premium reflects the acquirer's expected stream of earnings from the acquisition, including earnings exceeding the return authorized by the target's state regulator. One possible source of excess earnings is double-leveraging. The acquirer buys the target utility's equity in part with debt, then persuades that utility's rate regulator to set rates that allow an equity-level return on that equity purchased with debt.<sup>192</sup> An acquirer's ability to finance equity with debt, then persuade regulators to allow equity-level returns on that debt, owes nothing to the target's performance merit. It results solely from the interaction of three factors: (a) the distinction financial markets make between interest cost and equity cost, (b) the target's utility customers' duty to pay the rates set by the regulator, and (c) the acquirer's ability to use its control of the acquired target to effect the double-leveraging—something no individual stockholder could do.

While double-leveraging has its critics,<sup>193</sup> my point is different: The opportunity to double-leverage contributes to the control premium target shareholders receive, but it has no connection to the target's performance merits.

189. The author was a witness in the Maryland and D.C. proceedings on this transaction. The acquisition, subject to conditions, was approved in 2018 by the commissions in both jurisdictions. *In the Matter of the Merger of AltaGas and WGL Holdings*, Case No. 9449, Order No. 88631 (Md. Pub. Serv. Comm'n, April 04, 2018); *In the Matter of the Merger of AltaGas and WGL*, Case No. 1142, Order No. 19396 (June 29, 2018).

190. Direct Testimony of AltaGas CEO David M. Harris in Md. Pub. Serv. Comm'n Case No. 9449, 7 (April 24, 2017).

191. *Id.*

192. Financial analysts call this technique "double-leveraging" because there is debt at both the holding company level and the utility level. They also describe it, without intending to be pejorative, as "financial engineering" because the extra earnings come not from performance merit but finance technique. *See, e.g.*, Letter from Ryan Wobbrock, Vice President at Moody's, to Lori Wright of Great Plains Energy (May 18, 2016), provided in discovery in KCC Docket No. 16-KCPE-593-ACQ (using the term "financial engineering" when referring to one of GPE's acquisition debt scenarios).

193. In rejecting Great Plains Energy's original proposal to acquire Westar, the Kansas Corporation Commission described double-leveraging as allowing the utility to charge rates exceeding cost:

d. The target company's merits

Executive decisions affect value. A poorly managed utility can have frequent outages, surly employees, unreliable infrastructure, sloppy money management, and high operating costs. The result—high rates, poor service, diminished reputation, low customer loyalty, and regulatory penalties—will push earnings down. The service territory will be less attractive to new load, less able to attract top talent, and less appealing to investors—leading to deferred maintenance, more outages, higher rates, and more alienated customers. Excellent management, in contrast, produces high-quality service at reasonable prices, higher customer loyalty and greater regulatory satisfaction—allowing the prospective acquirer to project a long-lasting stream of stable earnings and rising value. A target's meritorious performance justifies a portion of the control premium.

Of these four possible contributors to value to the acquirer, only the fourth is attributable to the target's merits; the first three are not. Yet regulators, both state and FERC, typically allow the entire premium to go to the target's shareholders—a mismatch of risk and reward that gets no attention from the FERC.

3. Legal principle: Target shareholders have no automatic right to the entire control premium

In effectively competitive markets, costs are borne by the cost-causers and value is received by the value-creators. If regulation is to emulate competition, the control premium must follow that logic. The Commission's merger approvals do not. As just explained, the control premium is not likely attributable entirely to the target's merit; yet the Commission routinely approves transactions that give the control premium entirely to the target's shareholders.

This principle—that the control premium should not go automatically to the target's shareholders if they did not create its value—has been contested by merger

[I]t appears that while the Joint Applicants do not propose to include the acquisition costs in rate base, they still plan to recover the acquisition premium indirectly from ratepayers. . . . [I]f the Joint Applicants are allowed to use a capital structure for ratemaking purposes that is not representative of the financing for the transaction, the ratepayers are actually subsidizing the acquisition premium. There is a separate weighted cost of capital at the operating utility level versus the parent level. Traditionally, there is little difference between the weighted cost of capital at both levels. But as proposed by the Joint Applicants, the parent (GPE) is taking on additional leverage at historically low rates. As a result, the weighted cost of capital for GPE will be significantly less than that of the operating utility subsidiaries. Such a financial structure allows the Joint Applicants to recover the acquisition premium by taking advantage of the *difference between the higher returns paid to the operating utilities and the low cost of debt*. GPE “acknowledges that there is a financial benefit derived from the way the transaction is being financed.” Rather than refund the difference to the ratepayers, GPE is retaining those funds to pay the acquisition premium. Essentially, GPE is using the ratepayers as its bank.

In the Matter of the Joint Application of Great Plains Energy Inc., Kansas City Power & Light Co. and Westar Energy, Inc. for Approval of the Acquisition of Westar Energy, Inc. by Great Plains Energy Inc., FERC Docket No. 16-KCPE-593-ACQ at ¶¶ 44 and 45 (Apr. 19, 2017) (footnotes omitted) (emphasis added). The Kansas Commission rejected this transaction in the above-cited Order. An order on reconsideration invited a revised application at a lower price with less debt. The two companies then reached a new agreement under which they would merge via a non-cash, stock-for-stock exchange with no implicit premium. That revised merger agreement was approved by the KCC in its Order Approving Merger, In the Matter of the Joint Application of Great Plains Energy Inc., Kansas City Power & Light Co. and Westar Energy, Inc. for Approval of the Acquisition of Westar Energy, Inc. by Great Plains Energy Inc., Docket No. 18-KCPE-095-MER (May 24, 2018).

applicants. They argue that any allocation of the control premium to the target's ratepayers violates statutory and constitutional principles. They make three main arguments: (a) The franchise is an asset—their asset—so like any asset they are entitled to the gain on sale; (b) their ownership of the target's stock necessarily entitles them to all value associated with that stock; and (c) denial of the gain is a taking without just compensation, prohibited by the Fifth Amendment. Responses follow.<sup>194</sup>

a. A utility franchise is a conditional privilege; it is not the shareholders' private asset

A utility's franchise consists of rights and responsibilities: rights granted by the government, responsibilities undertaken by the utility. The rights include an exclusive right to provide legally-defined services to a largely captive customer base, and the right to receive compensation that satisfies statutory and constitutional standards. The responsibilities include providing defined services that satisfy regulatory standards, refraining from undue discrimination, and charging only those rates authorized by the regulator.<sup>195</sup>

The franchise is a privilege, conditioned on compliance with its terms. The franchise is not an asset, like a McDonald's franchise or a New York City taxi medallion—something whose owner, having purchased it with cash, can resell. It is not like corporate stock, or buildings, or trucks or power plants. The franchise is created by the government, granted to whomever the government chooses, based on standards the government establishes. The franchise is a privilege to serve, not an asset to keep or sell.

The franchise does have value to its holder; but that value is created and supported by government action. It is not like the wireless spectrum, where each purchaser takes a risk that what it pays to prevail in the FCC auction it will lose in the competitive wireless market. That very risk disciplines the auction bids. The utility does not buy its franchise, so it takes no risk on its value. Its shareholders therefore have no legally supported expectation of selling it for a gain. The franchise is not a private asset because it never loses its public character.

b. Ownership of stock does not determine entitlement to the control premium

To argue that stock ownership necessarily entitles the stock owner to the full premium is to reason in a circle. The question is: "Are the owners of target stock entitled to the premium?" The answer cannot be: "Yes, because they are owners of the stock." In utility regulation, the benefits from owning stock are affected by regulatory decisions. Shareholders impliedly accept that regulation can devalue

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194. The page limits assigned to this article necessarily constrain the detail provided here. A fuller dialogue can be found in testimony prepared by the author, and responded to by applicant witness John J. Reed, within the dockets listed at *supra* note 27.

195. These rights and responsibilities are detailed in SCOTT HEMPLING, REGULATING PUBLIC UTILITY PERFORMANCE, *supra* note 188, at Chapters 1-5.

their holdings. That has been the law since medieval times.<sup>196</sup> When a government decision limits the target shareholders' gain, they suffer disappointment. But the Constitution's concern is not with disappointment but with just compensation. As discussed next, shareholders already receive just compensation through the authorized return on the utility's prudent, used and useful investment.

c. Target shareholders receive their just compensation through normal cost-based rates

A utility's shareholder's right to reasonable compensation comes from the statutory "just and reasonable" standard and the constitutional requirement of "just compensation." Satisfying the statute necessarily satisfies the Constitution.<sup>197</sup>

The statutory standard is satisfied by conventional cost-based ratemaking, which computes an annual revenue requirement by summing reasonable expenses (including depreciation and taxes) and the cost of capital. The cost of capital is calculated by multiplying (a) a rate base of the reasonable capital expenditures necessary to provide utility service (actually, the original cost of those expenditures less accumulated depreciation) by (b) a weighted rate of return reflecting contractual interest rates and a regulator-estimated cost of equity. As Justice Brandeis famously explained: "The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return."<sup>198</sup> The "capital embarked in the enterprise" is the money prudently invested in assets that serve the public:

The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would give definiteness to these two factors involved in rate controversies which are now shifting and treacherous, and which render the proceedings peculiarly burdensome and largely futile. Such measures offer a basis for decision which is certain and stable. The rate base would be ascertained as a fact, not determined as matter of opinion. It would not fluctuate with the market price of labor, or materials, or money.<sup>199</sup>

When set properly, cost-based rates lawfully compensate shareholders for "capital embarked in the enterprise." The control premium received by target shareholders is not compensation for that capital; it is the acquirer's payment for control of the franchise privilege. That privilege's value derives from government action, not target shareholder action. As already explained, the control premium reflects the acquirer's bet that its control will increase the franchise's value. The acquirer's decision to bet on that value does not give the target shareholders any

196. *Munn v. Illinois*, 94 U.S. 113, 126 (1877) (holding that when someone "devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use; but, so long as he maintains the use, he must submit to the control.").

197. *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591, 600, 607 (1944) ("Since there are no constitutional requirements more exacting than the standards of the Act, a rate order which conforms to the latter does not run afoul of the former.").

198. *Missouri ex rel. Sw. Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 290 (1923) (Brandeis, J., concurring).

199. *Id.* at 306-08.

constitutional right to that value (though as noted in Part V.D.2 above, value properly attributable to performance merit can justify target shareholders keeping some portion of the control premium). The gain from selling control of the franchise, therefore, is not constitutionally protected, at least not automatically.<sup>200</sup>

To argue that target shareholders have a constitutional right to the entire control premium is to ignore common-sense scenarios where they would not. A legislature seeking to discourage debt-leveraged acquisitions with high premia could impose a tax on the gain from those transactions. The tax would reduce shareholder gain directly. A legislature could even prohibit those acquisitions—or others, like acquisitions involving non-integrated entities, international currency risk, or higher-risk businesses. Like the tax, these prohibitions would reduce target shareholders gains, by reducing the universe of acquirers competing to buy a target and therefore lowering the premium paid. Statutes taxing capital gains are common, and the Supreme Court has rejected constitutional challenges to limits on acquisitions.<sup>201</sup> Rational government action to reduce shareholders' hoped-for gain does not violate the Constitution.

This constitutional analysis loses nothing by acknowledging that shareholders of unregulated companies sell their businesses at a premium and keep the gain. In that context, the acquirer's willingness to pay a control premium, and the target shareholders' expectation of that premium, are both disciplined by competition in the target's product market.<sup>202</sup> And an unregulated target receives neither government protection from competition nor government assurance of reasonable prices for its products. No logical reason exists to question the premium's appropriateness or to disappoint the target shareholders' expectation of keeping the resulting gain. A regulated monopoly utility market lacks those factors.

#### 4. FERC's error: Approving transactions with premia unrelated to the target's performance

When targets select acquirers based on price rather than performance, control of the industry's infrastructure moves to entities able to pay the most—those with the largest access to acquisition financing, those most able to risk non-recovery of the purchase price. These entities are not necessarily the ones most prepared, committed and able to improve the industry's performance, or the ones whose assets,

200. If in granting the franchise the government entity promised, either by statute or contract, that the target could keep the gain, the target's constitutional right to that gain would be strong under either the Takings Clause or the Contract Clause. *New Orleans Water-works v. Rivers*, 115 U.S. 674, 681 (1885) (holding that the City's grant of an exclusive franchise to water company was a contract, which even a later-enacted state constitutional amendment banning utility monopolies could not impair).

201. Prohibiting or limiting certain acquisitions were devices central to PUHCA 1935, which was upheld against Fifth Amendment attack. *North American Co. v. SEC*, 327 U.S. 686, 710 (1946) (holding that section 11(b)(1)'s divestiture requirement did not deprive shareholders of their Fifth Amendment right to just compensation; Congress could decide that "the benefit alleged to flow from efficient, common management of diversified interests" was "clearly outweighed by the actual and potential damage to the public, the investors and the consumers resulting from the use made of pooled investments"); *American Power & Light Co. v. SEC*, 329 U.S. 90, 106-7 (1946) (applying reasoning from *North American Co.* to uphold section 11(b)(2), which required the SEC to simplify corporate structure).

202. As explained in Part IV.C above.

when coupled with the target's, produce the most efficient coupling. This preference for price over performance perpetuates itself, because each acquisition premium tends to establish the floor for future premia. A target CEO does not wish to risk a shareholder derivative suit by failing to get the highest possible price.

The FERC ignores these facts. Ignoring them for three decades means allowing the industry to consolidate in the hands of the best-financed rather than the most-skilled. When merger orders address the purchase price—an infrequent event—they do so “only insofar as [the price] affects rates.”<sup>203</sup> That result is not consistent with the public interest.

*E. Preserving regulation: Boilerplate instead of analysis*

Utility consolidation and complication make regulation more difficult. But the Commission addresses a merger's effect on regulation only in terms of jurisdiction, not difficulty.<sup>204</sup> Provided an applicant accepts the Commission's power to police interaffiliate transactions, the merger's effect on the FERC's regulatory jurisdiction is resolved.<sup>205</sup> As for the merger's effect on state regulation, if the state commission has merger authority the FERC will not address the issue; if the state commission lacks merger authority the Commission will consider, case by case, whether to address the issue, but only if the state asks.<sup>206</sup>

Regulatory jurisdiction is useful only if it is effective. This subsection describes three risks that mergers pose to regulatory effectiveness. The first one actually deals with both jurisdiction and effectiveness. The Commission has addressed none of these areas.

1. Preemption: May states reject, or disallow costs from, a utility's affiliated nonpower purchases?

Consider a holding company system with utility subsidiaries serving retail and wholesale customers in multiple states. That holding company typically has a services subsidiary that provides accounting, legal, procurement, and planning services to its utility and non-utility affiliates. Because these services are non-electricity services, the sales terms are not subject to the FERC's jurisdiction. But the FERC does decide how to reflect the service costs in the utilities' wholesale rates (assuming those rates are cost-based rates). Direct services will be charged

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203. Merger Policy Statement, *supra* note 57, at text adjacent to n.64 (1996) (responding to Oklahoma Commission's concern that a purchase price based on expected returns from non-utility investments could reduce the utility's stock value if those returns do not materialize).

204. As discussed in Part III.B.3 above, the Merger Policy Statement's concern with jurisdiction stemmed from the D.C. Circuit's interpretation of FPA § 318: that the SEC's approval under PUHCA 1935 of an affiliate's at-cost contract precludes FERC from disallowing from wholesale rates a utility's payments made under that contract, even where market prices were lower than the affiliate's cost. The 2005 repeal of PUHCA 1935 eliminated the issue.

205. Order 642, *supra* note 32, at text accompanying n.107 (describing the 1996 Merger Policy Statement as requiring merger applicants to “either commit to abide by the Commission's policies with respect to intra-system transactions within the holding company structure or be prepared to go to hearing on the issue of the effect of the proposed registered holding company structure on effective regulation by the Commission”).

206. *Id.* at text accompanying n.108 (stating that the Commission will “consider, on a case-by-case basis, whether to set this issue for hearing”).

directly to the affiliated purchaser; common costs must be allocated among all the affiliated beneficiaries. Here's the uncertainty: When the state commissions set their utilities' retail revenue requirements, are they free to include, for the affiliated service, a lower cost than what the FERC approved for wholesale rate purposes? (The state law basis would be a finding that the retail utility should have used lower-cost alternatives, such as third-party vendors or self-supply.) The Merger Policy Statement takes no position. That omission leaves utilities and states at risk of arguing over whether the state is (a) preempted from using a different number under the reasoning of *Mississippi Power & Light*, or (b) free to use a different number under the reasoning of *Kentucky West Virginia*.<sup>207</sup>

The answer may turn on section 1275(b) of EPAct 2005, which states:

(b) FERC Review. —In the case of non-power goods or administrative or management services provided by an associate company organized specifically for the purpose of providing such goods or services to any public utility in the same holding company system, at the election of the system or a State commission having jurisdiction over the public utility, the Commission, after the effective date of this subtitle, shall review and authorize the allocation of the costs for such goods or services to the extent relevant to that associate company.

Citing this language, a utility could argue that the FERC's allocation decision binds states. States could respond by citing section 1275(c) ("Nothing in this section shall affect the authority of the Commission or a State commission under other applicable law."), except that one then must decide whether "other applicable law" is the *Mississippi Power & Light* precedent or the *Kentucky West Virginia* precedent.

The correct answer is the *Kentucky West Virginia* precedent, because nothing in the Federal Power Act or in the FERC's decisions commands a utility to purchase services from an affiliate. To avoid unnecessary litigation, the Commission should make clear that either (a) its allocation approval is solely for wholesale rate purposes, or (b) a utility's membership in a holding company system does not remove that utility's discretion to find the lowest-cost services. Either statement leaves states free to treat the service company cost like any other cost: reviewable for prudence.

## 2. Acquisition debt constrains regulatory options

Part V.D.1 explained that the acquirer bases the premium on expectations of increased earnings—from the target's monopoly position, and from geographic

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207. In *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354 (1988) the Court held that when, in the context of a centrally planned holding company, FERC allocates capacity costs among the retail utility subsidiaries, the FERC is deemed to have "ordered" the retail utility to buy the amount of capacity that FERC allocated, so that the state commission was preempted from inquiring into the prudence of that purchase). In *Kentucky W. Va. Gas Co. v. Pennsylvania Pub. Util. Comm'n*, 837 F.2d 600 (3d Cir. 1988), the court of appeals upheld against a Natural Gas Act preemption challenge the Pennsylvania Commission's disallowance of purchase costs paid by a utility to its affiliate. The court reasoned that a state commission "may legitimately inquire into whether the retailer prudently chose to pay the FERC-approved wholesale rate of one source, as opposed to the lower rate of another source . . . without impugning the reasonableness of the wholesale rate," because the state and the FERC are doing different things—the state regulating the buyer, and the FERC regulating the seller.

and product expansion enabled by that monopoly position. Acquisition debt puts pressure on regulators to act consistently with those expectations. The pressure comes from rating agencies, lenders, stockholders, and management. Regulators—state commissions in particular—thus face two types of constraints.

The first constraint is on ratemaking. Where the acquirer paid a premium expecting that authorized returns on equity will exceed the real cost of equity, state regulators seeking to lower the authorized returns to that real cost of equity will face resistance if that lowering would damage the merged entity's credit rating. The second constraint is on market structure. If the acquirer has incurred acquisition debt expecting the revenue flow from the target's future infrastructure projects,<sup>208</sup> a regulator's decision to allow third-party bidding on those projects will again trigger concerns about the merged entity's credit ratings. This conflict between holding company finance and customer benefit receives no attention from the Commission.

### 3. Sufficiency of states' regulatory resources: Ignored

Effective regulation means setting standards for utility performance, then judging that performance and assigning consequences. This job's difficulty rises when a utility's corporate family has multiple service territories, business objectives, financing sources, profit centers, and sources of risk. Suppose a utility's cost of capital rises; or worse, suppose it cannot access, on reasonable terms, capital to complete necessary infrastructure projects. Is the reason general market conditions, internal utility management decisions, or actions and events occurring elsewhere in the corporate family? Or is the holding company diverting dollars to other investments? Complexity makes regulatory decision-making more time-consuming, more resource-intensive, and less certain to succeed.

My personal observation, having worked with and in front of many state commissions, is that state regulatory person-power has not kept up with the industry's complication. Worse, veterans hired in the 1970s and 1980s, in the eras of oil price increases and nuclear cost overruns, are retiring. Utilities don't face similar employee losses; with their statutory right to recover regulatory affairs costs in rates, they can build benches that budget-constrained commissions cannot afford.

Focusing on regulatory jurisdiction rather than regulatory effectiveness, the FERC misses these practical facts. Assume for argument's sake that it is not the Commission's "role to paternalistically protect the interests of affected state commissions when those commissions have adequate authority to protect themselves and have expressed no need for us to safeguard their interests."<sup>209</sup> The concern is not about state commissions protecting "themselves"; it is about the FERC protecting the public interest, which the Commission acknowledges includes retail customers. Assessing state commissions' preparedness may be uncomfortable,

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208. Discovery in GPE's original proposal to acquire Westar showed GPE saying: "Increased access to attractive rate-based growth opportunities" is among the transaction's "compelling strategic rationale[s]." This language is cited in the author's direct testimony in that case. Direct Testimony of Scott Hempling On Behalf of Utilities Division of the Kansas Corporation Commission, Docket No. 16-KCPE-593-ACQ, at 47 (Dec. 16, 2016).

209. Public Service Co. of Colorado & Southwestern Pub. Service Co., 75 F.E.R.C. ¶ 61,325, at p. 62,048, 1996 FERC LEXIS 1110 (concurrence of Comm. Massey).



even impolitic. But discomfort does not determine jurisdiction. The Commission is obligated to determine a merger's effect on the effectiveness of state regulation.

## VI. APPLICANTS' DEFENSES OF FERC'S DEFERENCE TO APPLICANTS

This article has argued that the FERC must consider whether a proposed merger's effects—on corporate complexity, financial structure, interaffiliate relations, and regulatory effectiveness—will not only worsen the electric industry's performance but also preclude improvements to future performance. This Part VI anticipates three opposition arguments, their common theme being that the FERC's deference to these transactions has statutory support.

### A. FERC's jurisdictional limits

One might argue that corporate complexity, financial structure, and regional and national consolidation are not the FERC's problems. This argument has two possible sources of support.

First, by enacting PUHCA 1935 alongside the FPA,<sup>210</sup> the argument might go, Congress intended the two statutes to address two different spheres: PUHCA 1935 dealing with concerns over concentration, corporate structure, and business mixing;<sup>211</sup> the FPA dealing with wholesale sales and transmission service. This argument fails because in at least four major substantive areas the two statutes overlapped. PUHCA section 10(b)(1) forbade acquisitions leading to a "concentration of control of a type detrimental to consumers, investors and the public interest."<sup>212</sup> That provision overlaps with the FERC's acknowledged authority under section 203 to examine a merger's effect on competition. PUHCA section 10(c)(2) required acquisitions to "tend[] toward the economical and efficient development of an integrated public-utility system." Satisfying this standard requires evidence of operational cost reductions and managerial efficiencies that overlap with evidence the FERC routinely requires to determine, under FPA §§ 205 and 206, whether cost-based rates for wholesale power and transmission service reflect reasonable costs. Section 7(d) of PUHCA 1935 prohibited financings that are "not reasonably adapted to the security structure" or the earning power of the issuer, that are "not necessary or appropriate to the economical and efficient operation" of the issuer's lawful business, that involve an "improper risk," or that are otherwise "detrimental to the public interest or the interest of investors or consumers." These concerns overlap with FPA § 204, which requires the FERC to ensure that, in the absence of state authority, utility financings do not harm the public interest. Indeed, the FERC's *Westar* conditions, forbidding a holding company from siphoning valuable assets from its utility subsidiary but leaving the associated debt

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210. The two statutes were passed simultaneously as the Public Utility Act of 1935.

211. For a detailed discussion of the PUHCA 1935 requirements, see Melnyk & Lamb 2006, *supra* note 19, at 7-9; Scott Hempling, *Electric Utility Holding Companies: The New Regulatory Challenges*, LAND ECON., Vol. 71, No. 3 (Aug. 1995); Scott Hempling, *Corporate Restructuring and Consumer Risk: Is the SEC Enforcing the Public Utility Holding Company Act?*, ELECTRICITY J. (July 1988).

212. See also *Municipal Electric Association v. S.E.C.*, 413 F.2d 1052 (D.C. Cir. 1969) (holding that section 10(b)(1) of PUHCA 1935, prohibiting acquisitions that tend toward a "concentration of control" of utilities, required SEC to consider whether an acquisition will have anti-competitive effects).

behind, could have been imposed by the SEC under PUHCA 1935.<sup>213</sup> FPA section 305(b), on interlocking directorates, prohibits a person from holding an officer or director position, absent Commission permission, with more than one public utility, or with a public utility and a bank authorized to issue securities of a utility, or with a public utility and a company supplying electrical equipment to that utility. These interlocking relationships could also have been banned or conditioned by the SEC under PUHCA section 2(a)(7)(B) (authorizing the SEC to limit interlocks as a condition of declaring a company not to be a “holding company”).<sup>214</sup> Finally, we know overlaps exist because Congress included FPA section 318 to resolve any conflicts arising from overlaps.<sup>215</sup>

The second argument concerns Congress’s intent in 2005. Because Congress repealed the SEC’s PUHCA 1935 powers while granting the FERC only minor new powers (relating to affiliate transactions and access to books and records), one might argue that Congress intended to remove the federal government from any corporate structure-type regulation, leaving these matters to the states. This argument fails. Even if the 1935 Congress did intend to confine the FPC’s merger authority to sales of wholesale power and transmission service, Congress could not have meant to deny the Commission tools needed to protect those jurisdictional services from merger-caused harm. The “principal purpose” of the FPA (and the Natural Gas Act) is “to encourage the orderly development of plentiful supplies of electricity and natural gas at reasonable prices,”<sup>216</sup> “with the greatest possible economy,”<sup>217</sup> to “protect power consumers against excessive prices,”<sup>218</sup> and “to protect consumers against exploitation.”<sup>219</sup> These general purposes apply to the entire statute, including section 203. *Gulf States* requires the FERC to act as “the first line of defense against those competitive practices that might later be the subject of antitrust proceedings.”<sup>220</sup> A holding company’s structural actions—debt-financed acquisitions, interaffiliate transactions, use of the retail franchise to gain unearned competitive advantage, consolidation that reduces marketplace diversity

213. See Order Conditionally Granting Authorization to Issue Long-Term Unsecured Debt and Announcing New Policy on Conditioning Securities Authorizations, 102 F.E.R.C. ¶ 61,186 (2003); see also Order Rescinding Authorization to Issue Long-Term Unsecured Debt and Clarifying Policy on Securities Authorizations, 104 F.E.R.C. ¶ 61,018 (2003).

214. For a detailed discussion of the FERC’s treatment of interlocking relations, see John J. Schulze, *On the Eve of the Federal Power Act Interlocking Directorate Regulations’ Diamond Jubilee, Are We Left With Cherries or the Pits?*, 29 ENERGY L.J. 667, 681 (2008) (explaining that “[l]ike FPA section 305, PUHCA 1935 addressed the concentration of control of public utilities, in part, by regulating certain interlocking directorates with financial institutions”); see also Robert H. Tucker, *The Public Utility Act of 1935: Its Background and Significance*, S. ECON. J. Vol. 4, No. 4, at 429 (Apr. 1938) (“Both acts limit interlocking control and speculative profits of officers and directors.”).

215. As interpreted by the Supreme Court, FPA § 318 provided that if respect to “any subject matter” a person is subject to a requirement of both statutes, the PUHCA 1935 requirement prevails over a conflicting the FPA requirement. *Arcadia v. Ohio Power Co.*, 498 U.S. 73 (1990).

216. *NAACP*, 425 U.S. at 670.

217. 16 U.S.C. § 824a(a).

218. *Pennsylvania Power Co. v. FPC*, 343 U.S. 414, 418 (1952).

219. *Hope Nat. Gas Co.*, 320 U.S. at 610.

220. *Gulf States Util. Co. v. FPC*, 411 U.S. 747, 760 (1973).

and availability of yardsticks—all these actions affect the Commission's core responsibility: to ensure that wholesale rates and transmission service are just and reasonable and not unduly discriminatory. Even under a narrow view of the FERC's authority, structural concerns matter.

### B. *Normal competitive forces*

The Edison Electric Institute has argued that mergers deserve the FERC's deference because they “represent the natural evolution of the markets.”<sup>221</sup> That argument rests on three premises not factually proven: that merging companies bargain at arm's length; that lenders compete to finance these transactions while assessing them meticulously to reduce their own risk; and that bond rating agencies add independent scrutiny. This argument also omits the fact that matters: Buying control of a monopoly franchise differs fundamentally from buying a company whose ultimate products are subject to competition. In the competitive context, bidders and targets are disciplined by the product prices set by the target's (and thus the merged entity's) ultimate product market. In the monopoly context that level of competitive discipline is missing.<sup>222</sup> Any discipline will come from regulators who set the prices—most importantly state regulators, because retail sales account for most of the merging companies' revenues.

The “mergers are a natural evolution of competitive markets” argument thus hangs on the quality of state commission decisions: specifically, whether state commissions' treatment of the control premium (in terms of rate-setting and also in terms of premium-sharing) replicate competitive forces. Because the FERC has made no finding on the level of discipline imposed by state commissions, it cannot base its deference on competitive forces.<sup>223</sup>

### C. *No merged entity failures*

Defenders of the Commission's merger policy also can argue that 30 years of continuous approvals have produced no obvious negatives. From the short-term

221. See, e.g., Order No. 642, *supra* note 32, at Part IX.C (citing argument of Edison Electric Institute).

222. As explained in Part IV.C above. It is true that even in a monopoly context, some element of competitive accountability is possible. There is franchise competition and locational competition; and in some states, border competition, where large customers within a few miles of a different service territory can buy from the utility in that service territory. Inter-fuel competition and self-supply are also possibilities, depending on state laws. And customer conservation, up to a point, can discipline the monopoly supplier. But there should be no disagreement that these forms of competition bring less accountability than the head-to-head competition that exists in effectively competitive markets. And it would be ironic for the FERC to cite these forms of competition as positive forces when it never considers whether mergers weaken those forces—as discussed in Part V.A.2 of this article.

223. On this point, an anonymous reviewer commented: “FERC does not have authority in the statute to substitute its judgment for that of State legislatures and State Commissions. . . .” Respectfully, this comment misses the point. The FERC would not be substituting its judgment for the state entity. The Commission would be assessing whether the economic context from which a merger arises is one that has disciplined the merging parties sufficiently to ensure that the merger is consistent with the public interest. A necessary step in that assessment is assessing the state's decisions, because most of a retail utility's earnings result from the state's decisions. As discussed *supra* note 160, *Conway Corp.* makes clear that the FERC may—and in the price squeeze context must—consider state decisions in determining the lawfulness of a FPA-jurisdictional wholesale rate. *Conway Corp.*, 426 U.S. at 279.

and no-harm perspectives, this position is plausible. Despite the variety of transactions (domestic and international; adjacent and remote; cash buyouts and stock-for-stock; vertical, horizontal and conglomerate), acquisition failures are rare. Indeed, the two prominent examples of acquirer failure—the acquisition of the Texas retail utility Oncor by a private equity consortium comprising KKR, Goldman Sachs and others,<sup>224</sup> and the acquisition of Puget Sound Energy by Enron<sup>225</sup>—are cited as examples of how “ring-fencing” protected the target utilities from their acquirers’ financial failure.<sup>226</sup> Also often cited are the holding company form’s financial advantages in terms of scale (“permit[ting] more efficient access to the capital markets”); and ability to attract a “broad [and diverse] pool of investors,” making the utility system “more robust,” “less susceptible to systemic risk,” and capable of attracting “divers[e] management and technologies.”<sup>227</sup>

But the short-term and no-harm perspectives are not the FPA’s perspectives. The statutory “public interest” covers more than today’s customers and more than the merging entities’ customers. The public interest is the long-term interest in an efficient industry: an industry that does not charge “excessive” prices or “exploit” consumers;<sup>228</sup> an industry whose cost and performance replicate the cost and performance of effective competition. If the FERC policy allows acquisitions that cause no harm, but precludes acquisitions or other investments that could improve performance, the results do not replicate effective competition. If the correct question is “Do these transactions produce competitive performance?” then the response “Nothing has gone wrong—yet” is a *non sequitur*.

## VII. RECOMMENDATIONS FOR FERC: ATTITUDE, ORGANIZATION, AND PROCEDURE

### A. *Attitude: View mergers as major structural events, not minor routine transactions*

The Commission gives fact-specific attention to each merger’s effect on wholesale generation competition. That feature aside, the merger opinions read like routine orders with predictable outcomes—transactional purposes and skeletal facts summarized from the application, concerns summarized from interventions, recitation of the three prongs (competition, rates, regulation)—all followed by nearly unanimous approvals, nearly every time.

Instead of approving applications based only on their self-descriptions, isolated from all other industry events, the Commission should treat each application

224. See *supra* note 179 and accompanying text.

225. Order No. 97-196, In the Matter of the Application of Enron Corp. for an order Authorizing the Exercise of Influence Over Portland General Electric Company, Oregon P.U.C. 97-196 (1997) (imposing 22 conditions relating to service quality, pricing of interaffiliate transactions, allocation of merger costs, financial separation and other matters), reh’g denied, Oregon P.U.C. 97-377.

226. See also Melnyk & Lamb 2006, *supra* note 19, at 20 (describing as advantages of the holding company form “its ability to provide strong structural separation,” including protecting utilities from non-utility debts and other financial risks); Order No. 669, *supra* note 80, at Exhibit M of the FERC’s required application for approvals under section 203.

227. Melnyk & Lamb 2006, *supra* note 19, at 21.

228. See *Pennsylvania Power Co.*, 343 U.S. at 418; *Hope Nat. Gas Co.*, 320 U.S. at 610.

as contributing to a cumulative effect: the long-term, likely irreversible consolidation and complication of the U.S. electric industry. Instead of treating “public interest” as a conclusory label attached to a routine approval of a multi-billion-dollar, market structure-changing transaction, the FERC should define the public interest in terms of its own long-term vision for industry structure, corporate structure, and financial structure. Then with each transaction, the FERC can ask this question: “How does this proposal contribute to, or impede, the trend toward the outcomes that satisfy the public interest?”

Even without a positive vision, the FERC should be asking these questions: “If the trend continues another ten years at the same pace as the prior ten years, is this the result we want?” And: “At what point will the level of industry consolidation and complication cause us to say that one more merger is one too many, for the affected region and for the nation?” Ignoring these questions now lays them on some future Commission’s desk.

On stating the answers, the FERC will need to face a new problem: the natural tendency of each acquisition-oriented company, whether acquirer or target, to push its desired transaction forward before the approval doors close. Those filings will force the FERC, finally, to think cumulatively, not isolatedly.

*B. Organization: Create a task force charged with a policy mission and research agenda*

The FERC should create a task force with a four-part mission: (a) define the types of performance that the FERC expects from the industry it regulates, (b) describe the types of utility conduct that will produce that performance, (c) identify alternative market structures and corporate structures that are likely to induce the desired conduct, and (d) create alternative merger policies that will replicate the competitive discipline necessary to produce the envisioned structure, conduct, and performance. The task force should have the expertise and hierarchical importance comparable to the Commission’s offices dealing with reliability and market manipulation. The task force should organize technical conferences aimed at collecting real data and insights, emphasizing experts’ perspectives over advocates’ positions.

The task force should also conduct research on these questions:

1. From the last 30 years of mergers, what conclusions can we draw about their effects on structure, conduct, and performance?<sup>229</sup>
2. About “bigger is better”—the slogan often repeated to support a transaction: Is it true? If it is true, “better” in what ways, and for whom? What information and insights can we gather about economies of scale

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229. As far as the author is aware, despite the dozens of merger approvals no objective study has tested the expectation, stated often but without factual support, that the consolidation and complication trends enabled by the repeal of PUHCA 1935 would be positive for the consumer. Compare, e.g., Melnyk & Lamb 2006, *supra* note 19 (asserting that PUHCA repeal “is a positive change that should lead to a more vibrant and resilient industry and better service at a lower cost”), with Niefer, *supra* note 65, at 532 (recommending that the FERC gain a “deeper understanding of the connection between market structure, firm behavior, and competitive effects”).

and scope for each aspect of the business, from distribution system planning to major capital expenditure financing, to know whether “bigger is better” has any evidentiary value?

3. What are the consequences, short-term and long-term, of financing acquisitions of equity with debt? Does the increased leveraging in the industry have a danger point?
4. At what point in the merger trend is one more merger too many, either because of effects on competition or because the small number of remaining entities makes each one “too big to fail”? How might we adjust current merger policy so we do not reach that point? Should merging companies be required to create a counterpart to the “living will” required of systemic banks by the Dodd-Frank legislation?<sup>230</sup>
5. To what extent do mergers give the merged entities competitive advantages that are unearned (*i.e.*, not attributable to performance merits)?
6. To what extent does each target’s focus on highest purchase price rather than best performer discourage prospective acquirers who cannot compete on merger price but could bring to the industry more efficiencies and innovation?
7. How might the FERC update its Appendix A merger analysis, which focuses on wholesale generation, to consider other products, known and unknown, such as transmission construction, demand response, retail sales, storage, and distributed generation?
8. What merger standards will replicate the discipline of retail competition, so that the dominant motive behind each merger is serving customers more efficiently, rather than maintaining or growing current market presence (for the acquirer) and maximizing gain (for the target)?<sup>231</sup>

None of the FERC’s issuances—in 1996, 2000, 2005, 2006 and 2007—and none of its merger decisions, addresses these questions.<sup>232</sup> Without answers, we cannot know if the merger trend, and each future merger’s contribution to it, are consistent with the public interest.

### C. Procedure: Order a notice of inquiry to examine unexamined questions

To address these information gaps, the Commission should open a notice of inquiry—soon, and expeditiously, before too much more consolidation and complication emerge from markets lacking effective competition. Announcing a notice of inquiry does risk triggering a rush of merger applications seeking approval before the standards change. Because rushed applications will not likely align

230. See section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (requiring certain bank holding companies and nonbank financial companies to have “resolution plans”); see also Federal Reserve Bank, *Living Wills (or Resolution Plans)*, <https://www.federalreserve.gov/supervisionreg/resolution-plans.htm>.

231. For additional study questions relating to wholesale competition, see, e.g., Niefer, *supra* note 65, at 532-33 (recommending that the FERC or Department of Justice study their merger review procedures).

232. Niefer, *supra* note 65, at 534 (“Although there have been some retrospective studies of the effect of mergers on consumers, there are little, if any, explicitly addressing the net effect of electric power mergers on consumers.”).

with the principles discussed here, the Commission will face a difficult question: whether to pause its approval process until it completes the inquiry.

Once before, the Commission rejected a request for a moratorium, saying it had “adequate regulatory safeguards . . . that protect against potential adverse effects,” and noting its authority to issue supplemental orders.<sup>233</sup> But that rejection necessarily had as its premise the no-harm standard, whose defects were addressed in Part IV.B above. And there is no supplemental order that can recreate alternative mergers or investments precluded by a consummated merger.

There are arguments that a pause itself could do harm.<sup>234</sup> While shareholders of prospective targets have no statutory or constitutional right to indefinite continuation of prior policy, the more they know about possible futures and the sooner they know it, the more they can protect their interests. A commission’s legal power to change its policies does not justify insensitivity to those affected by those policies.

### CONCLUSION

The Commission’s merger decisions embody deference and indifference: deference to applicants’ proposals and indifference to the consolidation and complication that result. Deference is inappropriate because these mergers are not disciplined by effective competition. Acquirers compete to buy control of a government-created, government-protected monopoly franchise. Targets compete to sell that franchise control for the highest price, seeking gains reflecting value they did not create. Because the franchises are monopoly franchises, the competition to buy and sell them is not effective competition, and the interests of merging parties and their customers are not aligned. Regulatory deference is illogical.

On competition, the FERC looks only for violations of conventional market power screens. Whether yardstick competition and franchise competition diminish causes the Commission no pause. Also ignored are the distorting effects that acquirers’ unearned advantages have on future markets.

On complication, the FERC’s indifference is complete. Multi-billion-dollar acquisitions of electric monopolies by distant, multi-business holding companies, both domestic and foreign, are now delegated to office directors. Even separate proposals to acquire the same Texas electric monopoly (from its bankrupt owner—whose excessively leveraged acquisition 10 years ago was also approved by the FERC) by two very different acquirers, each over 1000 miles away, were approved by office directors.<sup>235</sup> In none of these transactions does the FERC consider the

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233. Order No. 642, *supra* note 32, at Part IX.C, citing FPA § 203(b) (“The Commission may from time to time for good cause shown make such orders supplemental to any order made under this section as it may find necessary or appropriate.”).

234. *Id.* (citing Edison Electric Institute’s argument that, in the FERC’s paraphrasing, “even a temporary ban would impose large costs on both consumers and stockholders that would not be in the public interest”).

235. See, e.g., *Iberdrola, S.A., Iberdrola USA Inc., Iberdrola USA Networks, Inc., Green Merger Sub, Inc., UIL Holding Corp.*, 151 F.E.R.C. ¶ 62,148 (2015) (office director approving Spanish holding company’s acquisition of United Illuminating); *Oncor Electric Delivery Company LLC, NextEra Energy, Inc., EFH Merger Co., LLC, WSS Acquisition Co., T & D Equity Acquisition, LLC*, 158 F.E.R.C. ¶ 62,005 (2017) (office director approving NextEra’s request to buy Oncor); *Oncor Electric Delivery Co., Sempra Energy*, 161 F.E.R.C. ¶ 62,187

harms from remote management, diseconomies of scale, management distraction, or financing risk.

When effective competition is absent, mergers motivated by private interests will not align with the public interest. Deference and indifference will fail to protect that public interest. The Commission should view these transactions as the major structural events they are. Until it does, its merger policy will be inconsistent with the public interest.

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(2017) (office director approving Sempra's request to buy the very same Oncor). The debt-leveraged original acquisition of Oncor by the now-bankrupt owner was approved by the full Commission, without any analysis of the acquisition financing. On that financing, the FERC's decision had only a summary of the applicants' description. *Oncor Electric Delivery Company, TXU Portfolio Management Company LP, Texas Holdings Limited Partnership*, 120 F.E.R.C. ¶ 61,215 at text accompanying nn.20-21 (2007).