LOSING THE PUBLIC INTEREST: HOW PRIVATE EQUITY BUYOUTS OF UTILITIES GET SUNK BY REGULATORS

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I. INTRODUCTION

When Energy Future Holdings ("Energy Future" or "EFH") filed for Chapter 11 bankruptcy protection in April of 2014, the largest private equity ("PE") deal in U.S. history became the eighth-largest U.S. bankruptcy ever.[1] Wall Street analysts predicted the company's default on its loans more than two years prior to the filing.[2] But unlike other PE "megabuyouts" of the boom years of 2005-2007, whose fate also seemed destined for bankruptcy, EFH was unable to survive the financial downturn.[3] What makes Energy Future's story so noteworthy is not just the circumstances leading up to its ultimate demise, but the broader implications its story has for public utility leveraged buyouts ("LBOs") generally.

From the moment the EFH deal was announced it was met with controversy and intense public criticism.[4] Environmental groups opposed it because of the proposed construction of eleven coal-fired power plants; state lawmakers opposed it because of concerns over market power and lack of competition; and consumers complained that the deal would raise electricity prices.[5] But despite opposition from multiple fronts, the buyout was approved by federal and state regulators. Now that EFH has filed for Chapter 11 protection, the question of whether the bankruptcy was foreseeable seems reasonable to ask. For instance, since utility regulators knew the deal was a highly-leveraged buyout,[6] which can pose exacting financial risks, how did it survive scrutiny and earn approval? What exactly are the standards by which utility regulators approve public utility mergers and acquisitions ("M&A")?

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[1] Mike Spector, Emily Glazer & Rebecca Smith, *Energy Future Holdings files for Bankruptcy*, WALL ST. J., Apr. 29, 2014, http://www.wsj.com/articles/SB10001424052702304163604579531283352498074.
[2] Peter Lattman, *A Record Buyout Turns Sour for Investors*, N.Y. TIMES, Feb. 28, 2012, http://dealbook.nytimes.com/2012/02/28/a-record-buyout-turns-sour-for-investors/?_r=0.
[3] *Id.* (noting that Freescale Semiconductor and Hospital Corporation of America survived).
[4] EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET 224 (2014).
[5] *Id.* at 224.
[6] *See* APPELBAUM & BATT at 224. Of the $48.1 billion purchase price EFH paid for Texas Utilities, $39.8 billion consisted of debt, an astounding 83/17 debt-to-equity ratio.

This paper examines private equity buyouts of public utilities. In light of the financial risks attendant to a PE-sponsored LBO, as evidenced by the EFH bankruptcy, it scrutinizes the various state and federal regulatory standards that get applied in public utility M&A deals to determine how regulators evaluate transactions. In order to answer the overarching question of why some public utility LBOs get denied while others get approved, this paper will examine the differences between state and federal approaches, as well as the differences between the state approaches, and attempt to discover which differences are significant. By answering these questions, this paper attempts to develop a coherent understanding of the specific characteristics of PE-sponsored public utility buyouts that give regulators pause and justify denial. The paper uses case studies across four jurisdictions in order to ascertain the major concerns of utility regulators. In addition to fleshing out these dominant concerns, the paper also discusses other concerns that appear persuasive to regulators.

Based on the analysis of these cases, the paper finds that the three major concerns of regulators in PE-sponsored LBOs of public utilities are financial risks stemming from excessive leverage; insufficient customer benefits; and lack of transparency. Other concerns that appear persuasive to regulators are experience in the utility industry and trust. If PE-sponsored investment in public utilities continues to have the impact that it has had in recent years,[7] then it is important to understand why PE fails in some instances but is successful in others.

II. STANDARDS OF REVIEW OF PUBLIC UTILITY MERGERS & ACQUISITIONS

A. The Federal Approach

i. General Developments

[7] *See* Prequin, *Private Equity Investment in the Energy and Utilities Sector in North America* (August 2014), https://www.preqin.com/blog/101/9627/private-equity-north-america (reporting that from 2006 to mid-2014 over $181 billion was invested in the energy and utilities sector, in terms of aggregate deal value. Further, in 2011 the sector accounted for 15% of the total value of PE deals in North America, and has accounted for roughly 5% to 6% of the total number of PE deals since 2006).

Prior to the 1992 amendments and 2005 repeal of the Public Utility Holding Company Act of 1935 (PUHCA), that law "discouraged investment in electric and gas utility infrastructure by companies that could not restructure to satisfy PUHCA's prohibition on the ownership of diversified businesses."[8] Further, prior to 1992, PUHCA "prohibited combinations of electric and gas utility companies that were not located in the same region, coordinated, and additionally for electric utilities, interconnected."[9] .

The PUHCA was amended by the Energy Policy Act of 1992 ("EPAct 1992").[10] The EPAct 1992 introduced two major exemptions from PUHCA requirements, one for exempt wholesale generators ("EWGs") and the other for foreign utility companies ("FUCOs").[11] The EWG exemption, which allowed a company to acquire electric generation facilities to sell power at wholesale without becoming a holding company subject to PUHCA, "contributed greatly to the creation of a competitive power market through the expansion of non-utility generators."[12] Further, the FUCO exemption, which permitted a U.S. holding company to acquire foreign electric and gas utilities by deeming FUCOs not public utilities for PUHCA purposes, allowed U.S. utilities to "seek higher growth rates and returns through diversification."[13] These exemptions laid the foundation for public utility restructuring and utility M&A activity.

Despite the loosening of federal regulatory restrictions, in 2000 "the U.S. utility industry [remained] highly fragmented with approximately 3,169 separate electric utilities."[14] Due in part to this trend, Congress enacted the Energy Policy Act of 2005 ("EPAct 2005"), which repealed

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[8] Markian M.W. Melnyk & William S. Lamb, *PUHCA's Gone: What Is Next for Public Utility Holding Companies?*, 27 ENERGY L.J. 1 (2006).
[9] *Id.*
[10] The Energy Policy Act of 1992, Pub. L. No. 102-486, § 711, 106 Stat. 2776.
[11] *See* Melnyk & Lamb, *supra* note 8, at 9.
[12] *Id.* (describing non-utility generators as "generating companies not subject to PUHCA or state rate regulation that sold their power at wholesale, and typically at market rates, to distribution utilities").
[13] *Id.*
[14] *Id.* at 11.

PUHCA and replaced it with PUHCA 2005.[15] In addition to eliminating the geographic and business diversification restrictions imposed on holding companies of public utilities, EPAct 2005 removed prohibitions on the types of investments that holding companies could make and abolished constraints on non-utility businesses in acquiring public utilities or their holding companies.[16] The PUHCA 2005 also gave the Federal Energy Regulatory Commission ("FERC") authority to grant approval for some utility financing activity, which was formerly the domain of the U.S. Securities and Exchange Commission ("SEC").[17] The FERC also received the SEC's access to public utility holding companies' books and records and got the SEC's authority to impose certain recordkeeping and reporting requirements that involve costs borne by public utility subsidiaries and relate to FERC's rate determinations.[18]

ii. The FERC Standard of Review

Public utilities engaged in the interstate transmission or sale of electricity who wish to merge, sell, or acquire utility ownership interests are subject to federal regulatory approval prior to executing such a transaction.[19] The FERC is charged with regulating these transactions and derives its authority to regulate electric utilities generally from the Federal Power Act ("FPA").[20] Public utility applications for FERC M&A approval are primarily governed by FPA section 203,[21] but also by FERC regulations,[22] and other FERC orders[23] and policy statements.[24] The FERC requires that the transaction be "consistent with the public interest" and not result in cross-

[15] The Energy Policy Act of 2005, Pub. L. No. 109-58, §§ 1263, 1274, 119 Stat. 594.
[16] *Electricity Regulation Committee Report*, 27 Energy L.J. 267, 300 (2006).
[17] *Id.*
[18] *Id.*
[19] *See* 16 U.S.C. § 824b (2012).
[20] 16 U.S.C. § 824.
[21] 16 U.S.C. § 824b.
[22] 18 C.F.R. pt. 33 (2015).
[23] *E.g.*, *Revised Filing Requirements Under Part 33 of the Commission's Regulations*, Order No. 642, FERC Stats. & Regs. ¶ 31,111 (2000).
[24] *See Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592, FERC Stats. & Regs. ¶ 31,044 (1996) (*1996 Merger Policy Statement*); *See FPA Section 203 Supplemental Policy Statement*, FERC Stats. & Regs. ¶ 31,253 (2007).

subsidization.[25] The public interest determination includes an analysis of any adverse impacts of the proposed transaction on (i) competition, (ii) rates, and (iii) regulation.[26] The cross-subsidization determination includes an analysis of whether a merger would benefit a non-utility associate company at the expense of captive customers of the regulated utility.[27]

Effect on Competition – The FERC's objective in analyzing a proposed merger's effect on competition is "to determine whether the merger will result in higher prices or reduced output in electricity markets."[28] In effect, FERC examines whether unacceptable horizontal or vertical market power will result from a proposed merger. In both cases, an applicant can bypass the so-called "Competitive Analysis" if they can show that the merging entities do not currently conduct business in the same geographic markets (the horizontal dimension), or do not provide inputs to electricity products in the same geographic markets (the vertical dimension), or that either activity is *de minimis*.[29]

Horizontal Competition – The horizontal Competitive Analysis, also known as the horizontal screen, tests whether the merger would significantly increase market concentration in relevant geographic markets.[30] The screen is comprised of six steps and focuses on a merger applicant's operating experience for the two years prior to the application date.[31] Step four, the delivered price test ("DPT"), uses the Herfindahl-Hirschman Index ("HHI")[32] and market

[25] 16 U.S.C. § 824b(a)(4).
[26] *1996 Merger Policy Statement*, FERC Stats. & Regs. ¶ 31,044 at 30,111.
[27] 16 U.S.C. § 824b(a)(4).
[28] Order No. 642, FERC Stats. & Regs. ¶ 31,111.
[29] 18 C.F.R. pts. 33.2-33.3.
[30] *Id*.
[31] 18 C.F.R. pt. 33.3(c)(1)-(4). The steps: (1) define all wholesale electricity products sold by the merging firms; (2) identify destination markets (the customers) affected by the merger; (3) identify the suppliers in the market; (4) perform the delivered price test; (5) calculate market concentration for each supplier; and (6) provide historical transaction data.
[32] The HHI is a widely accepted measure of market concentration calculated by squaring the market share of each firm competing in the market and summing the results. The HHI can range from 0 – 10,000. A higher HHI indicates greater market concentration. The HHI increases both as the number of firms in the market decreases and as the

concentration thresholds from the 1992 Department of Justice/Federal Trade Commission ("DOJ/FTC") Guidelines.[33] Even where a horizontal screen indicates an unacceptable increase in market concentration, an applicant may propose market power mitigation measures and discuss how such measures would remedy market concentration in order to move forward with FERC's approval of a proposed merger.[34]

Vertical Competition – The vertical Competitive Analysis is similar to the horizontal Competitive Analysis, except that it concerns market power stemming from control of the supply chain, i.e., inputs to electricity products coupled with the provision of electric generation products.[35] The vertical Competitive Analysis is comprised of three steps and also focuses on a merger applicant's operating experience for the two years prior to the application date.[36] Step three also makes use of the HHI and is informed by the DOJ/FTC approach.[37]

Effect on Rates – The FERC's Section 203 public interest requirement that an applicant explain the merger's effect on rates acts as a mechanism to ensure that "captive" wholesale customers of merger applicants are protected.[38] Further, applicants have the burden of proving

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disparity in size between those firms increases. *See* DOJ/FTC 1992 Horizontal Merger Guidelines, pp. 15-17, https://www.ftc.gov/sites/default/files/attachments/merger-review/hmg.pdf.

[33] *See 1996 Merger Policy Statement*, FERC Stats. & Regs. ¶ 31,044 at n.33 ("The Guidelines address three ranges of market concentration: (1) an unconcentrated post-merger market --if the post-merger [HHI] is below 1000, regardless of the change in HHI, the merger is unlikely to have adverse competitive effects; (2) a moderately concentrated post-merger market --if the post-merger HHI ranges from 1000 to 1800 and the change in HHI is greater than 100, the merger potentially raises significant competitive concerns; and (3) a highly concentrated post-merger market --if the post-merger HHI exceeds 1800 and the change in the HHI exceeds 50, the merger potentially raises significant competitive concerns; if the change in HHI exceeds 100, it is presumed that the merger is likely to create or enhance market power.").

[34] 18 C.F.R. pt. 33.3(e).

[35] 18 C.F.R. pt. 33.4(a)(1).

[36] *Id.* The three steps: (1) define all relevant products, including upstream and downstream products; (2) define geographic markets, including upstream and downstream markets; and (3) analyze competitive conditions in both the upstream and downstream markets.

[37] *Id*.

[38] Order No. 642, FERC Stats. & Regs. ¶ 31,111 at 31,914.

that any proposed ratepayer protections (e.g., "hold-harmless" provisions) assure that customers are protected if the expected merger benefits do not materialize.[39]

Effect on Regulation – For merger applications involving public utility subsidiaries of registered holding companies, "applicants must include a commitment to abide by [FERC's] policies with respect to intra-system transactions [(i.e., cross-subsidization rules)] 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 [FERC]."[40] If a state commission has authority to act on a merger, FERC will not investigate any further "whether the transaction will impair effective regulation by the state commissions."[41]

Cross-subsidization – Under the amendments to section 203 implemented by the EPAct 2005, FERC "shall approve" a proposed transaction "if it finds that the proposed transaction . . . will 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 cross-subsidization, pledge, or encumbrance will be consistent with the public interest."[42] In Order Nos. 669, 669-A, and 669-B, FERC identified a four-factor test that applicants must satisfy in order to address the cross-subsidization concerns.[43] In its *Supplemental Merger Policy*, FERCrecognized that three types of transactions are unlikely to raise cross-subsidization issues

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[39] *See 1996 Merger Policy Statement*, FERC Stats. & Regs. ¶ 31,044 at 30,123.
[40] *Id*.
[41] *Id*.
[42] 16 U.S.C. § 824b(a)(4).
[43] *See* 18 C.F.R. § 33.2(j)(1)(ii). Under this test, the Commission examines whether a proposed transaction, at the time of the transaction or in the future, results in: (1) transfers of facilities between a traditional public utility associate company that has captive customers or that owns or provides transmission service over jurisdictional transmission facilities, and an associate company; (2) new issuances of securities by a traditional public utility associate company that has captive customers or that owns or provides transmission service over jurisdictional transmission facilities, for the benefit of an associate company; (3) new pledges or encumbrances of assets of a traditional public utility associate company that has captive customers or that owns or provides transmission service over jurisdictional transmission facilities, for the benefit of an associate company; and (4) new affiliate contracts between a non-utility associate company and a traditional public utility associate company that has captive customers or that owns or provides transmission service over jurisdictional transmission facilities, other than non-power goods and services agreements subject to review under sections 205 and 206 of the FPA.

and therefore established “safe harbors” for these types of transactions where no detailed case-specific inquiry is required.[44]

B. The State Commission Approach

i. General Considerations

Some of the primary considerations that FERC addresses when it reviews an application for M&A approval are also examined by the state commissions. First, that the transaction be in the public interest underpins the analytical approach of state commissions as it does at FERC. This includes issues of utility financial integrity, customer rate impacts, and cross-subsidization with non-public utility affiliates. Although a survey of all the different considerations that state commissions employ in their public interest analyses related to M&A transactions is beyond the reach of this paper, the case studies below offer a generally representative sampling of what motivates state commissions in their reviews. Further, a deep dive into the reasoning state commissions employ is critical to understanding how the public interest standard is applied, because it is such a broad standard that can yield divergent results. Also, by contrasting federal and state regulatory approaches, this paper presents a picture of how state and federal utility regulation is often complementary yet not entirely congruous.

III. PRIVATE EQUITY BUYOUTS DENIED AND BUYOUTS APPROVED

A. Private Equity Buyouts Denied

i. Portland General Electric Company

a) State Review[45]

[44] *See FPA Section 203 Supplemental Policy Statement*, FERC Stats. & Regs. ¶ 31,253 at PP 16-19. Safe harbors include: (1) transactions where a franchised public utility with captive customers is not involved; (2) transactions where the relevant state utility commission has jurisdiction to review the transaction and impose any necessary protections against cross-subsidization; and (3) transactions where the franchised utility transacts only with non-affiliates.

In March of 2004, a group of private equity interests, led by Texas Pacific Group ("TPG"), filed an application with the Oregon Public Utility Commission ("Oregon PUC") to approve the purchase of Portland General Electric Company ("PGE") from Enron.[46] The PE group formed a public utility holding company, Oregon Electric Utility Company ("Oregon Electric"), to purchase all of PGE's common stock for $1.4 billion.[47] The Oregon PUC denied the acquisition because it "fails to serve the customers of PGE in the public interest."[48] Despite a proposal to benefit customers and offset any alleged harms caused by the transaction, FERC concluded that "sources of harms remain that pose a risk to the utility and its customers . . . that outweigh the potential benefits of the acquisition."[49]

Oregon state law provides the basis for the Oregon PUC to review all proposed purchases of Oregon public utilities, including acquisitions by persons not engaged in the public utility business.[50] The Oregon legislature considered the protection of public utility customers from harms such as "the degradation of utility service, higher rates, weakened financial structure and diminution of utility assets," a matter of "fundamental statewide concern."[51] The legal standard for approval of an acquisition is that it must "serve the public utility's customers in the public interest" and the burden is on the applicant to make such a showing.[52] The law also provides that the Oregon PUC may condition an approval on "the applicant's satisfactory performance or adherence to specific requirements."[53] The Oregon PUC interprets this legal standard as

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[45] The author was unable to find any FERC order or docket which addressed federal regulatory consideration of the proposed TPG-PGE transaction.
[46] *In the Matter of Oregon Electric Utility Company*, 240 P.U.R.4th 141, Or.P.U.C Order No. 05-114, (2005) (*TPG Order*).
[47] *Id.* at 12.
[48] *Id.* at Summary.
[49] *Id.*
[50] *See* Oregon Revised Statutes 757.506 and ORS 757.511.
[51] *See* ORS 757.506.
[52] *See* ORS 757.511(3).
[53] *Id.*

requiring both a demonstration of a "net benefit" to the utility's customers, and that the proposed transaction "will not impose a detriment on Oregon citizens as a whole."[54] Further, the Oregon PUCdoes not simply weigh the benefits and harms of a proposed acquisition against each other, but it compares the "potential benefits and harms of the transaction against the [public utility] as it is currently configured."[55]

In the TPG-PGE case, the opposing parties (Oregon PUCstaff and numerous intervenors) raised issues concerning a number of potential harms, but the Oregon PUC only focused critically on three things: (1) the debt service requirements to finance this acquisition; (2) TPG's short-term ownership of PGE; and (3) lack of transparency. First, in terms of leverage, the Oregon PUC noted that the utility's debt as a percentage of total capital invested would go from 51 percent to 77 percent at closing and result in a number of potential harms.[56] The Oregon PUC concluded that PGE's credit ratings could drop as a result of the leverage and that its bond rating would be stronger in the absence of the buyout.[57] The Oregon PUC also reasoned that the increased debt service requirements could make Oregon Electric's (the holding company) debt less than investment grade. In both cases, the Oregon PUC concluded that leverage poses a significant risk to PGE's customers because it places "undue pressure" on PGE to engage in imprudent cost cutting and reduce capital investments.[58] The Oregon PUC also expressed concerns over the use of variable rate debt because despite its lower cost in the short-term and assurances by Oregon Electric that it would convert that debt to fixed rate if necessary, the lack of certainty about prospective company actions provided no assurance to maintain investment grade bond ratings. However, the Oregon PUC found that despite leverage "the risk of an

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[54] *TPG Order* at 17 (*quoting* PUCO Order No. 01-778 at 10-11).
[55] *Id.* at 18.
[56] *Id.* at 21.
[57] *Id.* at 22.
[58] *Id.* at 23.

Oregon Electric bankruptcy is extremely small and would not likely lead to a PGE bankruptcy" because "the ring fencing conditions included in the application would protect PGE customers."[59]

In regards to the short-term ownership plan, the Oregon PUC addressed multiple issues, mainly TPG's sale plans for PGE and whether due diligence by the next buyer of PGE or the Oregon PUC oversight would deter imprudent cost cutting and investment decisions.[60] Despite TPG's stated intention to hold Oregon Electric for longer than its normal five to seven year time horizon, the Oregon PUC found that TPG's plans to sell PGE would induce it to make "cost cutting and investment decisions that might eventually degrade customer service or lead to higher costs."[61] The Oregon PUC further found that prospective buyer due diligence and its own oversight would not be adequate to detect failures to increase necessary operations and maintenance ("O&M") spending or beneficial discretionary investments because the harmful effects might not become evident until after a sale of PGE.[62] Further, the lack of transparency at PGE was a key concern for many intervenors in the acquisition proceeding, but "[c]ontrary to the Intervenors' belief, [the Oregon PUC] has the authority to obtain information from TPG" under its general jurisdiction and regulatory powers.[63]

TPG and Enron ("the applicants") proposed seven potential customer benefits resulting from the transaction. First, the applicants offered a $43 million rate credit to customers, with $8.6 million to be provided annually over five years, but required it to be offset by any cost savings found in future rate cases.[64] The Oregon PUC reasoned that the applicants had failed to

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[59] *Id.* at 23-24.
[60] *Id.* at 25.
[61] *Id.* at 27.
[62] *Id.*
[63] *Id.* at 29.
[64] *Id.*

identify the basis of the rate credit and frustrated attempts to establish a link between any future cost savings and this instant application, and therefore determined that the rate credit provided only minimal benefit to customers.[65] Next, the applicants also included indemnification provisions to PGE for liabilities that Enron did not expect to provide PGE but for the sale agreement with TPG.[66] The Oregon PUC criticized this potential benefit because its realization depended on too many uncertain events, thus the benefit was "akin to an insurance policy which may never get used" and therefore it did not "assign much value to those potential benefits."[67]

Third, the applicants proposed to extend service quality measures (designed to trigger rate reductions in the event the company failed to meet those quality standards) that were due to expire in 2006.[68] The Oregon PUC found that "[e]xtending these reductions is a benefit of the transaction, although it does not have great value" because prudent, well-managed utilities should already be providing such service quality assurances.[69] The applicants also claimed that committing to maintain at least five Oregonians on the PGE Board would provide a "local focus benefit," which the Oregon PUC also found of no value because PGE already had a local focus.[70] Fifth, TPG assistance in the form of guiding the PGE Board on long-term strategy, capital investment decisions, and operational issues was claimed as additional customer benefit, but the Oregon PUC was unpersuaded because "TPG [had] no experience in the utility industry" and its argument "presume[d] that assistance could not be obtained elsewhere."[71] Although the applicants additionally committed to continue and enhance PGE's low-income program, and the Oregon PUC found it to be a tangible benefit to customers, it was limited to just a particular

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[65] *Id.* at 30.
[66] *Id.*
[67] *Id.*
[68] *Id.* at 32.
[69] *Id.*
[70] *Id.*
[71] *Id.*

customer group and represented only .01 percent of PGE's annual retail revenue.[72] Finally, the Oregon PUC found that the end of Enron's ownership was not a real benefit because PGE was currently not a distressed company, either financially or operationally, it had continued normal operations throughout the Enron bankruptcy, and Enron's ownership of PGE was certain to end regardless.[73]

Overall, the Oregon PUC found that the benefits of the proposed transaction were low because four of the seven claimed benefits provided only "minimal value" to customers, while the remaining three provided "no value" whatsoever.[74] It further found that the potential harms (lower credit ratings, heavy debt service obligations, and undue pressure to cut costs and reduce capital investments) "do not stand in isolation" but represent a "package of potential harms" that could result in the degradation of service, increased customer rates, a weakened financial structure for PGE, and diminution of utility assets.[75] Accordingly, the Oregon PUC concluded that "the application, as presented, [did] not provide a net benefit to PGE's customers" because "the collective risk these harms represent outweigh[ed] the potential benefits of the acquisition . . . [thus] [a]pplicants have failed to establish that customers would be better served under this acquisition than they would be if PGE remained as a separate and distinct entity."[76]

ii. Unisource Energy Corporation

a) State Review

In December of 2003, Unisource Energy Corporation ("UEC"), a holding company for public utility Tucson Electric Power ("TEP"), filed an application with the Arizona Corporation

[72] *Id.*
[73] *Id.* at 33. This point is noteworthy because it lends credence to the adequacy of ring-fencing mechanisms to protect utilities that are subsidiaries of financially distressed, or even bankrupt, holding companies.
[74] *Id.* at 34.
[75] *Id.*
[76] *Id.*

Commission ("ACC") to approve a merger agreement with private equity interests led by Kohlberg Kravis Roberts ("KKR").[77] The stock deal was valued at approximately $1.2 billion (comprised of $557 million in equity and $660 million in debt), and after the merger UEC would be the surviving entity.[78] The ACC denied the application, finding that the proposed reorganization, as it was structured, was not in the public interest because the purported benefits to ratepayers were "clearly not sufficient to outweigh potential detriments and risks associated with the transaction."[79]

Approval of mergers in Arizona is governed by the state's constitution and the ACC's affiliated interest rules.[80] The affiliated interest rule (No Harm Rule), provides that "the [ACC] may reject the proposal if it determines that it would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service."[81] However, the ACC has stated that the No Harm Rule establishes only a minimum standard of review for affiliate transactions,[82] and that the Arizona constitution requires it "to protect the convenience, comfort, safety and health of employees and patrons of public service corporations,"[83] and to act in the public interest, not merely consider it.[84] Thus, "it is clear that the [ACC] has a broader duty to consumers, employees and the public than to merely protect against higher rates," which requires it "to consider all factors implicated in this transaction and not solely the impairment of the financial status or services of the public service corporations."[85]

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[77] ACC Decision No. 67454, Docket No. E-04230A-03-0933 (2004) (*KKR Order*).
[78] *KKR Order* at 4.
[79] *Id.* at 31.
[80] *See* ARIZ. CONST. ART. 15 § 3; *see also* ARIZ. ADMIN. CODE, R14-2-803(C).
[81] ARIZ. ADMIN. CODE, R14-2-803(C).
[82] *KKR Order* at 28.
[83] ARIZ. CONST. ART. 15 § 3.
[84] *James P. Paul Water Co. v. Arizona Corp. Comm'n*, 137 Ariz. 426, 429 (1983).
[85] *KKR Order* at 28.

In the KKR case, the ACC considered the primary harms of the proposed transaction as: (1) the risks of increased leverage; (2) the detriments of a partnership structure with a concentration of power in a general partner inexperienced in the public utility sector; and (3) and uncertainties concerning ACC oversight over the new entities.[86] Regarding leverage, the ACC observed that after the transaction UEC would have more non-investment grade debt than it currently had and the utility subsidiary would continue to be the source of funds for the debt service.[87] After acknowledging that a potential bankruptcy was remote, the ACC stated that increased leverage may lead to cost cutting "with resultant negative effects on service quality or safety . . . an additional factor supporting our determination that the application is not in the public interest."[88] Further, despite ring-fencing mechanisms[89] that limit the exposure of the utility to bankruptcy, the ACC expressed concern that "in the event of a bankruptcy at the holding company level, a creditor or other third party could gain control of [UEC] stock."[90]

In terms of the partnership structure, the ACC expressed concern that access to information may become more difficult because the holding company will not be publicly traded and subject to SEC disclosure requirements.[91] Although the KKR agreed, in conditions, to provide full access to their records on the same basis as provided before the transaction, the ACC doubted equal access would be provided. The ACC stated, "As has been demonstrated in the course of this proceeding, the [KKR] believe[s] they can shield otherwise relevant information

[86] *Id.* at 34, 36.
[87] *Id.* at 36.
[88] *Id.*
[89] *Id.* at Exhibit B. Some of these ring-fencing provisions include amendments the charters of the public utility companies to ensure: legal separateness from their holding company and the PE partnership; a requirement that each utility may not file for bankruptcy without the affirmative vote of a designated independent director of their boards; a bar to pledging their assets or guaranteeing the debts of any other affiliate (except subsidiaries); a bar to the use of their credit to satisfy the debts or obligations of any other utility (except subsidiaries); a bar to the comingling of accounts and funds with affiliates (except subsidiaries); to maintain books and records to ensure transactional-level cost tracking accuracy; and to have their books and records independently audited and made available to the Commission.
[90] *Id.* at 36.
[91] *KKR Order* at 34.

from the [ACC] merely by keeping it at a level of the organization an additional step above the public service corporation."[92] KKR's refusal to disclose certain materials led the ACC to question whether KKR would enable it to maintain appropriate regulatory oversight, "a necessary and critical component of the [ACC's] constitutional duty to protect the interests of both [UEC] and its ratepayers."[93]

The ACC further found that corporate governance may suffer under the limited partnership structure of the surviving entity.[94] After the transaction, UEC's Board would be reduced from ten members to four, and the partnership's Board would consist of only two members, with authority to appoint UEC's board apparently falling on just one of those two members (the general partner).[95] Further, the partnership's board members would sit on UEC's board, leaving just two other members.[96] The ACC worried that the breadth of opinions and experience that would formulate corporate policy would be diminished, "especially given the power of the general partner."[97] It further questioned the general partner's complete lack of public utility experience, and tremendous consolidated power, as weaknesses of the transaction.[98] Also, the significant control limited partners had over UEC's day-to-day operations led the ACC to find that the partnership structure was not in the public interest.[99]

Regarding the benefits claimed by the applicants, the ACC considered an improved TEP capital structure and increased liquidity, a continued local community presence and retention of current management, and a commitment to spend $1.5 billion in O&M over the next four

[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] *KKR Order* at 35
[97]*Id.*.
[98] *Id.*
[99] *Id.*

years.[100] As a result of the transaction, some of the capital provided at closing would be infused as equity into TEP's capital structure to improve its overall capitalization and access to capital.[101] But the ACC stated that ratepayers would not benefit as a result because they had been paying higher rates based on a hypothetical capital structure that "contained more equity than [TEP] actually had, for many years."[102] Also, despite the KKR's assertion that they received financing on better terms than TEP otherwise could, the ACC concluded that there was no "indication that absent the Merger [TEP] [would] be unable to access the capital markets" and that "[t]he marginal benefit of the access to capital markets occasioned by the involvement of [KKR] d[id] not compensate for the added risks of the reorganization."[103]

KKR also claimed that the community would benefit from the proposed transaction because UEC headquarters would remain in Tucson, the current senior management would remain, and UEC would maintain its charitable giving commitments.[104] The ACC ironically stated, "While we recognize the benefits to the local communities flowing from a local management team and corporate presence, the threat appears academic as any future sale or merger involving [UEC] or its affiliates would require ACC approval."[105] The ACC further commended UEC for being a "generous supporter of communities and charities even while it has been rebuilding its financial health" but expressed confidence and an expectation "that UniSource and its subsidiaries will continue to demonstrate community involvement" in the

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[100] *Id.* at 31.
[101] *KKR Order* at 31.. TEP emerged from bankruptcy in 1992 and had been using a Commission-authorized hypothetical capital structure comprised of 44 percent equity for ratemaking purposes despite the fact that the company was actually financed completely with debt. *Id.* at 30.
[102] *Id.* Because the cost of equity is higher than the cost of debt, more equity in a utility's capital structure leads to a higher overall return on equity (ROE) determination, resulting in higher rates for customers.
[103] *Id.* at 32.
[104] *Id.*
[105] *Id.*

event the merger did not materialize.[106] In regards to the benefits of commitment to spend $1.5 billion in O&M, the ACC found that the applicant's argument did not "recognize that utilities already have an obligation to provide reasonable and adequate service, and are obligated to make that level of expenditure necessary to provide reasonable and adequate service."[107]

Overall, the ACC concluded that the proposal "outweigh[ed] the claimed benefits" and was not in the public interest, and therefore denied it.[108]

b) Federal Review

In April of 2004, UEC and KKR filed an application with FERC for authorization for an indirect disposition of jurisdictional facilities associated with the acquisition of UEC by KKR.[109] Section 203 of the FPA provides that the FERC must approve a disposition of jurisdictional facilities if it finds that the disposition "will be consistent with the public interest," which involves a consideration of (1) the effect on competition; (2) the effect on rates; and (3) the effect on regulation.[110] The FERC summarily approved the disposition of UEC by KKR because the traditional public interest concerns associated with a merger were not implicated by the transaction. It did not address any issues related to the cross-subsidization because those regulations had yet to be promulgated.

Regarding the effect on competition, FERC found that the change in upstream ownership would have no adverse effect on vertical or horizontal competition because the KKR did not own or control any other generation, transmission facilities, or inputs into electricity production, and

[106] *KKR Order* at 33.
[107] *Id.*
[108] *Id.* at 37.
[109] *UniSource Energy Corp.*, 109 FERC ¶ 61,047 (2004) (*UniSource Order*).
[110] Discussed *supra*, in Part I, section A (ii).

were not combining or eliminating competing entities in a relevant market.[111] The FERC also found that there would be no adverse effect on rates because the rates associated with TEP's electric supply contracts with wholesale customers were either fixed or varied due only to the recovery of fuel-related costs.[112] Although these fixed contracts prevented TEP from recovering transaction-related costs, TEP also made a hold harmless commitment to appease FERC.[113] Finally, FERC found that the proposed transaction would not affect federal or state regulation because it did not impair any state's ability to regulate UEC or TEP, nor had the Arizona Corporation Commission intervened in the matter.[114]

B. Private Equity Buyouts Approved[115]

i. Energy Future Holdings

a) State Review

In April 2007, Oncor Electric Delivery ("Oncor"), a Texas transmission and distribution utility and wholly-owned subsidiary of TXU Corporation, and Energy Future Holdings, a holding company formed by a group of PE interests led by KKR and TPG, filed a request with the Public Utility Commission of Texas ("Texas PUC") seeking approval to merge under section 14.101 of the Texas Public Utility Regulatory Act ("PURA").[116] In January 2008, the Texas PUC approved a stipulation and agreement between Oncor Electric, the Texas PUC Staff, and other stakeholders as meeting the public interest requirements of PURA section 14.101.[117]

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[111] *UniSource Order*, 109 FERC ¶ 61,047, at P 11.
[112] *Id.*
[113] *Id.* at P 12.
[114] *Id.* at P 15.
[115] Section includes Berkshire Hathaway even though its business model differs dramatically from PE.
[116] *Order on Joint Report and Application of Oncor Electric Delivery Company and Texas Energy Future Holdings Limited Partnership Pursuant to PURA § 14.101*, Public Utility Commission of Texas, Docket No. 34077 (2008) (*Oncor Order*).
[117] *Oncor Order* at 28.

In considering whether a transaction that involves the sale of at least 50 percent of the stock of a public utility is in the public interest, the Texas PUC determines whether the transaction will "(A) adversely affect the health or safety of customers or employees, (B) result in the transfer of jobs of citizens of this state to workers domiciled outside this state, or (C) result in the decline of service."[118] However, in the Oncor case the Texas PUC did not elaborate on how it applied that standard to the facts of the case because it relied on the stipulation and agreement between the parties. In its evaluation of the transaction, it summarily stated that, based upon the record evidence and the commitments offered by Oncor, the merger "will not adversely affect the health or safety of Oncor's customers or employees . . . will not result in the transfer of jobs of citizen of this state to workers domiciled out of this state . . . the merger will not result in a decline in service."[119]

The stipulation and agreement included over forty commitments and addressed ring-fencing, rate issues, capital expenditures, and reliability.[120] In addition to the ring-fencing provisions discussed in FERC's approval order, other ring-fencing provisions provided additional significant protections.[121] Further, EFH agreed that Oncor's board could not be overruled by any other affiliate board or any of its subsidiaries on dividend policy, debt issuance, capital expenditures, management and service fees, and appointment or removal of Board members.[122]

b) Federal Review

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[118] P.U.C. PUBLIC UTILITY REGULATORY ACT § 14.101.
[119] *Oncor Order* at 27.
[120] *Id.* at 7-27.
[121] *Id.* These additional ring-fencing conditions provided that Oncor would: include limit dividend payment to EFH to an amount not to exceed its net income; agree not to lend, borrow, or share credit facilities with any affiliates; agree that its assets shall not be pledged for any entity other than itself; notify lenders and obtain representations of its legal separateness from EFH in any new debt arrangements; and agree not to seek recovery in rates of any expenses related to a bankruptcy or default of EFH or any affiliates. *Id.*
[122] *Id.*

In early 2007, Oncor filed an application with FERC for approval of a disposition of its facilities to Energy Future Holdings.[123] Oncor is an electric utility that delivers power at cost-based rates approved by the Texas PUC and also provides open access wholesale interconnection and transmission service under FERC tariffs.[124]

The FERC approved the proposed Oncor-EFH transaction as consistent with the public interest and as otherwise meeting the requirements of section 203 of the FPA.[125] Regarding competition, FERC concluded that the transaction would have no adverse effect because the PE investors were not primarily engaged in the utility business, they did not conduct business in the same geographic markets, and they did not own any electric generation facilities in Texas or in any control area directly interconnected to Texas.[126] The FERC also determined that the transaction would have no adverse effect on rates because of a hold harmless commitment from the applicants protecting customers for five years.[127] Further, the FERC found that the transaction would not adversely affect regulation because it did not impair any state's ability to regulate the applicants, nor did any state commission intervene in the matter.[128]

Finally, regarding cross-subsidization requirements, FERC stated that because the Texas PUC had extensive rules about affiliate codes of conduct and because the applicants had proposed substantive ring-fencing mechanisms, it found its cross-subsidization requirements satisfied.[129] The Texas PUC's rules on affiliate codes of conduct are designed to assure captive wholesale or retail customers are protected from the effects of cross-subsidization through a prohibition on affiliate revenue sharing, a requirement of full cost allocation for shared

[123] *Oncor Electric Delivery Co.*, 120 FERC ¶ 61,215 (2007) (*FERC Oncor Order*).
[124] *FERC Oncor Order* at P 1.
[125] *Id.*
[126] *Id.* at PP 27-28.
[127] *Id.* at P 30 (these commitments came from the same stipulation that EFH filed at the Texas PUC, discussed *supra*).
[128] *Id.* at P 35.
[129] *Id.* at P 41.

resources, and various books and records provisions to ensure affiliate transparency and adequate commission oversight.[130] Further, the applicants proposed a comprehensive set of ring-fencing mechanisms to prevent cross-subsidization.[131]

ii. MidAmerican Energy

a) State Review

On July 15, 2005, MidAmerican Energy Holdings Company (MidAmerican or MEHC) filed an application with the Oregon Public Utility Commission (Oregon PUC) to acquire Pacific Power & Light, dba PacifiCorp, (PacifiCorp) from ScottishPower.[132] MidAmerican, a subsidiary of Berkshire Hathaway Energy, along with Berkshire Hathaway (the applicants), proposed to purchase all of PacifiCorp's common stock for $9.4 billion, with $5.1 billion in cash and $4.3 in debt and preferred stock.[133] In addition to receiving the regulated utility operations of PacifiCorp, the applicants would get an assortment of mining and other companies.[134] Following settlement discussions among parties, including the Oregon PUC staff and other stakeholder groups, a stipulation and amended application was submitted containing a series of conditions agreed to by the applicants. The Oregon PUC concluded that approval of the amended application and stipulation would serve PacifiCorp's customers in the public interest and therefore granted it.[135]

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130 *Id.* at 37.

131 *Id.* at 38-39. These ring-fencing measures included: a separate board of directors that would not include any members of another affiliate and be comprised of a majority of independent directors; a new holding company would stand between Oncor and its parent, EFH; Oncor would not provide, guaranty, or pledge any of its assets related to debt offering to finance the transaction or thereafter; each affiliate would be "arm's-length" from each other and maintain its books and records separately; and Oncor's debt-to-equity ratio could not exceed 60/40 and its cost of debt for ratemaking purposes would be capped at the actual rate existing immediately prior to the consummation of the transaction.

132 *In the Matter of MidAmerican Energy Holdings Co.*, UM 1209, Order No. 06-082, (2006) (*MidAmerican Order*).

133 *Id.* at 3.

134 *Id.*

135 *Id.* at 2.

As discussed in more detail above, the Oregon PUC's public interest approval for approvals of utility mergers requires both a demonstration of a "net benefit" to the utility's customers, and that the proposed transaction "will not impose a detriment on Oregon citizens as a whole."[136] Further, the Oregon PUC does not simply weigh the benefits and harms of a proposed acquisition against each other, but it compares the "potential benefits and harms of the transaction against the [public utility] as it is currently configured."[137]

In its MidAmerican approval order, the Oregon PUC addressed some of the potential harms that were raised by the parties in the proceeding, such as corporate control, financial stability, transmission and resource investments, and renewables and energy efficiency.[138] Regarding corporate control, several parties raised concerns about possible influence by Warren Buffett and Walter Scott, major shareholders in MEHC, without conditions creating transparency around their actions related to PacifiCorp.[139] In response, Buffett and Scott submitted affidavits "swearing that they will not exercise any control, directly or indirectly, on matters that pertain to PacifiCorp, and that they will recuse themselves from voting on matters concerning PacifiCorp activities or operations."[140] Berkshire Hathaway also agreed to provide the Oregon PUC access to all books that pertained to transactions between PacifiCorp and its affiliates, and all written information provided by and to credit rating agencies which pertained to MEHC and PacifiCorp.[141] Finally, to reduce any undue corporate influence, MEHC and PacifiCorp agreed not to "loan or transfer funds to Berkshire Hathaway, among others, or to assume any of Berkshire Hathaway's obligations or liabilities as a guarantor."[142]

[136] *TPG Order*, at 17 (*quoting* PUCO Order No. 01-778 at 10-11).
[137] *Id.* at 18.
[138] *MidAmerican Order*, at 4-13.
[139] *Id.* at 5.
[140] *Id.* at 4 (internal quotations omitted).
[141] *Id*. at 5.
[142] *Id.*

Regarding financial stability, the stipulation provided that MEHC would maintain PacifiCorp ring-fenced from other activities of MEHC, for PacifiCorp to maintain its corporate credit, long-term debt, and preferred stock ratings separate from MEHC's ratings, and provide interest rate protections for ratepayers.[143] Further, many dividend and capital structure restrictions also applied. For example, no dividends could be taken if PacifiCorp's unsecured debt is rated BBB- or lower by Standard and Poor's, and PacificCorp's holding company intermediary (PPW Holdings) is required to maintain consolidated common equity capital of at least 44 percent.[144] Also, if PPW Holdings is to issue debt, MEHC must notify the Oregon PUC 30 days prior and the Oregon PUC may amend the approval order to strengthen ring-fencing measures.[145] The Oregon PUC concluded that stipulated commitments would "sufficiently protect PacifiCorp from financial degradation and ratepayers from any ill effects arising from a ratings downgrade attributable to the transaction."[146]

Regarding transmission and resource investments, MEHC proposed multiple projects designed to enhance reliability, facilitate the receipt of renewable resources, or enable further system optimization.[147] This commitment generated concern among parties over potential customer rate impacts for discretionary projects.[148] However, MEHC proposed to mitigate those

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[143] *MidAmerican Order* at 6. On a related note concerning Berkshire Hathaway's use of renewable energy investment tax credits to offset profit at other Berkshire businesses, ring-fencing provisions are contractual in nature, as they are negotiated commitments aimed to satisfy regulatory requirements. Ring-fencing creates legal and financial separation among a utility and its affiliates, but only because an entity agrees in a contract to do so. To share tax credits among ring-fenced entities, Berkshire simply inserts an exception for taxes into the ring-fence agreement. For example, in its ring-fencing agreement with Constellation Energy for the purchase of Baltimore Gas & Electric, Berkshire and MEHC stated "except for tax and accounting purposes, at all times [the holding company will] hold itself out to the public as a legal entity separate from any other person and not identify itself as a division of any other person."
[144] *Id.*
[145] *Id.*
[146] *Id.* at 8.
[147] *Id.* at 9.
[148] *MidAmerican Order* at 9.

concerns through "rate discipline measures" such as rate credits.[149] Although the the Oregon PUC declined to identify the proposed investments and discipline measures as customer benefits, it did find that "[c]ommitments relating to these projects provide no harm to ratepayers or Oregonians as a whole."[150]

MidAmerican also made a number of commitments regarding renewable energy. For example, it agreed to acquire 1400 megawatts ("MW") of renewable power by 2015, with 100 MW coming online within one year of the close of the transaction, and 400 MW by the end of 2007.[151] It also agreed to work with advisory groups on demand side management programs and community renewable energy projects, which garnered praise from the Natural Resources Defense Council.[152] The Oregon PUC determined that the agreement "provide[d] an incremental benefit to ratepayers and Oregonians as a whole, and weigh[ed] in favor of our finding of a net benefit under ORS 757.511."[153]

The Oregon PUC also analyzed MEHC's proposed customer service benefits and a series of rate credits. MidAmerican agreed to extend existing customer service guarantees and performance standards into 2011, though they were due to expire in 2008.[154] MEHC further committed to $400,000 per year for low-income energy assistance programs, to maintain the current $10 million low-income bill payment assistance program, and fund an arrearage management program for low-income customers.[155] The Oregon PUC found that these benefits

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[149] *Id.*
[150] *Id.*
[151] *Id.* at 10.
[152] *Id.*
[153] *Id.* at 11.
[154] *MidAmerican Order* at 15.
[155] *Id.*

weigh “in favor of our conclusion that the Application satisfies the public interest test under ORS 757.511.”[156]

Regarding rate credits, MEHC pledged $142.5 million to be used company-wide in order to address non-fuel costs on an existing lease payment, to offset an increase in management and administrative and general costs, and for access to overhead line property insurance.[157] Although OPUC acknowledged that in the TPG-PGE case it found rate credits to be of no direct benefit to customers; here the source of the rate credits were identified and designed for MEHC to provide efficiencies in those areas.[158] This was a way of “assur[ing] that the claimed benefits of the merger will be flowed through to customers.” Thus, the Oregon PUC concluded that “the cost reductions in [those] Commitments provide a direct benefit to ratepayers.”[159]

In sum, Oregon PUC found that “the potential harms identified by parties have been mitigated by Commitments agreed to in the Stipulation . . . [and that] [t]he Stipulation provides additional benefits to ratepayers.”[160] It therefore concluded that the transaction would “provide a net benefit for PacifiCorp customers in Oregon and will not harm the public as a whole.”[161] Although OPUC did not expressly rely on it in its analysis, it did acknowledge in its order that MEHC was “a long-term investor” willing to make significant capital investments.”[162] The Oregon PUC further recognized similarities between PacifiCorp and MidAmerican Energy Company, another MEHC utility subsidiary, as evidence of MEHC experience in the utility

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[156] *Id.*
[157] *Id.* at 15-16.
[158] *Id.* at 17.
[159] *Id.* (internal quotations omitted).
[160] *MidAmerican Order* at 17.
[161] *Id.*
[162] *Id.* at 4.

industry.[163] Finally, the Oregon PUC also noted that many of the commitments that MEHC proposed extended to all six states in PacifiCorp's service territory, not just Oregon.[164]

b) Federal Review

The FERC issued its order authorizing the sale of PacifiCorp to MidAmerican as consistent with the public interest on December 22, 2005.[165] Despite potential market power concerns raised by multiple parties, FERC found that "[a]pplicants have shown that the combination of their generation assets will not adversely affect competition in any relevant market."[166] The FERC declined to examine the effects of future mergers on competition or assess "broader" market power issues, like political market power, stating that "[o]ur standard of review is flexible enough to consider any [eventual] changes in market structure . . . but we will not speculate on what general trends might emerge; rather, we will evaluate the effect of this merger on competition based on the record in this case, as the FPA requires."[167] Regarding effects on rates, FERC found that "[a]pplicants have shown that the Proposed Transaction will not adversely affect transmission rates or wholesale power rates. We rely on Applicants' hold harmless commitment in making our finding."[168] Further, FERC found that the transaction would have no adverse effect on federal or state regulation.[169]

IV. PUBLIC INTEREST APPROACHES COMPARED–DOMINANT CONCERNS DERIVED

After examining how state and federal regulators have reviewed particular utility M&A transactions involving PE firms or Berkshire Hathaway, a few salient principles become apparent. In no case examined did federal regulators deny an application, whereas in two cases

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[163] *Id.*
[164] *Id.*
[165] *MidAmerican Energy Holdings Co.*, 113 FERC ¶ 61,298 (2005).
[166] *Id.* at P 30.
[167] *Id.* at P 32.
[168] *Id.* at P 45.
[169] *Id.* at P 48.

state commissions denied the mergers. Further, in every case where they applied the FERC simply relied on hold harmless commitments as crafted at the state level and did not require additional concessions. Similarly, because FERC cross-subsidization (ring-fencing) regulations contemplate safe harbors, FERC did not impose any additional protections against cross-subsidization in the Oncor-EFH case.[170]

A. Federal and State Public Interest Standards

i. Federal/State Contrasts

First, state and federal regulators both use a "public interest" standard, though the focus of the inquiry is different. In practice, the FERC standard tends to be more concerned with market power issues, whereas the states focus directly on financial impacts and customer impacts. This regulatory interplay reinforces the notion that federal and state public utility regulation is often complementary. Both also rely on hold harmless commitments, but state commissions appear to wield this regulatory tool much more considerably, as evidenced by the numerous and extensive commitments proposed and/or required in the cases discussed above. This variation may simply be due to the fact that, in light of extensive hold harmless commitments at the state level, it is not necessary for FERC to exact more concessions, considering those commitments overlap state and federal concerns.

Second, the depth of public interest analysis tends to be far greater at the state level, which may just reflect the fact that the standards are different at state and federal levels. As analyzed in more detail below, the states' public interest requirements typically consider not only utility customers, but also employees and the public at large. Further, states' public interest

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[170] Because FERC cross-subsidization regulations were promulgated pursuant to EPAct 2005, they only applied to the Oncor-EFH case in this paper. Nonetheless, as in that case, FERC tends to invoke the safe-harbor provisions of its regulations because of the significant state ring-fencing commitments typically in place.

examinations must begin at the ground floor: there is no authority for state commissions to rely on a federal analysis of issues to which state jurisdiction is exclusive. Retail rate concerns are the exclusive province of the state commissions, therefore they must develop a substantial record in order to properly evaluate the public interest impacts. This is not to say that FERC gives short shrift to otherwise important considerations, only that the cases examined simply did not implicate the depth of market power concerns that primarily animate FERC's M&A review. For example, in the Oncor-EFH case, despite being the biggest PE deal in history, the FERC found the transaction would have no effect on competitive market power because of the intrastate nature of the deal and the fact that the PE owners were not already engaged in the utility business. In the PacifiCorp-MidAmerican case, FERC did show greater scrutiny where there was evidence of potential market power issues, but it declined to extend its market power analysis more broadly. Nonetheless, because FERC does not have to consider retail customer impacts and generally defers to state analysis where it can, it simply does not have the same evidentiary burdens of a state public interest analysis.

Moreover, the state public interest analyses employed in the cases discussed made light of the financial and corporate governance aspects of the merger deals, whereas the federal orders did not even mention the financing arrangements, the existence of leverage, or corporate governance. This is probably because the state standards (except Texas) require express considerations of financial impact and FERC's standard does not. In fact, the federal orders were not just agnostic about the involvement of PE as a utility investor, they were almost completely silent about it. In the KKR-UniSource case, FERC did not even mention that PE was behind the deal; and though it gave a brief description of the PE background of the parties in the Oncor-EFH case, it did not discuss any implications resulting from PE ownership or the PE business model. This is in stark contrast to the state commission orders, which did not just identify PE involvement, but analyzed its business model and the consequences on the public interest.

ii. State/State Contrasts

a) General Overview

Although each of the states examined in this paper utilize a public interest standard of review, the respective standards cover slightly different features of the public interest. Oregon requires a "net benefit" to the utility's customers relative to the utility as-is and no detriment to Oregon citizens as a whole. In Arizona, the public interest standard covers "consumers, employees and the public" and does not expressly require a net benefit, but involves interest balancing of risks and benefits. In Texas, the public interest analysis must consider the health or safety of customers or employees, the transfer of jobs, and a decline of service.

In applying their respective standards, the states consider many of the same factors, such as the utility's financial integrity, customer rate impacts, and the changes in the quality of utility service. Of all three states, the Texas public interest standard is the most difficult to analyze because PUCT approval of the Oncor-EFH merger relied on the successful stipulation and agreement between the applicants and stakeholders. Thus, rather than analyzing the record evidence and making express finding of facts with respect to the particulars of PUCT's standard, PUCT's order makes only conclusory findings regarding each requirement of the standard. Although a reasonable inference can be made that a stipulated commitment addressing an aspect of the PUCT standard also satisfies it, it is difficult to know how the PUCT wrestles with the public interest questions implicated by the Oncor-EFH transaction. Because the stipulation and agreement included substantial ring-fencing provisions that addressed myriad financial and corporate governance issues, it is clear that the PUCT does consider these issues even though its standard does not expressly require it.

The following discussion is organized by the relevant public interest considerations addressed in private equity buyouts in order to compare and contrast how different states view the relative importance of each consideration.

b) Financial Risks

In comparing Oregon and Arizona, both commissions focused on the financial risks associated with leverage. For example, in the Arizona KKR-UniSource and Oregon TPG-PGE cases, despite the existence of extensive ring-fencing mechanisms that made the possibility of a utility bankruptcy remote, the commissions concluded that the financial risks from leverage weighed strongly in favor of denial. They reasoned that leverage would lead to carrying more non-investment grade debt and the potential for credit ratings downgrades. In turn, both of these risks could result in the potential for increased debt service obligations borne by the utility customers in the form of rate increases or utility service quality cuts. According to those commissions, this "undue pressure" was inappropriate and weighed against the public interest.

In contrast, in the PacifiCorp-MidAmerican case that was approved, OPUC found it persuasive that the ring-fencing measures also provided interest rate protections for ratepayers, that many dividend and capital structure restrictions applied,[171] and that prior to the issuance of new debt, MEHC had to notify OPUC thirty days prior and OPUC could amend the approval order to strengthen ring-fencing measures.

c) Rate Benefits and Hold Harmless Commitments

[171] No dividends could be taken if PacifiCorp's unsecured debt was rated BBB- or lower by S&P; and a minimum consolidated equity of at least 44 percent was required.

Interestingly, OPUC has viewed customer rate hold harmless commitments as providing no direct benefit to customers and, conversely, as providing a direct benefit to customers. The critical difference appears to be whether the proposed rate credit can be offset by cost savings before actually flowing to customers. For example, in the TPG-PGE case, although the applicants offered a $43 million rate credit to customers, they required it to be offset by any cost savings found in future rate cases and did not identify the basis of the rate credit that would establish synergies between the merger and any future cost savings. Alternatively, in the PacifiCorp-MidAmerican case, the source of the rate credits was properly identified and designed to match anticipated cost efficiencies to be realized in those areas. Because this assured the OPUC that the claimed benefits of the merger would be flowed through to customers, OPUC concluded that it was a direct benefit to ratepayers.

In Arizona, the ACC virtually scoffed at the idea that an improvement in the utility's overall capitalization and access to capital would amount to a net customer rate benefit. The ACC reasoned that customers had been paying higher rates based on a hypothetical capital structure due to UniSource's mismanagement for many years and that the incremental benefit of the access to capital markets occasioned by the involvement of the applicants would not compensate for the added risks of the reorganization.

d) Corporate Governance and Influence

The Oregon and Arizona commissions demonstrated a similar approach to the corporate influence in one respect, but Arizona expressed concern in another. Both commissions regarded ring-fencing measures as adequate to protect the subsidiary utilities from undue corporate influence and bankruptcy. For example, in the PacifiCorp-MidAmerican case, despite concerns from parties of possible influence by Warren Buffett and Walter Scott, the OPUC determined they were only affiliated interests and that they are expressly not acquiring control or influence over PacifiCorp. However, the ACC found that corporate governance may suffer under the limited partnership structure of private equity because of a significant reduction in utility board membership, a lack of independent members there, and the power of the general partner to appoint all members.

e) Transparency and Oversight

The Oregon and Arizona commissions had contrasting views on issues related to transparency and oversight. In the Arizona case, the contention was highly persuasive and favored denial of transaction. There, during the course of the proceeding, the private equity applicants refused to disclose certain materials requested by commissioners, leading the ACC to openly criticize their tactics in the order. The irony, of course, is that even if the materials were not relevant to the proceeding as the applicants had argued, the mistrust it engendered damaged the applicants' credibility in the eyes of the ACC. In contrast, in the TPG-PGE case, OPUC was not concerned with a lack of transparency; it was confident it had the authority to obtain information from TPG under its general jurisdiction and regulatory powers.

f) Investment Time Horizon

Although Arizona did not address it, Oregon considered the private equity investment time horizon critical. In the denial of the TPG-PGE case, the OPUC found that TPG's plans to sell PGE would induce it to make "cost cutting and investment decisions that might eventually degrade customer service or lead to higher costs," that could not be assuaged by prospective buyer due diligence, nor its own oversight. Moreover, in the PacifiCorp-MidAmerican case, OPUC noted that MEHC was “a long-term investor” willing to make significant capital investments.

IV. CONCLUSIONS

This paper examined private equity buyouts of public utilities to ascertain the dominant concerns of utility regulators in approving M&A deals. By using federal and state case studies to compare and contrast how regulators employ the public interest standard of review, the paper concludes that there are three major issues related to PE-sponsored LBOs of public utilities that universally concern regulators: (1) Financial risks stemming from excessive leverage; (2) Insufficient customer benefits; and (3) Lack of transparency. While no utility commission claimed that any one of these concerns alone was dispositive, in every case examined they were highly persuasive. Further, other less dominant concerns that appear to be persuasive to regulators are experience in the utility industry and trust. These concerns were not front-and-center in commission analyses, but certainly colored the commissions’ approval or denial of a transaction. This paper concludes by making some final observations regarding these concerns in the private equity and Berkshire Hathaway contexts.

A. Financial Risks Stemming from Excessive Leverage

i. Private Equity

Because the hallmark of a PE firm’s business model is its use of leverage to acquire portfolio companies,[172] it may be inherently problematic for PE firms to get regulatory approval of a public utility LBO. Although KKR and TPG were successful at the Texas PUC, that was largely the result of an extensive commitment package that did not just mitigate financial risks, but further counteracted them with customer benefits. Also, ring-fencing alone does not appear

[172] APPELBAUM & BATT at 47.

to be enough because in all cases examined there were extensive ring-fencing mechanisms proposed, yet the Arizona and Oregon commissions denied applications based largely on risks from leverage even though they acknowledged the risk of bankruptcy was remote due to ring-fencing.[173]

ii. Berkshire Hathaway

In addition to offering traditional ring-fencing mechanisms, like creating legal and financial separateness between the utility and the parent, MidAmerican made many dividend and capital structure restrictions, and enabled the Oregon PUC to strengthen ring-fencing provisions if the holding company were to issue more debt. These extra measures gave the PUCO more assurance.

B. Insufficient Customer Benefits

i. Private Equity

Private equity's business model may further constrain its success with public utility regulators because of its tendency to juice financial performance through cost-cutting and downsizing. While regulators are amenable to utility managers finding operational efficiencies that get passed on to customers in the form of lower rates, they are not amenable to service declines. The Arizona and Oregon commissions were both very concerned with cost cutting and investment decisions that might degrade customer service. They also criticized proposed rate benefits as illusory or subject to offset, and therefore of no real benefit to customers. Private equity was successful with the Texas PUC because the customer rate benefits were real and substantial.

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[173] Interestingly, the fact that Oncor has remained a financially healthy utility despite the bankruptcy of its parent, Energy Future Holdings, is persuasive evidence that ring-fencing mechanisms work well. *See* James Osborne, *Energy Future Bankruptcy Unlikely to Resolve for Another Year*, DALL. MORNING NEWS, March 25, 2015.

Private equity's lack of utility experience also may prevent it from demonstrating sufficient customer benefits arising from a buyout because without other utility operations to share in functional support, there are fewer objective opportunities to create efficiencies through synergy.

ii. Berkshire Hathaway

MidAmerican was able to help its overall case for regulatory approval because it committed to invest in transmission and resources conditioned by rate discipline measures as well as invest in renewable energy that the Oregon PUC characterized as benefits. Further, MidAmerican committed to customer service guarantees and additional low-income assistance. Finally, it made a pledge of $142.5 million to hold customers harmless for increases in administrative and management costs, and to flow through synergistic merger efficiencies to customers without a potential for offset.

C. Lack of Transparency

i. Private Equity

Private equity's lack of transparency is also detrimental to its potential success with utility regulators because of the critical public oversight function that commissions perform. Forthrightness establishes credibility and trust, which are essential features of a functional regulatory relationship. In fact, lack of transparency may have seriously damaged KKR in Arizona because in that case, the Arizona Corporation Commission expressed a general distrust of the proposed buyout partly due to KKR's failure to disclose relevant information to the ACC.

ii. Berkshire Hathaway

MidAmerican was incredibly open with the Oregon PUC regarding the PacifiCorp acquisition. In addition to books and records commitments made by MidAmerican, Berkshire

Hathaway also agreed to provide the Oregon PUC access to all books that pertain to transactions between PacifiCorp and its affiliates, and all written information provided by and to credit rating agencies which pertains to MEHC and PacifiCorp.

V. Expectations

For private equity to be more successful with regulators in public utility buyouts, it will have to follow the roadmap laid out by this paper. It will not be enough to just limit financial risks from leverage with ring-fencing and hold harmless provisions; real, substantial customer benefits must be shown to satisfy the public interest standard. Further, collaboration, engagement, and transparency will all be key to establishing trust with a public utility commission. Commissions must be confident that their essential public oversight function will not be compromised as a result of letting private equity play ball. Finally, taking a longer-term investment view may be warranted because public utilities' social role is premised on stability, reliability, and predictability, attributes that run counter to private equity's natural penchant for a quick flip and payoff. Certainly, public utilities are ready for investment and probably worth the wait. Can private equity adapt?