CleanLaw 54: Ari Peskoe Speaks with Scott Hempling About Electric Utility Mergers and the Effects of Industry Consolidation – November 2, 2020

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Robin Just: Welcome to CleanLaw from the Environmental and Energy Law Program at Harvard Law School. In this episode, our Electricity Law Initiative director, Ari Peskoe, speaks with Scott Hempling, adjunct professor at the Georgetown University Law Center, an expert witness and author. They discuss electric utility mergers, the effect of industry consolidation and how to stop it, and Scott's new book, Regulating Mergers and Acquisitions of the US Electric Utilities: Industry Concentration and Corporate Complication. We hope you enjoy this podcast.

Ari Peskoe: This is Ari Peskoe, director of the Electricity Law Initiative. And I'm very pleased today to be joined by Scott Hempling, an attorney, expert witness, author, and educator. His new book is called Regulating Mergers and Acquisitions of US Electric Utilities: Industry Concentration and Corporate Complication. Scott, thank you so much for being here today and congratulations on the book's publication.

Scott Hempling: It's my pleasure to be here, Ari.

Ari: Well, yeah, I think you've done a real public service with this book. It is a comprehensive treatise on state review of utility mergers, and I'm really looking forward to diving in with you. I think it's really relevant not just for folks who are directly involved in reviewing these sorts of transactions or maybe involved down the line, but also I think it's helpful for understanding really one of the dominant trends in the industry, which is consolidation. But before we get to the topic, I think we just have to take a step back and talk about utilities. In the book you observe that utilities have "unearned advantages." It's such a perfect description that I think captures a lot about utility. So I want to start there. Can you explain to us what are these unearned advantages?

Scott: Traditional utility is the product of century-old government decisions, state government decisions, to decide that electricity is best provided at least in terms of delivery and often in terms of transmission and generation by a single monopoly company who is granted a physical geographic territory within which competition is prohibited. So the utility is a grantee of a public gift, that gift we call the franchise, the protection by government from competition, accompanied by statutory and constitutional protection of cost recovery and an opportunity to earn a fair profit.

Scott: Now, there are plenty of people who say, "That's fair enough. We need a utility that is obligated to serve. We need a utility that will stand ready to serve during all manner of weather and crises. We need a utility that has the obligation to plan to serve for the future for economic development, for population growth, for changes in economic development." But what happens when a utility who is blessed with all those advantages decides to enter a competitive business, maybe the microgrid business, maybe the solar business, maybe the storage business? To enter that business when you have behind you a government protection from competition and all of the reputational advantages, the brand loyalty, the financing access that goes with the government imprimatur, you have a leg up against your competitors that is not necessarily attributable to merit.

Scott: And so one of the problems in mergers that we can talk about is that mergers are often aimed at extending the dominance that one might legitimately have in a traditional utility market into one of our newly competitive markets. And the problem is that if we're trying to introduce diversity, new players in storage and distributed generation and energy efficiency and utility is there with all of its unearned advantages, we risk losing the competitiveness that we're trying to create.

Ari: And I think the unearned advantages, as you just described, start with that franchise, start with that grant to be the exclusive local provider. It was all about meeting local needs. And now with industry consolidation, with mergers, utilities are no longer really local companies anymore. And you do an incredible job of documenting this trend over the past 30 years as well as in your, what I would say, companion article that was published in the Energy Law Journal a couple years ago, and you detail 30 years of industry consolidation. Can you give us a sense of the scope of this consolidation, the scale of it?

Scott: Yes. I noticed as I was studying the matter that it helps to compare two companies. You think about Madison Gas and Electric and Baltimore Gas and Electric, MG&E and BG&E. While MG&E today serves Madison, Wisconsin area, it's the sole utility subsidiary of a publicly traded holding company called MG Energy, it turns out that the utility constitutes about 92% of all of the holding company's assets. It's still fundamentally a very small company. There's a couple of subsidiaries sitting there in the corporate family, and it turns out they're there for only one reason, to support the local utility which provides only local service.

Scott: Now, 30 years ago, BG&E, Baltimore Gas and Electric, looked just like MG&E. But today, BG&E is one of six utility subsidiaries of the Exelon Company. The Exelon Company owns about 300 other companies. They're in fossil, nuclear, solar, wind, trading. They make wholesale and retail sales in over 30 states, and BG&E is now a minor part of that holding company system, about 8% of the assets, 9% of the revenues. And so what we have today is most of the industry, most of the utilities that you see today are, like BG&E, a small member of a huge holding company system. I'll give you a few numbers.

Scott: Since about the mid '80s, which tends to span my career, we've had over 80 electricity mergers. This is what we have today. The trend has been nearly continuous through the whole 30 year period. Today, the 10 most active acquirers now own what used to be 64 independent utilities. That's over half the US total. About 83 formerly independent utilities and are now owned by only 13 holding companies. In the early '80s, there were several hundred independent investor owned utility monopolies. Today, only 14 remain unmerged with some other franchise utility. And the trend continues. Perhaps your listeners know that the Avangrid, which itself is a US subsidiary of Iberdrola, a Spanish government owned holding company, is now seeking to buy public service of New Mexico. So the trend continues, Ari.

Ari: Yeah, and then we also heard rumors a couple of weeks ago that two of the largest companies, Duke and NextEra, were considering a merger. And so, yeah, it seems like there's no end in sight. It's interesting that you document this for 30 years because halfway in that time period, 15 years ago, in 2005, there was a major change in federal law on this. Congress repealed the Public Utility Holding Company Act, which was enacted in 1935. So how did that change the legal landscape here and did that actually have an effect of accelerating the trend that you're talking about?

Scott: Before I get there, I do want to point out that possible merger of Exelon and Duke represents another feature of the trend, which is the mergers of the mergers of the merged. In other words, that will be a third generation merger whose origins really go back to the '80s itself. Now, with respect to the Public Utility Holding Company Act, what we had in the late 1920s and the early '30s was a situation where hundreds and hundreds of very small local utility companies were under the control of only 13 holding companies. Sound familiar? And we get to the early '30s and we're discovering abuses. We're discovering that stock is being sold door to door and the stock turns out to be worthless.

Scott: We're talking about holding company systems that have manufacturers of washing machines and dryers in the same corporate family as utility companies with an obligation to serve. We have situations where state regulators who are in their infancy in terms of the technology of regulation, can't keep track of the accounting information that will tell them whether the purported costs being used to support rates are real costs or are inflated costs. We don't know whether captive customers of electricity and gas service are being used to subsidize competitive service. Nobody really can keep track of this thing.

Scott: And then comes the depression and the loss of confidence in the stock market. And one of the things that the Roosevelt administration recognized was that much of the loss of trust in stock market occurred because of the structure of these holding companies. That people had hoped to have conservative investments for their retirement dollars, people had hoped to pay reasonable rates for electricity and gas, and neither of those hopes were at all true. So Congress came up with a very simple solution, and that is that every single utility company should be in a single "integrated public utility system." The definition in the statute was that an integrated public utility system was local, it was subject to effective state regulation, its parts were interconnected or capable of interconnection, it was conservatively financed, it was locally governed and controlled.

Scott: So that was the principle underlying the Public Utility Holding Company Act. And the many provisions in the statute to hold the industry to that standard were as follows. There were limits and prohibitions on the existence of non-utility businesses in the corporate family. There were prohibitions on aggressive financing. Acquisitions, here's the key point, were permitted. The famous Section 10 (c) (2) allowed future acquisitions only if they "tended toward the economical and efficient development of a single integrated public utility system." In other words, the purpose of an acquisition had to be to serve the public interest. There couldn't be any other purpose to it. There were prohibitions on excess debt leveraging. In short, Congress had a vision. What we want for the industry is public interest as the priority. Public interest vision for market structure and for corporate structure. And so Congress then created through the Holding Company Act, this set of prohibitions and permissions that effectively aligned private corporate decisions with the public interest vision. That was the idea behind the Public Utility Holding Company Act. And Ari, it stayed in place until 2005.

Ari: And I think your book focuses on the state's having to figure out a new public interest vision since Congress had repealed the public interest vision that it put in place in 1935. So before we get into the state regulator side of this, what they're doing, what they should be doing, I want to talk just a little bit about the utility perspective of this consolidation. Why do you think these deals are happening? What's in it for the two sides of these deals, the target company and the acquiring company here?

Scott: When we talk about these transactions, and yes, you've just used exactly the right terminology. We call them mergers, Ari, but they're almost always acquisitions. Somebody is buying something and somebody is selling something. And so the seller, we call the target and the buyer we call the acquirer. I'll give it to you in one sentence. What the mutual interest is is to monetize a market position. And by market position, we're talking about the target companies, government-granted, state government-granted control of their electricity customers in a particular geographic region. It's a market position. And what these two entities, the target and acquirer are looking to do is to monetize that position.

Scott: So what's the target's goal? The target's goal, look, if you're going to sell your house, you're going to sell it for the highest possible price. If you're going to sell your used car, you're going to sell it for the highest possible price. And if you're the board of directors of a target company, you're going to sell control of the franchise for the highest possible price. I didn't make this up. All you have to do is go to the proxy statements that target companies are required to file at the Securities and Exchange Commission. And with respect to every single one of these transactions, there is a required narrative in this document. And you read that narrative and you see that the utility CEO is acting as an auctioneer. He's literally working the phones pushing bidders to raise their bids until everybody but one drops out. And what he's got when he's done is the highest possible price for shareholders. That's what the target's after. Simple enough.

Scott: The acquirer's goal is a little more complex. The acquirer is looking first to buy customers. We're talking about a monopoly service. The acquirer is buying captive customers whose monthly payments for something they can't live without creates a predictable stream of income in large part not just because they're captive customers, but because the price that they pay for electricity is set by the government under statutory and constitutional limitations that assure that the buyer of the company will have an opportunity to earn a reasonable return. Now, contrast a competitive market with a monopoly market, because first of all, there's nothing particularly surprising about what I just said. Mergers and acquisitions happen all the time. What's the problem with the target seeking the highest possible price? What's the matter with an acquirer trying to buy a market position? It happens all the time.

Scott: Well, here's the thing. In a competitive market, the acquirer is buying... What are they buying? They're buying a chance to compete in that market. So their offer price is going to reflect their risks, the risk of losing existing customers, the risk of failing to attract new ones, the risk of making investments that fail to earn sufficient returns. They're not going to pay too much because they've got a lot of risk. But utilities acquirer doesn't face those risks. They don't face those risks because the customers are captive and the government's going to be setting the prices. So they pay a lot more, but they're looking to buy customers, they're looking to buy, Ari, that unearned advantage that you get from the franchise so they can expand into still other markets.

Scott: In fact, I know of holding companies, Exelon is one of them, who have specifically said, "Well, you know what? We have a lot of risky investments in our holding company structure. We need to buy a utility so we can balance out those risky investments with a sure one." So what we've got is utilities sometimes being required just to fill a spot in an otherwise risky portfolio, Ari.

Ari: Yeah. And I want to get into risks of that from the consumer perspective and what the state's responsibilities are to try to address those issues. When you were talking about the holding company days of old before, I was thinking about this quote from one of these investigative reports that were put together for Congress back in the '20s and '30s. And they were saying that the holding companies were motivated "by a desire for size and the power inherent in size." And they were talking about how there really was no economic logic to some of these holding companies of yesteryear, but while you were talking about here is the desire to tap into these predictable revenue streams from the company's perspective, at least, sounds like an economically rational approach. Is that fair to say?

Scott: It's economically rational from the perspective of the holding company. It has no particular benefit for the public, for the consumer, or even for the ultimate shareholder. What finance advisors say, and you can ask your financial advisor, the shareholder can diversify on her own. You can buy some bonds, you can buy some stocks, you can buy some international, you can put things in cash. You don't need or want a holding company to do it for you. So it's one of the examples where the holding company's interests are not necessarily the same as the customer interests, the ultimate shareholder's interest, or the public interest.

Ari: So let's talk about the public interest and the state's role in this. And before we dive in specifically to the merger review, I think it's important to put in context what the role of state regulators are generally with regard to utility oversight. And so the merger review is just one of any number of corporate transactions that a state has oversight over. So I'm wondering if you could talk a little bit about the sort of transactions that public utility regulators are scrutinizing and what is even the purpose of this from a state regulators perspective?

Scott: Remember what we have here. The government somewhere, somehow, one day, many decades ago, handed this franchise to a private corporation, a profit oriented entity with no competition. And the deal in the 1920s when this concept of the franchise was put together was a utility saying, "You give us a monopoly and we'll live with your regulation." Now, what is the purpose of regulation? You just think about a speed limit. And a speed limit is the purest form of regulation. Why do we have a speed limit? Because when people get on the highways, they are likely to put their self-interest ahead of somebody else's interest and they're going to drive too fast. They're going to be late for the soccer game. They're going to be late for the concert. They're going to be late for the ball game. So they're going to drive a little too fast because they think they can get there sooner and maybe they won't have an accident.

Scott: Well, we don't trust people to always align their self-interests with the public interest. And so we have speed limits. And that is the purpose of regulation, always to align private behavior with the public interest. And so we asked the question, when you have just handed a for-profit company a monopoly over an essential service, what are they likely to do in terms of conduct, which if unregulated would be harmful to the public? Well, they might jack up their rates. They may overbuild and charge people for overbuilding. They may stick their power plants in the wrong neighborhood and hurt people. They may set up affiliates, cousins, brothers, sisters, and buy fuel or other goods from them and overpay for them and then overcharge their customers for that. They may issue far too much debt.

Scott: And so for each of these areas, if you read any typical state legislation, it's going to say the commission will set the rates, the commission will approve major capital expenditures like for generation, transmission, or the undergrounding of distribution lines, and the state's going to review major purchases of off system power and off system fuel, the state's going to review the issuance of securities, stock, and debt, it's going to review the citing of major facilities that could harm the public if placed in suboptimal locations. That's what the typical state regulatory legislation will do. It will list those concerns and it will assign to an independent commission, the job of making those decisions.

Scott: All added up, what we're saying is this franchise is a family jewel. It's government created, it's essential for life. We need to make sure the entity that is privileged to be the franchisee always has a private interest aligned with the public interest. These are all the verbs, the actions the utility could take that could harm the public interest. Here's the regulator to make sure those decisions are aligned with the public interests. And mergers come in that context.

Ari: And I know one of the challenges of dealing with an issue of state law is that we have 50 different states, and so each state is doing something slightly different on this. But can you generalize as to what state law instructs regulators to do when they get a merger application? How are they supposed to review it? What are they supposed to take into account?

Scott: I can generalize because the statutes at the state level on mergers are very, very general. You'll generally get in this state statute, the commissions merger authority accompanied by this standard, the commission shall approve the merger if it is "consistent with the public interest." So the discretion to define the public interest is left with the commission. Sometimes these statutes will have checklists. The commission should look at the effect on rates, on reliability, on competition, on shareholders, on customers, on the environment, on jobs, on economic development, checklists. But there has never been as far as I can tell in a statute, an actual standard for determining what the public interest is.

Ari: So you document that these merger applications are almost always approved by state regulators. What's the basis for the conclusions that it is in the public interest for these two entities to consummate this transaction?

Scott: The most common criterion that the state supply is that the merger does no harm. And we have to talk about what we mean by harm, but what I want to contrast is that no harm standard with the standard that any investor would use and with the standard that the target and the acquirers use. Remember what the target is saying is, "I got to get the highest possible gain out of this thing, so I've got to get the highest possible price." The acquirer is thinking like any investor, "I have a hurdle rate. I have a particular return on investment that I need to get with the shareholder dollars I'm spending, and is this merger going to get me that optimal return on money?" So you've got the two parties to the merger with a philosophy, a strategy of maximization. And then you have the typical state commission, which is saying just don't hurt us.

Scott: So when you asked the question, what is it that states are looking for when they approve these things? Fundamentally, it's no harm. Now, I want to be fair, every one of these merger decisions at the state level has the commission getting something. The utility might say, "Well, we'll send a $100 refund to every customer once." The merging companies might say, "Well, we'll invest a certain amount in renewable energy, or we'll build a headquarters building in Downtown Baltimore." So states will say, "We're going to get something for it," but I will tell you that when you look at the numbers and compare the gains that go to the target and the value that goes to the acquirer, with the economic value of what the states say they're getting, there's lopsidedness.

Ari: So, yeah, the examples you provided are mostly short-term gains for the public, and let's get into what these harms are and then we can compare and contrast these harms to the gains. I think it's fair to characterize the potential harms here as those that are directly related to the financial terms of the transactions and harms that may materialize somewhat down the road. So let's start with the immediate harm of the transaction itself. You described what I think you see as a misallocation in the direct financial benefits. Can you describe that harm?

Scott: Yes. Remember what I said about the target company seeking the highest possible price. Let's contrast an individual investor with the acquirer of a utility. So when an individual investor buys a stock, what is she buying? She's buying only a sliver of the company, a very small sliver of the company. That sliver gives her no influence. So what does she pay? She pays the market price. She looks up in the Wall Street Journal, she calls up her broker and there's a market price for slivers of stock and she pays it. In a utility acquisition, what's the acquirer buying? They're buying something besides the stock. They're buying control. And so the acquirer is going to pay more than the market price. That excess or purchase price over market price, that's the value of control. And so they will pay what we call a control premium. And that can be in the billions. That can be in the billions.

Scott: Now, in these transactions, the entire control premium, the value of control, it all goes to the target's shareholders. And what I argue in the book and what I've argued in testimony before state commissions is that value comes from sources unconnected to the target utilities marriage, okay? Now, Oprah makes a lot of money and Michael Jordan made a lot of money. And guess why? Because they busted their tails. They are hugely talented, and they work very hard and they did it on their own. There weren't anybody holding up Michael Jordan's arms and pushing him up to the ceiling when he flies to the basket. But what is the source of this value of control?

Scott: Well, it's largely the government protected franchise. So it's the captive customers. The fact that they need power every day, every week, every month, and that they will pay for it because they don't want to be shut off. And the government protects this company from competition. So I've argued that the main source of value of control, the main source of value that underlies this control premium is the government action protecting the company from competition and the customer's captivity that makes the dollars flow. So why isn't most, if not all, of the control premium going to the customers? Why does it go to the target shareholders?

Scott: Now, remember in a competitive market, if a company is very, very valuable, I mean, I know a guy I worked out with at the gym and he was in IT and he came up with some kind of software, something or other, and he sold this thing to IBM and he made a huge amount of money. Well, that's because he went through all the risks and had all the talent and all the savvy to come up with this thing, this widget, and he sold it in a gain. Now he's not at the gym anymore. Now I think he owns his own gym. But that's not what's going on here. So this is not a free market transaction. And so what I've argued is that these transactions embody at their core, a diversion of public value for franchise gain. That's one of the four harms. And you're correct to identify that as something that occurs before the transaction while at the time of consummation. Yes.

Ari: Right. Yeah, basically the shareholders are extracting this value that they didn't earn. And then you also argue that these transactions can be economically wasteful. And I think what you're saying is that in a competitive market here, perhaps the two companies would be better spending their time and effort and resources elsewhere than just extracting this value from the public.

Scott: Yeah, there's a couple of ways to think about it, Ari. So when I was a young man basically until age 20, I had planned a career as being a cellist. And I went to a lot of auditions and there wasn't any audition where the winner was selected based on what they paid. I had to come out and be the best. Whether it was auditioning for a concerto opportunity or auditioning for a chair in a youth symphony, you audition based on merit. But what would happen to the quality of an orchestra if the people were selected based on what they could pay rather than how they could play? And so that's the problem is that when you have selection of the new franchisee, a selection run by the target, not based on talent, merit, plans, or anything else other than highest price, you're not going to get the best performer. You would in an effectively competitive market, but you won't in a monopoly market. And so I view that as a version of economic waste.

Scott: And that goes back to my point about no harm. If you define harm like an economist would, you read Paul Krugman's great textbook on economics, you read any textbook on economics, harm includes opportunity cost. And so when you have selected an acquirer based on price rather than performance, there is opportunity cost and that's harm. And my problem with the no harm standard is not just that it doesn't maximize, it doesn't even take into account the most significant harm, which is the failure to get the best performer.

Ari: Another potential harm here is to competition. And this one may require a bit more of a crystal ball inquiry than the other two in trying to figure out whether a merger will be harmful to the competitive environment. How do you look at that issue?

Scott: The irony here is palpable because we're at a point in history where because of technology, because of the willingness of young people to take risks in IT and the willingness of young people to have consumption habits different from their parents, we're at a point in history where in electricity, as in so many other markets, we can have new technologies, new products, new services, new players, competition among modes and competition within modes. And so we have this potential at the very point in history where, as we've already discussed, the concentration of the industry continues and actually accelerates. And so what we're worried about is are we creating a situation where the competitiveness of markets that we would need to have the diversity emerge is going to be impeded by the mergers and acquisitions that we're allowing to take place?

Scott: And you can see this happen within the same state commission. There are. I'll take the example of DC and Maryland where I work here and I've testified before both jurisdictions. Both jurisdictions are making efforts to bring in renewable energy, but think about storage, think about energy efficiency, demand aggregation, and they're approving every merger that comes before them. And when you're a witness trying to bring to their attention this contrast between the goal of diversification and the reality of concentration, it doesn't even make the footnotes in their orders.

Scott: So that's a conceptual concern, but more specifically, which is I think where you're headed with your question, what are we worried about? Well, let's take an example like storage. And I am not a storage expert. You had an excellent expert, the two of you, in one of your podcasts recently, but I know enough about the technology to know that there can be large scale storage and small scale storage. And I think I know enough about the technology to know that there isn't what we call a natural monopoly over the service. It's not economically inefficient to have multiple providers of storage even in similar locations.

Scott: And so what you don't want to have at a point in history where it's going to be somewhat costly to start putting these new mechanisms into place, you don't want a situation where the market becomes concentrated and prices are higher than necessary. We're going to be asking a lot of the public to change their behavior. They may see carbon taxes, they may see actual rationing electricity. We don't need to be hitting them with high prices at the same time. But look, if you're a monopoly already and you have the unearned advantages that we've talked about and you feel that you owe it to your shareholders to maximize those unearned advantages by getting a leg up in one of these new industries, you're going to do it. And that's the way CEOs think.

Ari: I think though then the last time I see it as related, and I wonder if you do, which is about the corporate decision-making process of this new entity. And one thing that I am concerned about with these holding companies is whether the interest in the C-suite diverge from the interest of these utility operating companies. And I think of the merger of Exelon and Pepco that I know you were involved with.

Ari: My recollection is the Maryland Public Service Commission was split. Three to two, they approved the merger and the dissent talked about the state's interest in energy efficiency, in distributed energy resources, and whether or not the utility holding company, parent Exelon, which is the largest owner of nuclear generation in the country, would be motivated to meet those state expectations for efficiency and things like that when their shareholders want them to sell more energy and want higher priced energy, how those competing goals will ultimately get settled out was a concern for the dissenting commissioners. So I think this was the final harm you touch on is this, I think the corporate control that may diverge from local interests. How do you see that issue?

Scott: Well, you've hit on it, Ari, because at the top of every merged company is a holding company. I understand that a holding company has no statutory obligation to utility customers. It's not actually the corporate franchisee. It has no obligation to utility customers. Only the utility subsidiary does. So the holding company's for-profit aspirations can readily conflict with the utility subsidiary's service obligations. You hit upon exactly the right concern. I was a witness before both the DC commission and the Maryland commission on that Exelon-Pepco merger, and what we raised was this. Prior to the merger, Pepco was a wires only company. Because of decisions the commission and the DC council had made back in the late '90s to introduce retail competition, Pepco, I can't recall now whether it was voluntary or mandatory, divested all its generation. So Pepco was in the market as a buyer of generation. And what does a buyer want? It wants low cost generation.

Scott: Well, here comes along Exelon, which is fundamentally a generation owner. All right, it has other utilities, but some of those utilities like Commonwealth Edison do own generation and Exelon itself has got, remember those 300 subsidiaries? All kinds of generation. And what is the interest of somebody who owns generation? Just like I want to sell my house for the highest possible price, those generation owners want to sell their output at the highest possible price. So you have a conflict right in the C-suite, right at the core of the company, but that's the only one kind of conflict. Let's take another example.

Scott: Perhaps your listeners know of FirstEnergy, which has merchant generation companies, wholesale competitive generation companies, some of whom have gone bankrupt. Exelon has got a few, NextEra down there, the holding company of Florida Power & Light has a few, and some of these companies have gone bankrupt or are heading toward bankruptcy. Now, what does the holding company need to do? Well, it needs to pour cash into these things. Well, now wait a minute. The utility is sitting there in that same corporate family and the utility needs financing because Pepco in DC has got an underground lines and maybe Pepco wants to build a new storage or new microgrids, maybe it needs to issue new equity to pay down some of its loans. Well, when a utility is a subsidiary of a holding company, its sole source of equity is the holding company. It can borrow money externally, but it doesn't raise equity externally. So what are you going to do if you've got a holding company at the top whose priority is to save one of its failing merchant companies while utility needs equity?

Scott: So those are two examples among others of hierarchical conflict, the one being well, wait a minute now. Is our interest the interest of the seller or is our interest the interest of a buyer? And the other is, well, what if equity is short, funds are short, and utility needs money and the failing competitive company needs money, what is the utility supposed to do? There's also the pressure for growth. If you're a holding company and you've been telling your shareholders every year, we're growing, we're growing, we're growing, well, then you're going to want to borrow more money to buy more. That's what Avangrid, the subsidiary of Iberdrola, is doing or hopes to do in New Mexico is grow.

Scott: Well, if you grow, you got to borrow more money. That means the corporate family is now in more debt. The risk to the utility company at the bottom is that it's lenders are saying, "Wait a minute. If your source of equity is now getting more debt, you might not be getting the equity you need for your own needs, and that means you're going to become more dependent on debt, and that makes us lenders worry. So maybe we need to raise the cost of loaning to you." And so those are three examples now, Ari, of what I call the hierarchical conflict when you're making the utility company a smaller and smaller part of what essentially is a conglomerate.

Ari: Yeah, it really highlights to me the continuing relevance of that Public Utility Holding Company Act 10 (c) standard that doesn't exist anymore, which seemed designed in part to avoid the internal conflicts that you're talking about. To move now to the what the solution to this problem is, what state regulators should be doing, I think what you argue is it's not just that state regulators are often overlooking these harms. It's that they lack a positive public interest vision for what a merger should do for consumers. What might a positive vision look like here?

Scott: Sometimes I've thought it's really not as complicated as people make it out to be. So suppose you were a young family and you're thinking about buying a house. Well, what are you asking? You're thinking, well, what's the commute to work? What are the schools like? What kind of people are going to be my neighbors? Is it going to be diverse? Is it going to be interesting? Are they responsible in terms of environmental care? Do they have a sense of community? And what's the price? And so you're going to have this, yes, I'll call it a vision. You're going to have this sense about what life is going to be like. You're going to have identified what's important to you and your family. And this is what needs to happen at the state regulatory level. State commissions need to ask questions like this.

Scott: Well, what is the mix of services and products that we want to have available for our citizens? And then what are the types of companies who will be able to provide those products and services most cost-effectively? And then this, well, what is the market structure? Is it monopoly or is it competition that will most likely attract and reward those cost-effective companies? And then finally, what do our screens need to be so that if we have a chance to get the best possible candidate into our state to provide utility service, what are our screens? What are our must haves? What are our must not haves? What are our discretionary haves?

Scott: So that's what I mean by a vision. Just like when a family buys a house, they're thinking about those mix of things, some of which may be in conflict. You add too much to the list and the cost gets too high, but what you do is you have a purpose. And what I found in my research and what I explained in the book is you can read every one of these state commission decisions and every one of these states statutes and you will not see that vision. Now, you may go elsewhere. You go to the website of a company, you can go to the website of a commission and you will sometimes see some statement about what we're trying to achieve here as regulators, but often not in a way that I just described. And you won't find it in any of these merger decisions. You won't find a merger policy statement that describes a vision. You won't find it in the merger decisions. You won't find it in the filing requirements that a merger applicant has to make with the commission. And so we're starting with a vacuum of vision.

Ari: How do you think you can convince the state regulator that this is a project that they should take on?

Scott: This is quite a challenge. In my years of advising commissions as well as testifying before them, I've encountered two statements. When I say, "Sir, ma'am, Mr. Chair, Madam Chair, you should have a merger policy." And I'll get one of two responses. We have a merger pending, so we can't talk about it. Or we don't have a merger pending, so we don't care about it. And so that's how 30 years have gone by. There's also this problem. And I admit it in the book, no merger has caused visible, tangible harm, not at the type that would end up in the headlines.

Scott: We're not talking about Enron situations. We're not talking about KKR crashes. We're not talking about any 2008 style meltdown of the economy. What we're dealing with is a slow loss of economic opportunity. And so I'm starting the answer by confessing that it is hard to grab commissions by the lapels and say your individual decisions are accumulating into a tragedy of the commons where the sum of all of this over 30 years is a concentration and complication no one intended. So that's the negative. What's on the positive side?

Scott: If we can find a way to help commissions merge the vision that they do have because you do have. Over my 35 years now in the business, there's been a real change. When I got into the business in 1984, it was people made their money doing rate cases. And I just had somebody talking to my students, my law students at Georgetown yesterday, this gentlemen, Laurence Daniels, the chief of litigation at the DC Office of People's Counsel. A wonderful gentlemen. And he was saying when he got in the business 21 years ago, what they were concerned was about payphones being used for drug crimes. But now what they're doing at the DC commission is focusing on storage and microgrids.

Scott: And so I think if we can find a way to marry the vision that some states have for energy resource diversity, for empowering the consumers, for finding ways to be the most efficient users of electricity. And there is that trend. If we can find a way to mesh that with merger policy, then I think we'll have created an opportunity to rethink these things. But I will confess I've not found the magic words yet to make it happen, Ari.

Ari: There are other actors here that matter. Your book has detailed advice for state regulators about conducting these reviews, how to critically evaluate utility claims. The other actors here are participants in these proceedings. There's rate payer advocates, there's clean energy and environmental interests, there's industrial consumer interests. And as you mentioned earlier in our conversation, a typical utility strategy is to offer various goodies to these parties, maybe a few million dollars for your efficiency program, a rebate for residential customers, things like that, but then potentially inflict all of the harms that we've been talking about. So what message do you have to folks representing these other interests in these proceedings? How can they avoid just taking the candy and supporting the merger?

Scott: It's difficult. And these are my friends. These are people that I have as clients, not in these cases, and I have as friends, as neighbors, and it is... You are right. It is very tempting to intervene in a merger case to get stuff and you walk out of the merger case better off. Let's see, there was a national housing organization that got money in the Exelon merger before DC commission, got money for low-income housing. Who isn't against fixing weatherization for low-income housing? You've got people in the Maryland case that got money for trails, you've got labor unions that got a new downtown office building. It's very tempting to get into these cases and get something, and it's a pretty low price to pay if you're the acquirer to pay this amount.

Scott: What can I say to these people who are my friends? What I need to be more persuasive at is to say, think the longterm, okay? Every one of these mergers, let's say you're a labor union. Every one of these mergers makes the guy on the other side of the table bigger. Every one of these mergers makes that person more likely to have influence in the legislature and in the Congress. Every one of these mergers makes that person less interested in what's going on in your small world and more interested in some bigger world outside of yourself. It's a longterm vision that we have to have.

Scott: And part of it, part of it is that our political sector, I'm not talking red and blue now, I'm talking about you go to California, right? There's the raisin growers. There's the plum growers. There's the orange growers. There's the apple growers. There are so many slivers of political interests and economic interests, and if we could pause to say each one of us, each one of us is a customer, is a shareholder, is someone who breeds, is someone who swims, is someone who raises children or served by somebody else's children, what we need to try to find a way to do is to encourage so many of these groups that have crucial missions, right? Missions that we don't want to ever do without and help them to see that their short-term aims are leading to a long-term concentration and complication of an industry.

Scott: But again, I will confess that I haven't gotten the magic answer to this yet. And I will often find people who say, "Look, Scott, you have to be realistic." Well, I guess I wrote the book because I wanted to be realistic. I wanted people to be realistic about what we have done cumulatively with all these approvals. I'm glad you brought it up. It's perhaps a conversation that we ought to have within our various communities, Ari.

Ari: Yeah, it's interesting that it's the cumulative impacts that I think is something that's difficult to grapple with at the state level, and particularly for these advocacy organization that get involved in these proceedings to see beyond their local interests and even their local short-term interests is difficult. Just to change topics a little bit here, I mentioned you have a separate article in the Energy Law Journal a few years ago, a couple of years ago about FERC's review of mergers, the Federal Energy Regulatory Commission, and you level a similar charge that they also lack a public interest vision for these mergers. They have a similar tendency to approve every application that comes before them. And one thing that I'm concerned about as we recreate these super holding companies that existed generations ago is the consolidation of transmission owners.

Ari: Here in New England I think we have the most, perhaps the most extreme example of this, where three of these holding companies I believe own 90% of the high voltage transmission lines in our region. And they're organized through this RTO's structure, Regional Transmission Organization structure called ISO New England. And despite the fact that they have this enormous control over the region, they also still maintain these local parochial interests in building out projects within their state granted monopoly service territories. And as I think about what the industry needs to decarbonize, to integrate new technologies, again, it seems like you have these incentive structures that are not accounting for the public interest needs. So I wonder if you have just some final thoughts about a federal perspective on this as we... Because I think it is one of the challenges here is, again, this sort of cumulative impacts are difficult for state regulators to see, difficult for local advocates to see, but if there's anybody who should have that approach, it should be the federal regulator here.

Scott: Yes, I should say first that the Federal Energy Regulatory Commission, and I do have great respect for that agency. I've taken them to court and I've won and I've lost, but I know people over there. It's a professional shop. In this area of mergers, there is... It's MIA, missing in action. There's no merger policy there. Now, they'll say there's a document, the 1996 document, but without getting into the detail this late in our conversation, there's no vision for what the future is. So it's a good example of what we've been talking about at the state level, that there's a mismatch between the constant predictable approvals of mergers and at least on the surface for 20 years now since 1996, the argument by FERC that they want more diversity and more competition.

Scott: Let's think about your region to be more specific. You see, so you've got these three companies, and who are they? You've got National Grid from the UK, you've got Iberdrola from Spain, and you've got, I grew up knowing it as Northeast Utilities, but now it's called Eversource. I guess when your reputation takes a hit, you change your name. By the way, each one of those companies is a product of mergers who have merged because there used to be up in New England, there probably was a good, I don't want to exaggerate, but there probably among the six states, there were probably a good 30 separate independent investor owned utilities and now there are just a much smaller number. So what happens in this context of when you merge them? Well, first of all, you lose diversity. You lose diversity even among the monopolies. Now, one of the concepts that people who will listen to your broadcast might not understand is that monopolies do compete.

Scott: Now, within their service territory, their customers are captive, but we have something called benchmark competition. So I might live in Hartford and you might live in Boston and we get together for a couple of drinks one day and I start bragging about the things that my utility is doing for me. And you're saying, "Hi, how come my utility is sitting on its butt not doing anything?" State regulators get together, go up to Concord, New Hampshire and they are at a regulatory conference. And somebody from Rhode Island is chatting with a commissioner from New Hampshire, and all of a sudden they're realizing that they're getting told two different stories and one utility is doing great and the other one's not.

Scott: When you get diversity among monopolies, you get what's called benchmark competition. And you can learn from that. You can have states force them into doing better things. And in your context, it seems to me that if the two states can say to each other, "You know what? We need to start executing policies that make for better transactions between our two subregions getting wind from my area to the demand in your area or vice versa," that is, I think, easier to make happen if each one of the states has got control over the utility in its state, but it's hard to exercise that control when your utility is now part of a multi-state holding company system.

Scott: There is also something that you already know very well from your own scholarship is that within these planning organizations like ISO New England, officially, there's an independent board of directors at the top that makes decisions purportedly independent of any of the market participants. But the reality that I've been told, and you know more about this than I do, and others like Christina Simeone, who I quote in the book and have written marvelous analyses of the informal decision-making structure within these regional organizations, it's very easy for the consolidation of the utilities through mergers to end up producing control. And what is that control going to be used for?

Scott: Well, if these are wires only companies, then the control is going to be used for getting the best possible deals for customers. But if these companies are generation owners and they want the markets to have high prices, or if they want the markets to work so that their local generation is protected from competition somewhere else, they're going to resist the type of transmission policies that will enable low cost power or renewable power to displace their own power. And so I am concerned, as you implied, that the trend in consolidation when it's intraregional can lead to these problems.

Scott: And I guess I want to point out then before we close this distinction between two types of acquisitions. So my worry about the Avangrid, the Iberdrola Avangrid New Mexico is, well, what's the State of New Mexico's commission going to do? Do they speak Spanish at the commission or are they going to... Do they know the currency exchange rate between the Spanish currency and the US currency? How are they going to keep... Do they know how the accounting books are kept in Spain? That's going to be hard to regulate over a distance.

Scott: So I'm not crazy about these long distance transactions that don't have integrated operations as their purpose, but then when you have the intraregional transactions, like the ones that National Grid and Iberdrola and Eversource have been part of, you worry about the loss of benchmark competition and the ability also to collude. The smaller number of competitors you have in a group, the easier it is for them to meet to breakfast, right? At the International House Of Pancakes and split up territories or collude on prices. And that can be done implicitly or explicitly. So I agree with you that we have a problem there, Ari.

Ari: Yeah, and my concern is that they use their control to maintain the status quo. And I think we're in such a technologically dynamic time that we need new thinking. And the more we just have a few organizations, the fewer organizations we have involved in thinking about the future of the industry, I think we're all harmed by that.

Ari: Scott, I think we're going to end it here. I want to thank you again for coming. As I said at the outset, I think understanding industry consolidation is really valuable to anybody who's involved in this industry. It's one of the most important trends. And unfortunately, I think there doesn't seem to be an end to that trend. So it's something we'll have to continue and we'll have to see how it affects all of the other changes that are happening in the industry, whether those are changes in the generation mix, in demand side technologies, all these things are going to be affected by which entities are in charge and what their interests are and how they're controlled. So I think your book is extremely valuable and I would encourage everyone to visit your website to get a taste of the book and then to go and read it for themselves. Thank you so much, Scott, for being here.

Scott: It's been my pleasure. Thank you, Ari.

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